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MEMO

### Operational Definition of Maastricht Price Stability Criterion

The Treaty requires a high achievement of price stability criterion to enter a third stage of Economic and Monetary Union. According to the Article 121(1) of the Treaty each Member State should refer to the achievement of a high degree of price stability, which should be apparent from a rate of inflation which is close to that of, at most, three best performing Member States in terms of price stability.

According to the Article 1 of the Protocol No 21 the criterion of price stability shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability.

The first operational definition on price stability was made by the Commission in the Convergence Report of 1993<sup>1</sup>. In measuring the performance of member states, the Commission has set up an **inflation reference range** by assuming that the first and the third best performing country determine the reference range.

In 1996 Convergence Report<sup>2</sup> the Commission has used **six alternative methods for calculating inflation reference values** by concluding that they produced similar results within a range of 0.5 percent. The Commission was including into formula one to three best performers and using weighted and unweighted averages. It was considered that the reference value measured against one country is the strictest possible way in which the reference value could be defined. Since 1998 the Commission has been calculating the operational reference value as the arithmetic average of the inflation rates of the three Member States as it argued that the range of 0.5 produced marginal effects.

Commission in its report of May 2000 has raised another question of whether countries not participating in the euro should be considered for the inflation and interest rates reference values.

Commission has referred to changing circumstances in pursuing price stability by means of monetary policy which have changed with the introduction of euro in those countries. It was also argued that countries aiming to join euro should orient their convergence efforts to economically relevant benchmarks of the euro area economies. A number of euro members which are above the value for inflation was also indicated in the report for information purposes as a reference.

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<sup>1</sup> SEC(1993)/1755 final

<sup>2</sup> COM(1996)/0560 final

It should be also considered, whether in the operational definition of the inflation criterion “the best performing member states” should be selected as those having “the lowest average inflation”. It follows from the use of that definition that a very low inflation, e.g. substantially below the average rate of the euro area or the EU, could be treated as a non-representative performance. To avoid an analysis towards that direction it might be also appropriate to set an upper limit of the reference value.

The Commission in report of May 2000 has concluded that these considerations may be relevant in future applications of the convergence criterion, however since than the procedure has not been followed as provided in the Protocol No 21 of the Treaty<sup>3</sup>. In 2002 the Commission has further used a definition which excluded non euro Member States from the group of the reference countries.

European Central Bank on its behalf has introduced an inflation definition for the best performers in terms of price stability, which in 2003 was fine-tuned to “inflation being less but close to 2%”. It helps to benchmark the criterion for stability of prices in a more transparent and objective manner and takes into account gravity affect of euro area to convergence.

In 2004 Convergence Report the reference value was calculated as a simple and non weighted arithmetical average of best performers with lowest average inflation. Although the average inflation in Lithuania at that time was lower, this country has been excluded from the calculation of the reference value as it was further concluded that countries with negative inflation rates do not represent best performers in terms of price stability.

To conclude, the analysis of price stability still requires a broad assessment and a use of the range of reference setting methods. Operational definition of the price stability criterion should take into account a definition of price stability criterion provided by European Central Bank, as well as a range of estimates pertaining to deviations to the averages of inflation in a selected group of EU/euro zone member states.

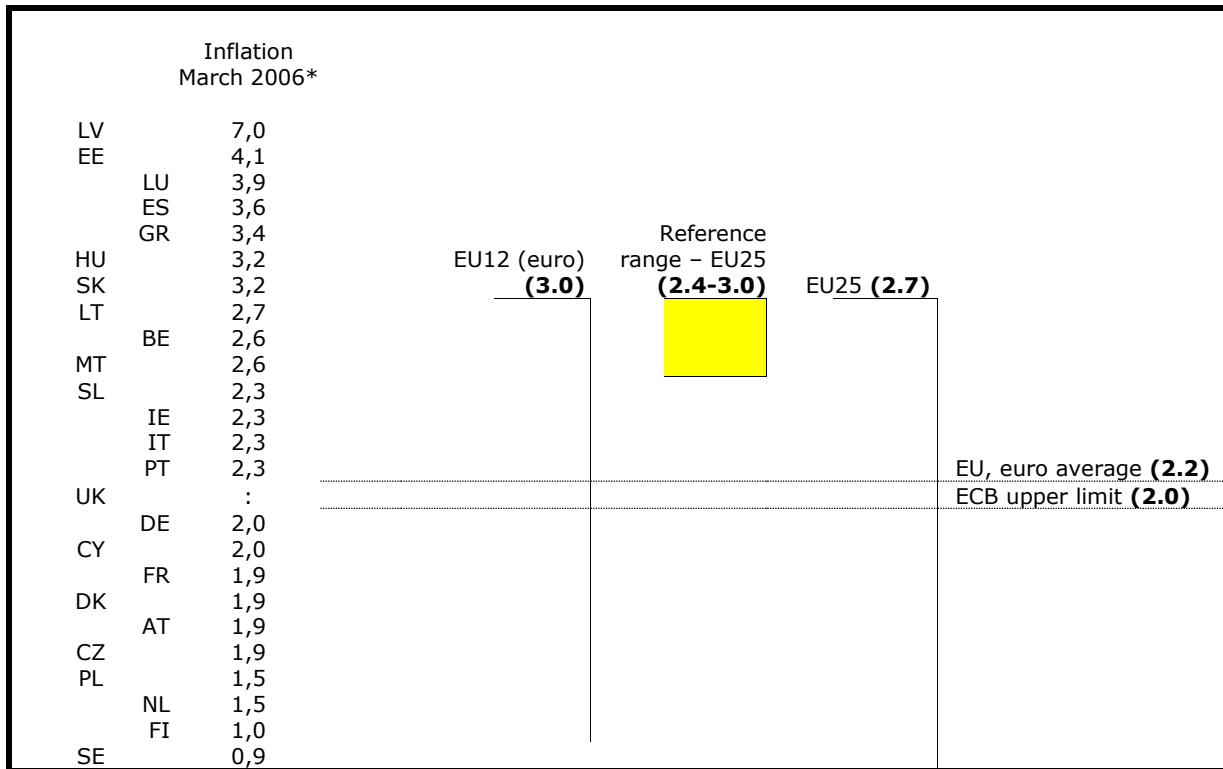
Further in the annex a list of emerging results for inflation reference value is provided after using different methods of calculation.

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<sup>3</sup> According to the Article 6 of the same Protocol the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, the European Central Bank, and the Economic and Financial Committee adopt appropriate provisions to lay down the details of the convergence criteria, including criterion of price stability, which shall replace this protocol.

# ANNEX

## Emerging results after operating with methodology for inflation reference value



\*Eurostat, April 2006