



EUROPEAN CENTRAL BANK

18 December 2003

**POLICY POSITION
OF THE GOVERNING COUNCIL OF THE EUROPEAN CENTRAL BANK
ON EXCHANGE RATE ISSUES RELATING TO THE ACCEDING COUNTRIES**

I. GENERAL PRINCIPLES

Upon accession to the European Union, new Member States are required to treat their exchange rate policy as a matter of common interest and to pursue price stability as the primary objective of monetary policy. Moreover, economic policies will become subject to a number of multilateral surveillance procedures within the EU policy framework. However, beyond these obligations, which are laid down in the Treaty establishing the European Community (the Treaty), the choice of the monetary and exchange rate strategy after EU accession is, in the first instance, a responsibility and prerogative of the Member State concerned.

The ten new Member States will all join the European Union as Member States with a derogation. This means that, while not yet adopting the euro, they will be committed to striving towards the eventual adoption of the euro upon fulfilment of the convergence criteria laid down in the Treaty. The Treaty foresees that: i) at some point following accession, new Member States will join the Exchange Rate Mechanism II (ERM II); and, ii) when they are deemed to have fulfilled the Maastricht convergence criteria, they will adopt the euro.

Any unilateral adoption of the single currency by means of “euroisation” outside the Treaty framework would run counter to the economic reasoning underlying Economic and Monetary Union, which foresees the eventual adoption of the euro as the end-point of a structured convergence process within a multilateral framework. Unilateral “euroisation” cannot therefore be a way of circumventing the stages foreseen by the Treaty for the adoption of the euro.¹

As the acceding countries differ greatly in their economic structure, exchange rate and monetary regimes, and the degree of nominal and real convergence already achieved, no single path towards ERM II and the adoption of the euro can be identified and recommended. It should be noted that there has been no such single path for the current euro area members either. Therefore, country situations and strategies will be assessed on a case-by-case basis throughout the process leading to the adoption of the euro. In this

¹ Report by the (ECOFIN) Council to the European Council in Nice on the exchange rate aspects of enlargement, Brussels, 8.11.2000, Council of the European Union press release no. 13055/00.

context, the Governing Council of the ECB may give specific recommendations to individual countries. As in the past, the principle of equal treatment will continue to apply during the entire process of monetary integration.

II. EXCHANGE RATE MECHANISM II

The Resolution of the European Council of 16 June 1997 (the Resolution)² established ERM II in order to link the currencies of EU Member States outside the euro area to the euro. ERM II replaced the European Monetary System that had been created in 1979. Within the framework of ERM II, exchange rate stability is explicitly subordinated to the primary objective of price stability for all participating currencies.

ERM II has two roles, as set out in the Resolution. One is to act as an arrangement for managing exchange rates between the currencies of Member States participating in the mechanism and the euro, and the other is to play a role in the convergence criteria for joining the euro. The first of these roles builds on two key provisions of the Resolution, namely that “lasting convergence of economic fundamentals is a prerequisite for sustainable exchange-rate stability,” while at the same time underlining that “the exchange-rate mechanism will help to ensure that Member States outside the euro-area participating in the mechanism orient their policies to stability, foster convergence and thereby help them in their efforts to adopt the euro.”³ These provisions illustrate how the mechanism is designed to deal with the complex relationship between economic fundamentals and exchange rate stability. The second role of ERM II is provided for in Article 121 of the Treaty and the corresponding Protocol on the convergence criteria, which is annexed to the Treaty. Hence, ERM II acts as a testing phase for both the central rate and the sustainability of convergence in general.

Main features

ERM II is a multilateral arrangement of fixed, but adjustable, exchange rates with a central rate and a standard fluctuation band of $\pm 15\%$. The economic policies of participating Member States should be consistent with the preservation of the central rate and, thus, avoid misalignments. Interventions at the margin will in principle be automatic and unlimited, unless they conflict with the primary objective of price stability in the Member State or the euro area. Very short-term financing can be made available to support such interventions.

ERM II is based on a multilateral agreement between the Member State concerned, the euro area member countries, the ECB and other Member States participating in the mechanism. In this context, decisions

² Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union, Amsterdam, 16 June 1997 (OJ C 236, 2.8.1997, pp. 5-6). As foreseen in the Resolution, the operating procedures of ERM II were set out in the Agreement of 1 September 1998 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in Stage Three of Economic and Monetary Union (OJ C 345, 13.11.1998, pp. 6-12).

³ Paragraphs 1.1 and 1.3 of the Resolution respectively.

concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement of the participating members, including the ECB. All participating members in the mechanism, including the ECB, have the right to initiate a confidential procedure aimed at reconsidering central rates. Such realignments may be necessary, for example, if equilibrium exchange rates evolve over time, as shown by the past experience of current Member States.

ERM II can accommodate features of a number of the exchange rate strategies currently used by the acceding countries. Incompatibilities with ERM II are the cases of free floating (or managed floats without a mutually agreed central rate), crawling pegs, and pegs against anchors other than the euro.⁴ With regard to currency boards, the ECB does not consider them to be a substitute for participation in ERM II, implying that countries operating a currency board will be required to participate in ERM II for at least two years before the convergence assessment that is made before a country can finally adopt the euro. However, countries that operate a euro-based currency board deemed to be sustainable might not be required to go through a double regime shift, i.e. floating the currency within ERM II only to re-peg it to the euro at a later stage. Such countries may therefore participate in ERM II with a currency board as a unilateral commitment, enhancing the discipline within ERM II. However, the ECB has stressed that such an arrangement will be assessed on a case-by-case basis and that a common accord on the central parity against the euro will have to be reached.

As foreseen in the Resolution, formally agreed fluctuation bands narrower than the standard one may be set at the request of the non-euro area Member State concerned. Such decisions will be taken on a case-by-case basis and would be deemed exceptional – as they were in the past – taking into account that the standard band is appropriate for Member States that are engaging in a convergence process. Multilaterally agreed narrow bands can only be considered at a very advanced stage of convergence, as in the case of Denmark.⁵

Entry into the mechanism

Participation in ERM II is voluntary for Member States outside the euro area. However, as membership of ERM II is a precondition for the eventual adoption of the euro, new Member States are expected to join the mechanism at some stage. ERM II membership can take place any time after EU accession. While the procedure for joining ERM II may be initiated at any time by the Member State concerned and is not linked to specific calendar dates, the main features, notably the central rate and the width of the fluctuation band, have to be agreed among all parties involved in the mechanism.

Entry into ERM II is not subject to a set of pre-established criteria, and there are no preconditions to be fulfilled to join the mechanism. To ensure a smooth participation in ERM II, however, it would be

⁴ Report by the (ECOFIN) Council to the European Council in Nice on the exchange rate aspects of enlargement, Brussels, 8.11.2000, Council of the European Union press release no. 13055/00.

⁵ Denmark participates in ERM II with multilaterally agreed bands of $\pm 2.25\%$.

necessary that major policy adjustments – for example with regard to price liberalisation and fiscal policy – are undertaken prior to participation in the mechanism and that a credible fiscal consolidation path is being followed. Moreover, as with any exchange rate regime, participation in ERM II is only one element of the overall policy framework and hence should not be regarded in isolation. It must be compatible with other elements of this overall policy framework, in particular with the monetary, fiscal and structural policies.

The central rate chosen should reflect the best possible assessment of the equilibrium exchange rate at the time of entry into the mechanism. This assessment should be based on a broad range of economic indicators and developments while also taking account of the market rate. The outcome of such an assessment cannot be predetermined by any of the parties to the agreement.

Decisions on central rates are taken by mutual agreement of the various parties to ERM II. Consequently, unilateral announcements about the intended central rates are not in line with the multilateral nature of the arrangement and should be avoided. In any case, they would in no way prejudice the ultimate choice of the central rate.

Realignments of the central rates should be made in a timely fashion. In that regard, the ERM II Resolution stipulates that all parties may initiate a procedure aimed at reconsidering central rates. Such realignments may be necessary, for example, if equilibrium exchange rates evolve over time, as shown by the past experience of current Member States. Such developments are likely to be all the more relevant in an environment of real convergence, in the case of significant changes in external competitiveness, or in the presence of inconsistent macroeconomic policies.

Length of participation

The Treaty sets out the minimum period of participation in ERM II prior to the adoption of the euro.⁶ A protocol attached to the Treaty elaborates on the criterion for participating in the exchange rate mechanism, stipulating that a Member State must have respected the normal fluctuation margins provided for by the exchange rate mechanism without severe tensions for at least the last two years before the examination. In particular, the Member State must not have devalued its currency's central rate against the euro on its own initiative within this period.⁷ A minimum stay of two years in the mechanism prior to the convergence assessment leading to final adoption of the euro is therefore expected.

Beyond the minimum period of ERM II membership of two years prior to the convergence assessment, there are no restrictions on the length of stay in ERM II for new Member States. Although all new

⁶ See the third indent of Article 121(1). The fourth indent of Article 121(1), which states the interest rate criterion, also refers to participation in ERM II as follows: “*the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels*”.

⁷ Protocol on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community.

Member States are ultimately expected to join the euro area, no timetable is foreseen and there can be no ex ante assurance regarding a limitation of the length of participation in the mechanism. Therefore, the length of participation in ERM II should be assessed in terms of what is most helpful to accompany the convergence process, rather than in terms of the required minimum period of two years.

There should be no presumption that the initial central rate will be the ultimate conversion rate for euro adoption. This derives not only from the fact that realignments may be necessary, but also from the relevant institutional provisions: the decisions on central rates and on conversion rates are distinct, they are taken at different periods in time, and are made through different decision-making processes.

Key considerations regarding membership

The decisions regarding the timing of entry and duration of participation in ERM II should be based on the extent to which participation in the mechanism enhances the prospects of achieving a lasting convergence of economic fundamentals. The overall goal of this process should be to foster macroeconomic stability in the new Member States, thereby providing the best possible contribution to sustainable growth and real convergence. New Member States should also consider the extent to which the limitation of exchange rate flexibility may help anchor expectations and promote the pursuit of sound macroeconomic and structural policies, thus fostering real and nominal convergence. While participation in ERM II per se does not ensure supportive and consistent macroeconomic and structural policies, it has the potential to act as a catalyst, enhancing the disciplinary effect of such policies.

To determine their optimal strategy regarding ERM II and later euro adoption, new Member States will have to consider the specific circumstances of their country, including their overall monetary integration strategy, monetary and exchange rate policy framework and fiscal position. In addition, they will need to consider to what extent the transition process and progress in the catching-up of real incomes could have a bearing on the desired degree of adjustability of their exchange rates. Given the risks implied by premature rigidity of the exchange rate, it might be appropriate for some new Member States to only consider applying for ERM II membership after a further degree of convergence has been achieved. This is particularly advisable when an early rigidity of the exchange rate could precipitate disorderly realignments with potentially disruptive economic consequences, including for the credibility of the mechanism as a whole. For other new Member States that have implemented significant structural reforms and have shown the ability to advance convergence through sound economic policies and an exchange rate regime that is in principle compatible with ERM II, entry into the mechanism can take place soon after accession, provided that there is mutual agreement on the central parity.

In certain cases, new Member States may consider it desirable to envisage a longer stay in ERM II while further convergence takes place. In addition, further progress towards sustainable convergence of economic fundamentals, structural reforms and progress in the catching-up of income levels could result in changes to the equilibrium real exchange rate that may be more difficult to accomplish through

domestic price changes alone. In such a scenario, it would be necessary to remain in ERM II for a longer period and to realign the central rate, if necessary, before locking in the exchange rate permanently and adopting the euro.

III. THE ADOPTION OF THE EURO

All new Member States are expected to adopt the euro in due course once they are deemed to have fulfilled the conditions set by the Treaty. Such conditions include an assessment of the sustainability of the degree of nominal convergence achieved. Under Article 121(1) of the Treaty, this assessment will also consider the situation and development of the balance of payments on current account and the development of unit labour costs and other price indices. As in the past, the assessment will be made on a case-by-case basis and will need to take into account the specific situation of each individual country.

The assessment should be based on the principle of equal treatment with the current Member States. Therefore, no additional criteria for the adoption of the euro by the new Member States will be introduced, while at the same time there will be no relaxation of the criteria laid out in the Treaty, including the criteria concerning the sustainability of nominal convergence. With regard to exchange rate stability, the criterion refers to participation in ERM II for a period of at least two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro. The assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate while also taking into account factors that may have led to an appreciation, which is in line with what was done in the past. In this respect, the width of the fluctuation band within ERM II shall not prejudice the assessment of the exchange rate stability criterion. Moreover, the issue of absence of “severe tensions” is generally addressed: i) by examining the degree of deviation of exchange rates from the ERM II central rates against the euro; ii) by using indicators such as short-term interest rate differentials vis-à-vis the euro area and their evolution; and iii) by considering the role played by foreign exchange interventions.