

ERM II: POTENTIAL SOURCE OF INSTABILITY IN THE NEW EU-MEMBER COUNTRIES

Daniel Stavárek
Silesian University

Introduction

The EU summit in Copenhagen in December 2002 decided that May 1, 2004 is the date of EU enlargement – the largest one in its history. Ten countries joined the EU and were granted the status of “Member State with a Derogation”. The new member countries (NMC) did not adopt the euro immediately but their central banks (NMCB) became members of the European System of Central banks (ESCB), however they will not participate in the process of common monetary policy decision-making until they introduce the euro.¹ All rules and procedures of monetary integration of the NMCB are drawn in advance by the relevant European authorities (EA) – mainly by the EU Commission and the European Central Bank (ECB). During negotiations, they were considered by the EU as an integral part of the *acquis communautaire* and therefore the NMC need follow and fulfill them. This paper focuses only on one of the rules - Exchange Rate Mechanism II (ERM II) that is a specific arrangement of exchange rate policy for the NMC during the interim period from their EU accession to the euro adoption. The paper aims to evaluate impacts of the ERM II on economies of the NMC and provide some policy implications. The paper starts with the description of the ERM II from the institutional point of view and with the discussion about exchange rate stability assessment. The second part analyses actual exchange rate regimes in NMC and illustrates that due to significant differences among them the ERM II will not influence the NMC similarly. The third section deals with pros and cons of the ERM II and the last part presents some conclusions and policy recommendations.

Exchange Rate Mechanism II

ERM II is a direct successor of the original ERM established in connection with the ECU (non-cash predecessor of the euro) implementation in March 1992. Since then, the ERM has undergone dynamic development² gaining the current shape on January 1, 1999 – the starting point of the third stage of EMU and the day of the euro launching. ERM II is unlike his forerunner a bilateral system where currencies of participating countries are linked only to the euro and not to all currencies involved.³

¹ Bialonczyková (2003) provided a review of changes in performing the central bank function after joining the EU in the case of the Czech National Bank.

² Above all, speculative attacks and currency upheaval in 1992-93 resulting in widening of fluctuation band from $\pm 2.25\%$ to $\pm 15\%$ should be reminded.

³ Denmark was the only member country of ERM II on April 30, 2004.

Resolution of the European Council (EC, 1997) determines the process of setting the central parity and the width of the fluctuation band. Final decision is taken by mutual accord of the ministers of the eurozone, the ECB and the minister and central bank governor of respective NMC intending to participate in ERM II.⁴ The standard fluctuation band is $\pm 15\%$; however the possibility of setting a narrower band is not excluded. All parties have the right to initiate a confidential procedure if central parity is deemed to need realignment. Generally speaking, ERM II is based on quasi-fixed exchange rate arrangement which was widely applied in 1980s and 1990s, nevertheless since that time the international financial system and foreign exchange markets have been going through many significant changes that have made the hybrid exchange rate regimes inefficient and old-fashioned.

Automatic ECB's support to the NMCB interventions arises when exchange rate is fluctuating very close to the band margins. Intervention within the bank not need be, but may be, supported by the ECB. Both the ECB and the NMCB are formally entitled to suspend interventions when the price stability as the main goal of monetary policy might be jeopardized. ERM II is designed only for the EU member countries and participation in it is in principle voluntary. However, if we take under consideration the fact that all NMC are really aspiring EMU-membership and that participation in ERM II for at least two years is indispensable to fulfill the Maastricht exchange rate stability criterion, participation in ERM II proves to be obligatory.

While the convergence criteria for the adoption of euro are defined rather precisely, there are no clearly set conditions for the ERM II participation. Outline of the ERM II joining process can be found in European Commission (2003). The whole process consists of the four essential steps: (i) the exchange rate procedure, (ii) the ERM II Committee, (iii) the ERM II exchange rate meeting, (iv) the final communiqué. The time schedule is not fixed and depends on the degree of agreement reached between the authorities of NMC and the EA. It might be very quick process and take just a few days (as in case of Austria), but more realistic expectations count with a half of year. It means that due to technical and logistic reasons the first NMC from the "group of ten" could enter the ERM II at the very beginning of 2005 rather than immediately after joining the EU in May 2004, which has been mentioned quite frequently.

Similarly some questions rise about the proceedings and efficiency of ERM II interventions in practice. Concerns may be considered as a logical consequence of the lack of experiences with the ERM II functioning. There have never been participating so many countries in ERM II as it is expected for the forthcoming years. But on the other side, uncertainty about conditionality and limitations of both the marginal and intramarginal interventions or about intensity and symmetrical

⁴ The European Commission and the Economic and Financial Committee are asked only for consultation.

assessment of central parity realignments turns out the ERM II to be a “black box” from the NMC’s point of view.⁵

Review of Exchange Rate Regimes and Exchange Rate Stability Assessment

As mentioned above, fulfillment of the exchange rate stability criterion is linked very tightly to the ERM II, but these two terms are absolutely not interchangeable, as it is possible for a country to participate in ERM II yet not fulfill – or not even be heading towards fulfilling – the exchange rate stability criterion (CNB, 2003). With respect to a width of fluctuation band it is also highly advisable to distinguish between functioning of the ERM II and the assessment of exchange rate stability. The present position of EA regarding to assessment of exchange rate stability and fulfillment of the criterion is presented below.

The EA standpoint stems from the pertinent official documents such as Treaty on European Union, as elaborated by the relevant protocol, and the Council Resolution establishing the ERM II (97/C 236/03) with effect from January 1, 1999⁶, and can be summarized as follows:

- (i) Participation in ERM II for at least years at the time of the assessment is mandatory.
- (ii) Devaluation of the central parity within the two-year period is not allowed and is considered as a violation of the exchange rate stability criterion.
- (iii) Fulfillment of the criterion requires the exchange rate to have been maintained within a fluctuation margin ± 2.25 % around the central parity in ERM II “without severe tensions”.
- (iv) If the exchange rate moves outside the band, a distinction is to be made between a breach of the upper margin and a breach of the lower margin.

The EA’s attitude can be set forth that revaluation or in other words upward realignment of the central parity does not endanger fulfillment of the criterion and is virtually possible. In a similar way, a breach of the upper margin is implicitly more admissible than a breach of the lower margin. Furthermore, maintaining of the exchange rate within a band narrower than standard accompanied by massive and long-lasting interventions or non-market operations might be assessed as an insufficient fulfillment of the criterion and the application for the EMU membership might be rejected.

One can note that the final decision about the NMC admission to the EMU will be more political than economic and therefore the vagueness and non-exact interpretation of the exchange rate stability assessment aims to leave some leeway

⁵ For more details about the uncertainty and concerns associated with the ERM II see Lavrač (2003) among others.

⁶ The most important passages are the third indent of Article 121 (1) of the Treaty and Article 3 of Protocol No.6. The last expression of the EA’s opinion on the fulfillment of the exchange rate stability criterion can be found in the 2000 Convergence Report (European Commission, 2000), Annex D, Article D.4.

for the EA's decision-making. It will be interesting to see how the ERM II will be treated and the exchange rate stability assessed in the case of the UK once it finally decides to join the EMU. It is probably misleading to anticipate that the same principles of ERM II and exchange rate stability assessment will be employed for the GBP (British Pound) as it is supposed to be for the NMC.

As it is evident, ERM II represents very specific exchange rate arrangement that differs significantly from the actual exchange rate regimes in many NMC. Table 1 illustrates development of exchange rate arrangements in the group of twelve accession countries during the whole period of transformation process. The way from the centrally planned economy to the market-driven one is divided to three stages characteristic by heterogeneous aims and policies applied.⁷

Exchange Rate Arrangements in Accession Countries **Table 1**

	<i>fix</i>	<i>intermediate</i>	<i>float</i>
<i>stabilization phase</i> (1990 - 1994)	Czech Republic	Cyprus	Bulgaria
	Estonia		Latvia ('92-'94)
	Hungary		Lithuania ('92-'94)
	Latvia (since '94)		Slovenia
	Lithuania (since '94)		Romania
	Malta		
	Poland		
	Slovakia		
<i>transition phase</i> (1995 - 2000)	Bulgaria (since '97)	Czech R. ('95-'97)	Bulgaria ('90-'97)
	Estonia	Cyprus	Czech R. (since '97)
	Latvia	Hungary	Poland (since '00)
	Lithuania	Poland ('95-'00)	Slovakia (since '98)
	Malta	Slovakia ('95-'98)	Slovenia
			Romania
<i>preparatory phase</i> (2001 - ERM II)	Bulgaria	Cyprus	Czech Republic
	Estonia	Hungary	Poland
	Latvia		Slovakia
	Lithuania		Slovenia
	Malta		Romania

fix: currency board, conventional peg, narrow band; *intermediate*: tightly managed float, broad band; *float*: managed float, free float

Source: web site of the International Monetary Fund, Nerlich (2002), p.5.

As the Table 1 backs up there is a lot of diversity in the field of exchange rate regimes among the NMC.⁸ Three of them follow a currency board arrangement

⁷ Cyprus and Malta do not belong to the group of transition economies and consequently their exchange rate regimes have been totally consistent during the whole period under consideration without any need for an adjustment.

⁸ The ratio between fixed and floating exchange rate regimes has been changing during the transformation process in favor of floating arrangements. In accordance with conventional wisdom at that time, which emphasized the role of fixed exchange rate as a nominal anchor for macroeconomic stabilization, majority of Central and Eastern European (CEEC) countries decided for some form of fixed exchange rate regime (Lavrač and Žumer, 2003). As the fixed

(Bulgaria and Estonia with respect to the euro, and Lithuania initially with respect to the USD but changed to the euro on February 2, 2002). Latvia has a conventional fixed exchange rate regime with a peg against the SDR and Malta has adopted a fixed peg to a weighted basket of euro, USD, and GBP. Hungary maintains a crawling peg arrangement with a central rate fixed against the euro and a $\pm 15\%$ fluctuation band and Cyprus as the second country with the intermediate regime has a fixed peg to the euro with a fluctuating band $\pm 2.25\%$ around the central parity. The remaining five countries have chosen a managed float but their monetary policy goals and inflation targets are defined differently.

Knowing the design of ERM II and valid exchange rate regimes in NMC one can conclude that NMC will witness differently intensive shifts in their exchange rate arrangements aimed to shape the regimes more in line with the ERM II. Until recently, the ERM II was understood as a homogenous mechanism whose strict rules have to be followed by all participating countries without any exemption. Actual perceiving of the ERM II is broader and allows also functioning of other alternative exchange rate arrangements that are consistent with the ERM II requirements (Lavrač, 2003). Fixed pegs against the euro with fluctuation bands smaller than $\pm 15\%$ are in principle in line with the EU Treaty and will, if not supported by a multilateral agreement, be treated as unilateral commitments. While currency board arrangements might be judged compatible with ERM II – subject to an assessment on a case-by-case basis and regarded as unilateral commitments – fixed pegs against currencies other than the euro, free floats and crawling pegs are not compatible with the requirements. See Fahrholz (2003) for more about mutual relations between political economy and exchange rate arrangements.

As adoption of the euro is generally accepted as a goal of all NMC one can highlight that euroization is another possibility how to introduce the euro as a legal tender and simultaneously how to avoid potentially dangerous ERM II. However, all relevant EA are very reserved and skeptical about the euroization in NMC. Even the Ecofin and the president of the ECB have tipped off that adoption of the euro in conflict with the Maastricht Treaty's principles will not be welcomed from the EU side.⁹

Analysis of the ERM II Effects

Although the exchange rate is only one element of the set of economic policies, its influence on the internal as well as on external stability and equilibrium of the economy is prominent. Whereas the fixed exchange rate is the leading variable as the economic development and policies must adapt to the requirements of the maintaining of fixed exchange rate, the floating exchange rate rather follows

exchange rates successfully stabilized economy and helped to reduce inflation, the CEEC preferences started to move towards more flexible exchange rate arrangements as a result of the need to manage increasing foreign capital inflows. Interestingly enough, this move seems to be against the supposed coming back to fixed exchange rates in the shape of ERM II.

⁹ See Stavárek (2003) for more about benefits from and costs of euroization in the case of the Czech Republic.

development of other variables with the ability to mitigate the consequences of sub-optimal economic policies.

Necessity to subordinate exchange rate arrangements to the principles of the ERM II is a crucial factor that has to be taken into analysis of the ERM II impacts on the economies of NMC. The more far away is the present exchange rate regime from the ERM II the more changes are likely to be expected and the more they will be mirrored in the real economy. There are logically more concerns about the ERM II in the NMC with floating exchange rates than in the NMC with currency board or hard peg to the euro. The concerns are multiplied by the fact that fluctuation band seems to be, at least according to all existing indications, $\pm 2.25\%$ around the central parity, which may cause the two-year participation in the ERM II not to be a problem-free.¹⁰ In a further text we analyze ERM II effects on NMC focusing on three fundamental levels: (i) stabilization of exchange rate, (ii) consistency of macroeconomic policy, (iii) stabilization on inflation.

The role in stabilizing the exchange rate by anchoring the expectations is one of the most-emphasized benefits of ERM II participation. This should subsequently contribute the process of economic convergence to the level of more developed EU-member countries. Commitment of the ECB to stand by the NMCB in interventions defending the fluctuation band margins should enhance the ERM II stabilization role even more. Nevertheless, considering more probable fluctuation band $\pm 2.25\%$ around the central parity, the space for the exchange rate development is so limited that intramarginal interventions are likely to be applied very often and to be more important. However, the ECB support in such kind of interventions is not guaranteed and therefore the stabilization effect seems to be rather undermined. On the other side, the standard band with fluctuations of $\pm 15\%$ around the parity is sufficiently wide to allow almost normal development of exchange rate and its anchoring function is subsequently deficient, too. Furthermore, the central exchange rate may be subject to adjust, mainly due to strong real appreciation trends that are evident in converging countries. The stabilizing role of ERM II would also be in practice limited by this way.

There is also an argument that participation in ERM II will invoke effective pressure for responsible macroeconomic policies and for consolidation and reforming of public finance above all. Any form of fixed exchange rate regimes strictly requires consistent and sound macroeconomic policies and its successful operation is not compatible, for example, with a long-term fiscal deficit or with wage growth that is not in line with productivity growth (CNB, 2003). However, we believe that sustainable fiscal and structural policies should precede the introduction of a fixed exchange rate arrangement and that restrictions on the movement of exchange rate

¹⁰ During the period from 12 March 2002 to 18 March 2004, the average exchange rate CZK/EUR was 31.509 and the exchange rate was fluctuating within the band +5.64%; -7.37%. In the case of Slovakia, the average exchange rate was 41.967 SKK/EUR and the fluctuation band +6.98%; -3.66% around the average. The most volatile currency was Polish Zloty with the average exchange rate 4.2416 PLN/EUR and the fluctuation band +15.64%; -22.37%.

should thus be the consequence of implementing consistent policies, and not the trigger form them. NMC are parts of financially globalized world and attract massive foreign capital inflows that are expected to continue. Any soft peg regime, such as ERM II, can be exposed to speculation, if markets decide to test the willingness and ability of the central bank to protect the official exchange rate and band margins which speculators find not to be sustainable and in accordance with real economic situation and policies applied.¹¹

Participation in ERM II is also being recommended because its ability to encourage low and less volatile inflation. Fixed exchange rate contributes to the anti-inflationary development both directly through stabilization of import prices and indirectly through stabilization of inflation expectations. However, looking at annual rates of inflation in NMC as of December 31, 2002 the need to moderate or curb the inflation is not urgent.¹² The macroeconomic issue of the highest importance arises in NMC whose monetary policy strategy is being pursued in the shape of inflation targeting. Although the exchange rate development is monitored within the concept of inflation targeting in small open economies such as the NMC very properly, the ERM II goes further and sets the maintaining of official central exchange rate as a monetary policy target along with the inflation target. Parallel existence of two monetary targets may undercut the comprehensibility of monetary policy and negatively affect credibility of the central bank. An open conflict between the monetary targets is not excluded either. The shorter the participation in the ERM II will be the lesser extend of the conflict is supposed to surface in NMC with inflation targeting and presently floating exchange rate regime.

Conclusion

Although the ERM II has some stabilizing potential we see it preferably like a potentially dangerous institutional mechanism instead of stable and flexible arrangement guiding the NMC to their soft landing in the EMU as it has been frequently stressed by the EA. We perceive the possibility of financial crises, conflict between monetary policy goals, difficulties in meeting the Maastricht criteria and postponing of adoption of the euro due to ERM II as very feasible, mainly in countries experiencing huge inflows of foreign investment resulting in appreciation pressures, suffering from unconsolidated public finance and enormous budget deficits, or standing ahead of indispensable reforms of pension, social-care and health-care systems. We recommend that such NMC should remain outside of the ERM II for some time after its accession to the EU and concentrate on efforts to pursue structural reforms thoroughly and to improve efficiency and competitiveness of the economy. We see as advisable for all NMC to stay in the ERM II for the minimum of two years only and to set the time of participation in the ERM II in conformity with fulfillment of other convergence criteria. Situation in Estonia is considerably different. Estonia has never changed its exchange rate regime and

¹¹ Attack on Hungarian forint in January 2003 can serve as an illustration of such episode.

¹² Only two NMC exceeded the Maastricht criterion of 3.8 %, namely Hungary with the inflation of 5.3 % and Slovenia with the inflation of 7.5 % (www.eiu.com).

stayed in the currency board. Such kind of exchange rate arrangement is likely to be in accordance with the ERM II principles and it is expected that participation in the ERM II would not initiate any instability pressures in the Estonian economy. Thus, Estonia is supposed to become one of the first new members of the EMU at the very beginning of 2007.

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Zusammenfassung

ERM II: POTENTIALE QUELLE DER INSTABILITÄT IN DEN NEUEN EU MITGLIEDSLÄNDERN

Daniel Stavárek
Silesian University

Der Beitrag konzentriert sich auf die Analyse der Folgen von dem europäischen Mechanismus der Devisenkurse ERM II auf die reale Ökonomie der neuen Länder der EU. In dem ersten Teil beschäftigt sich man mit dem Aufbau und Funktion ERM II zusammen mit dem Prozess des Beitrittes zu ERM II. Der zweite Teil widmet sich der Diskussion über aktuelle Devisenbetriebsarten in den neuen Mitgliedsländern und dem Zusammenhang ERM II mit der Erfüllung des Maastrichtskonvergenzkriteriums der Stabilität des Devisenkurses. In dem dritten Teil des Beitrags wird eine Analyse der Gesamterscheinungen von ERM II in den spezifischen Bedingungen der neuen Mitgliedsländer durchgeführt. In dem letzten Teil werden Abschlüsse und Empfehlungen der Wirtschaftspolitik präsentiert.

Zu den Schwerpunktab schlüssen gehört die Tatsache, dass obwohl ERM II fest verbunden mit dem Kriterium der Stabilität des Devisenkurses ist, kann man diese zwei Begriffe nicht verwechseln. Verantwortliche europäische Institutionen begreifen die Stabilität viel genauer und sie erwarten die Durchsetzung der Fluktationszone nur $\pm 2.25\%$ um die zentrale Parität im Gegenteil zum Standardbereich $\pm 15\%$.

ERM II zählen wir zu der Potentialquelle der Unstabilität vor allem in den Ländern, die einen massiven Zufluss des ausländischen Kapitals annehmen, die unter unkonsolidierten öffentlichen Finanzen und hohen Defiziten der Staatskalkulation leiden und vor den Reformen der Pensionsysteme, Sozialsysteme und Gesundheitssysteme stehen. So kann die Applikation ERM II zu Finanzkrisen, zu dem Konflikt der Ziele der Währungspolitik, zu der Nichterfüllung von anderen Konvergenzkriterien führen, und damit zu der Verspätung der Aufnahme von Euro. Neue Mitgliedsländer mit solchen Charakteristiken sollten auch nach dem Eintritt in EU ein paar Jahre außerhalb ERM II bleiben und sie sollten sich vor allem auf richtige Durchführung der strukturellen Reformen und die Erhöhung der Effektivität und Konkurrenzfähigkeit konzentrieren. Der Eintritt in ERM II empfehlen wir im Einklang mit der Erfüllung von anderen Konvergenzkriterien so zeitlich festlegen, damit es nach dem Verlauf der zweijährigen unbedingt nötigen Anwesenheit in ERM II möglich wäre, sofort in EMU eintreten und Euro annehmen. Auf keinen Fall ist es für neue Mitgliedsländer erwünscht, ihre Währungen in ERM II länger als obligatorische zwei Jahre erhalten.