

# International Economics Policy Briefs

## EU Accession and the Euro: Close Together or Far Apart?

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### Introduction

In May 2004, ten countries are due to join the European Union.<sup>1</sup> They are therefore obliged to join the European Monetary Union (EMU) and adopt the euro as their national currency.<sup>2</sup> Most of them,

moreover, have been eager to do that. None of them sought an opt-out of the sort that Britain and Denmark obtained in 1991, when the Maastricht Treaty was drafted.<sup>3</sup> Membership in EMU is not automatic, however, because the accession countries must first satisfy the preconditions contained in the Maastricht Treaty. Although those preconditions are rigorous, and some of the accession countries are still far from meeting them, most of those countries have indicated that they want to enter EMU at the earliest possible date.

One of the preconditions for entering EMU is that the accession countries achieve exchange rate stability. To this end, they must participate for two years in an exchange rate mechanism known as ERM II, under which they must limit fluctuations in the euro values of their national currencies. They cannot permit their currencies to rise or fall by more than 15 percent from an agreed central rate vis-à-vis the euro. Because of this two-year requirement, the accession countries cannot enter EMU before 2007.

On May 20, 2003, however, Pedro Solbes, the European commissioner for

<sup>1</sup> Eight are Central European countries: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia; the other two are Cyprus and Malta. This policy brief concentrates on the first eight, but much of the analysis applies equally to the other two.

<sup>2</sup> Although the acronym EMU stands for Economic and Monetary Union, it is widely used to stand for European Monetary Union, and that it is how it is used in this policy brief.

<sup>3</sup> The Maastricht Treaty (also known as the Treaty on European Union) was signed in February 1992 and entered into force in November 1993. It amended the Treaty establishing the European Community and is now integrated into it.

economic and monetary affairs, said that the accession countries would have to meet a stricter exchange rate test. He told reporters in Prague that the European Commission had decided some years ago to assess the achievement of exchange rate stability by asking whether the accession countries had kept their exchange rates within the 2¼ percent band that was the “normal” band under the exchange rate mechanism of the European Monetary System, now known as ERM I, which prevailed when the Maastricht Treaty was drafted, rather than the 15 percent band of ERM II itself.<sup>4</sup>

<sup>4</sup> Quoted by *Reuters News* on May 20, 2003. It should be noted that the European Commission’s findings on this and other preconditions for EMU entry are advisory. The commission and the European Central Bank (ECB) must submit reports to the Council of Ministers, which has then to decide whether a country has qualified for entry.

This policy brief urges the European Commission to reconsider its position. The commission’s decision to use the narrow exchange rate band of ERM I rather than the wide band of ERM II derives from an overly rigid interpretation of the sensible principle that all EU countries should be treated equally. It does not take account of the fundamental difference between the conditions prevailing when the Maastricht Treaty was drafted and those prevailing today. This brief does not claim that the accession countries are different in ways that would justify differential treatment. It argues instead that the economic environment is different now that EMU is in being. Failure to take account of this difference when applying the principle of equal treatment may have grave consequences. It may expose the accession countries to the risk of exchange rate crises that could damage them severely and further delay their entry into EMU. It may also complicate

### Box 1. The Convergence Criteria

Under Article 122 of the Treaty establishing the European Community, the European Commission and the European Central Bank must report every two years to the Council of Ministers on each Member State not yet admitted to the monetary union, assessing that Member State’s progress in fulfilling the requirements for admission.

The requirements are listed in Article 121 and two protocols annexed to the Treaty—the protocol on the convergence criteria and the protocol on the excessive deficit procedure. Article 121 requires that each country’s domestic legislation satisfy the requirements of the Treaty and the Statute of the European System of Central Banks and that the country achieve “a high degree of sustainable convergence” measured by four criteria:

- **the achievement of a high degree of price stability**, which the protocol on the convergence criteria interprets as meaning “an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best-performing Member States in terms of price stability.”
- **the sustainability of the government financial position**, which the protocol interprets as meaning that the Member State is not currently the subject of a decision by the Council of Ministers that it has an excessive deficit. Pursuant to Article 104(c) and the pro-

col on the excessive deficit procedure, the Council of Ministers must employ two criteria to determine whether a Member State has an excessive budget deficit: (a) whether the government’s planned or actual deficit exceeds 3 percent of GDP, unless the ratio has declined substantially and continuously and come close to that reference value or, alternatively, the excess over the reference value is only exceptional and temporary, and (b) whether the government’s debt exceeds 60 percent of GDP, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

- **the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State**, which the protocol qualifies by recasting the last clause: the country shall not have devalued its currency on its own initiative during the two-year period.

- **the durability of convergence . . . and . . . participation in the exchange rate mechanism being reflected in the long-term interest rate level**, which the protocol interprets as meaning “an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability.”

severely their ability to satisfy another precondition for EMU entry—the price stability criterion.

This brief begins by describing the preconditions that the new EU members must satisfy in order to enter EMU and the original rationale for them, and it develops more fully the important distinction just mentioned—the need to distinguish between conditions prevailing when EMU was not yet in being and those prevailing today, now that EMU is in being. Thereafter, we propose modifications in the preconditions for EMU membership, including the exchange rate requirement. Finally, we weigh the policy options open to the accession countries if those preconditions are not modified.

### **Qualifying to Enter EMU**

The primary objective of the European Central Bank (ECB) is to maintain price stability. That was agreed at Maastricht in 1991. It was also agreed, however, that the task of achieving price stability should not be left to the ECB. It should be assigned instead to the member countries, as the price of entering the monetary union, and most of those countries were far from achieving it in 1991. In the previous year, the annual inflation rate exceeded 10 percent in two EU countries and exceeded 5 percent in three others. No country had an inflation rate lower than 2.5 percent. Furthermore, five countries had budget deficits larger than 5 percent of GDP, while four had stocks of public debt larger than 90 percent of GDP, and these conditions were deemed to pose a serious threat to the future functioning of the monetary union. Lax fiscal policies could skew the policy mix by forcing the ECB to pursue a very tight monetary policy, and they might even threaten the ability of the ECB to maintain price stability; a debt crisis in a member country would put pressure on the ECB to monetize that country's debt or cope with the banking crisis that could follow a debt crisis.

Accordingly, Article 121 of the Maastricht Treaty set out four “convergence criteria” by which to judge the eligibility of individual countries to enter EMU (box 1). As the membership of EMU could not be known until eligibility had been determined, it was, of course, impossible to draft the criteria with reference to economic conditions in what is now known as the euro area. Therefore, the first and fourth criteria, pertaining to price stability and the long-term interest rate, used as their benchmarks the national inflation rates and long-term interest rates of the “three best-performing Member States in terms of price stability,” while the second criterion, pertain-

ing to fiscal sustainability, borrowed its deficit and debt criteria from Article 104 of the Maastricht Treaty, under which individual countries may be cited and sanctioned for running “excessive” budget deficits.<sup>5</sup> The third criterion, discussed at length later, was meant to achieve exchange rate stability

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***The European Commission's decision to use the narrow exchange rate band of ERM I rather than the wide band of ERM II fails to take into account the fundamental differences between the conditions prevailing when the Maastricht Treaty was drafted and those prevailing today.***

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during the run-up to EMU, with the dual aims of confirming each country's commitment to price stability (which, of course, is required for long-lasting exchange rate stability) and of precluding discontinuities in the transition to the euro.

Many writers on EMU have criticized these convergence criteria. It has been noted, for example, that the long-term interest rate is an imperfect indicator of a country's commitment to price stability; the behavior of a country's long-term interest rate is bound to reflect market participants' expectations regarding the country's chances of entering EMU, as well as their expectations about future inflation. The case for imposing an exchange rate criterion is even weaker. It asks a country to prove that it can maintain a stable exchange rate in order to enter

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<sup>5</sup> The much-discussed Stability and Growth Pact aims at clarifying and tightening the excessive deficit procedure, and it also commits each EU country to achieve and maintain a budget “close to balance” over the medium term. There have been many proposals for reforming the excessive deficit procedure and the Stability and Growth Pact, reflecting the realization that they can force governments to adopt strongly procyclical fiscal policies; see, e.g., Sapir et al. (2003). If they are reformed, the principle of equal treatment, discussed later, should not prevent the European Union from applying the amended rules to the accession countries when judging their eligibility to enter EMU. That is because the fiscal criterion shown in box 1 asks whether a member country is subject to a formal finding that it has an excessive deficit, and the standards used for that purpose must be applicable uniformly to all EU countries.

a monetary union in which it will cease to have an exchange rate of its own.<sup>6</sup>

A larger question, however, is more relevant here: Should the accession countries be made to replicate the work of the original EMU members now that EMU is up and running and the ECB has taken over the task formerly assigned to the national central banks of the euro area countries? When EMU was not yet in being, it made sense to base the inflation-rate and interest-rate criteria on the track records of the three EU countries with the lowest inflation rates. Now that EMU is in being, it would make far more sense to base those criteria on the average inflation rate and average long-term interest rate in the whole euro area.<sup>7</sup>

The European Commission has insisted repeatedly on strict adherence to the principle of equal treatment without taking account of the point just made. It insists that the accession countries must meet the same requirements for EMU entry as those that have already entered. Equal treatment, however, should not mean identical treatment. It can and should mean *equivalent* treatment, taking account of the changes in the institutional and economic environment brought about by the creation of EMU itself.<sup>8</sup> The European Commission came close to acknowledging the validity of this distinction in its convergence report for Greece, the only country to enter EMU after it came into being:

It seems desirable that the assessment of a “high degree of price stability” should also take into consideration the price performance of the euro area as a whole as well as the ECB’s definition of price stability. This is all the more so since the euro and the euro area economy constitute the economically relevant benchmarks to which countries aiming to join the euro should orient their convergence efforts (European Commission 2000).

But the European Commission ducked the issue, saying that it might be relevant to future use of the convergence criteria but had no practical bearing on the eligibility of Greece. In fact, it ducked a lesser question: whether the existence of EMU calls for a small but sensible change in the way that the “three best performing countries” are selected. Because

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***Failure to take account of the difference in conditions (now that EMU is in being) may expose the accession countries to the risk of exchange rate crises that could damage them severely and further delay their entry into EMU.***

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<sup>6</sup> It can perhaps be argued that two years of exchange rate stability offer prima facie evidence that the prevailing exchange rate is at or near the long-term equilibrium rate and is therefore one at which a country can safely substitute the euro for its own national currency. But this rationale is flawed. It assumes implicitly that the exchange rate would have been equally stable and at the same level had it been floating freely rather than being constrained to remain within the narrow band imposed by ERM I. Furthermore, it ignores the stabilizing effect of likely EMU entry—the belief by market participants that a country will soon enter EMU at its existing exchange rate. Finally, it wrongly treats the past as prologue; the absence of large shocks in the two-year period of exchange rate stability does not necessarily foretell the absence of large shocks in the years ahead.

<sup>7</sup> Begg et al. (2003) and Jiri Jonas (“Absurd Inflation Criterion for New EU Members,” *Financial Times*, July 14, 2003) make the same point. Buiter and Grafe (2002) go further: As a monetary union is the means par excellence for achieving inflation convergence, requiring prior inflation convergence for EMU entry puts the cart before the horse. See also Balcerowicz (2003).

<sup>8</sup> Wyplosz (forthcoming 2004) makes the same point, but he puts equal emphasis on the change in the environment and on the economic differences between the original candidates for EMU membership and the accession countries. The former, he says, had already achieved a great deal of real convergence and had therefore to focus mainly on nominal convergence, whereas the accession countries must do both. He argues, however, that EMU membership will foster the real convergence of the accession countries, because monetary integration will promote trade integration.

there was no way to know initially which countries would qualify to enter EMU, they had to be chosen from the whole EU membership, not from the smaller EMU membership.

Consider, moreover, the possible consequences of using the original convergence criteria, especially the one pertaining to price stability, when deciding whether a new EU member is ready to enter the EMU. Although the single monetary policy of the ECB imposes strict limits on national inflation rates within the euro area, it does not align them perfectly. In June 2003, the inflation rate for the whole euro area was 2 percent. If that same rate were used as the benchmark for the convergence criterion reproduced in box 1, a country would be precluded from entering EMU if it had an inflation rate higher than 3.5 percent. In that same month, however, the three “best performing” EU countries (Germany, Austria, and Britain) had inflation rates averaging just 1 percent. Hence, use of the original convergence criterion could prevent a country from entering EMU if it had an inflation rate higher than 2.5 percent—a rate that is not very far above the one used by the ECB as its measure of price stability—and a rate lower than the ones actually reported by five euro

area countries in June 2003 (Greece, Ireland, Italy, Portugal, and Spain). The point of this example, however, is not to show how EMU entry might be made easier for the accession countries; it is instead to show why mechanical adherence to equal treatment could have effects that were surely unforeseen when the convergence criteria were drafted.

The same exercise, however, raises another question. How far are the accession countries from meeting the convergence criteria listed in box 1? Table 1 shows how they would fare if they were seeking entry now (but uses as a benchmark the euro area inflation rate, as proposed in the previous paragraph, along with the euro area average of long-term interest rates). In 2002, all eight countries listed in table 1 had stocks of debt no larger than 60 percent of GDP, and four had budget deficits no larger than 3 percent of GDP. In mid-2003, moreover, five of the six that issue long-term government bonds had interest rates below the relevant benchmark. But three countries were still far from meeting the inflation benchmark. All of the accession countries have reduced their inflation rates dramatically since the mid-1990s, as shown in table 2, but Hungary,

Slovakia, and Slovenia must continue to reduce them.<sup>9</sup>

Furthermore, risks lie ahead. EU membership will put new pressures on the government budgets of the accession countries. They must contribute to the EU budget and must conform to the requirements of EU legislation, the *acquis communautaire*, which will force them to increase their spending on infrastructure and environmental quality. They will, of course, qualify for financial assistance from the European Union itself, but it will impose cofinancing requirements. According to estimates cited by Jürgen von Hagen and Zizhong Zhou (2003), EU

<sup>9</sup> Balcerowicz (2003) draws an interesting comparison between the nominal convergence achieved thus far by the accession countries and the convergence achieved by Greece, Portugal, and Spain at a “comparable” point in time—four years before they entered EMU. He finds that most of the accession countries are closer now to meeting the convergence criteria. Consider, for example, the price stability criterion: Spain’s inflation rate, at 4.6 percent, was lower than those of Greece and Portugal four years before entering EMU. In June 2003, however, six of the eight accession countries had inflation rates below 4.6 percent.

**Table 1. Convergence indicators for accession countries**

Country	Annual inflation rate (HICP basis, June 2003)	Fiscal indicators as percent of GDP (2000)		Long-term interest rate (June 2003)
		Deficit	Debt	
Czech Republic	0.0	-3.9*	27.1*	3.79
Estonia	0.4	1.3	5.8	n.a.
Hungary	4.4	-9.2	56.3	6.69
Latvia	3.7	-3.0	15.2	n.a.
Lithuania	-0.3	-2.0	22.7	4.25 <sup>a</sup>
Poland	0.6	-4.1	41.8	5.07
Slovakia	8.7	-7.2	42.6	4.79
Slovenia	6.2	-2.6	28.3	3.86 <sup>a</sup>
Euro area comparator	3.5 <sup>b</sup>	-3.0 <sup>c</sup>	60.0 <sup>c</sup>	5.93 <sup>d</sup>

\* = preliminary

n.a. = not available

HICP = Harmonized Index of Consumer Prices

a. Euro-denominated issue.

b. Average for euro area countries plus 1.5 percent.

c. Reference values from Protocol on the Excessive Deficit Procedure.

d. Average for euro area countries plus 2 percent.

Sources: European Bank for Reconstruction and Development, Eurostat, and Bloomberg.

### Box 2. The Balassa-Samuelson Effect

The accession countries are undergoing a process of economic transformation. The progress of this process can be measured by comparing the per capita income levels of these countries with the average level in the European Union. Most accession countries have experienced advances in per capita income since 1993, but a substantial amount of catching up remains to be done before they reach the average income level in the EU-15 (see table below). This process is apt to raise their inflation rates insofar as it reflects rapid productivity growth in the traded goods sector, a phenomenon known as the Balassa-Samuelson (BS) effect.

**Index of GDP per capita in accession countries** (EU-15=100; purchasing power standard)

Country	1993	2002
Czech Rep	60.0	59.2
Estonia	33.0	41.0
Hungary	45.8	55.1
Latvia	25.1	34.6
Lithuania	35.5	38.4
Poland	23.3	38.7
Slovakia	43.2	47.8
Slovenia	59.8	72.6

Sources: Eurostat and Begg et al. (2003).

To derive the BS effect, consider two countries (advanced and transition), each with two sectors (traded and nontraded goods). The catch-up process involves a rapid rate of productivity growth in the transition country's traded goods sector—more rapid than in its nontraded sector or in the advanced country. This rapid productivity growth in the transition country's traded goods sector results in an increase in wages in that sector. Under the *assumption* that wages are equalized across sectors, the rise in wages in the transition country's traded goods sector pushes

up wages in the nontraded goods sector and, with no productivity growth there, results in an increase in prices of nontraded goods.

Thus, productivity growth from the catch-up process generates relatively higher prices for nontraded goods in the transition country. This implies that the transition country will experience some real appreciation of its exchange rate. Using one conventional definition of the real exchange rate—the ratio of nontraded goods prices to traded goods prices—this real appreciation results directly from relatively greater inflation in the nontraded goods sector. Using another conventional definition of the real exchange rate—the nominal exchange rate adjusted for relative price levels—and *assuming further* that prices of traded goods are equalized on world markets and that the transition country is a small supplier on these markets (so that the increase in supply of traded goods resulting from catch-up productivity growth does not depress the price of traded goods), the real appreciation results from the rise in nontraded goods inflation in the transition country (taking into account the share of nontraded goods in the relevant price index).

A number of authors have endeavored to estimate the magnitude of the BS effect in accession countries; results from these studies are summarized in Buiters and Grafe (2002), Kovács (2003), and von Hagen and Zhou (2003). Without adjusting for differences in study methodology, however, it is difficult to compare estimates across studies. The results can depend importantly on whether a particular study examines countries individually or as a group, on the similarity of data and measurement techniques across studies, and on the price index used (and the share of nontraded goods in it). Mihály András Kovács (2003) addresses these comparability issues in two ways: first, he reports work from a joint study that used similar methodologies and data to assess the BS effect in five accession countries (Czech Republic, Hungary, Poland, Slovakia, and Slovenia); and second, he adjusts results from other studies so as to make the estimates as comparable as possible. The bulk of the estimates in Kovács's study suggest that BS inflation in the accession countries is on the order of 2 percent per year, similar to the effects reported for Spain and smaller countries in the eurozone before EMU came into being.

membership could raise the budget deficits of the accession countries by amounts as large as 3 or 4 percent of GDP. Even if the actual amounts turn out to be smaller, they pose a serious problem for those accession countries that have still to cut their budget deficits sharply. Attention must also be paid to the need for further *real* convergence of the accession countries and the implications of that process.

Most discussions of this matter begin by noting that there is a large gap between the levels of income per capita in the accession countries and in other EU countries. It is smaller now than in 1993 (see box 2) but is still substantial. The gap is therefore cited to stress the need for the accession countries to improve the functioning of their economies—to liberalize markets and prices, strengthen competition policies, and foster the development of their financial systems.<sup>10</sup>

Yet there is another important dimension to the problem. It is the risk that the further growth of the accession countries' economies will jeopardize their ability to hold down their inflation rates. This risk derives from the functioning of the Balassa-Samuelson effect, described in box 2. Briefly, it poses the threat that the prices of nontraded goods will rise faster than the prices of traded goods—which are held down by prices in world markets—and that the increase in the prices of nontraded goods will raise the general price level, relative to foreign price levels. In other words, the Balassa-Samuelson effect causes the real exchange rate to appreciate.

This appreciation is unavoidable. It is an equilibrium phenomenon. Most of the accession countries have indeed experienced substantial amounts of real appreciation (figure 1).<sup>11</sup> There are nevertheless two ways in which it can manifest itself: an in-

crease in the domestic price level, or an increase in the price of the domestic currency—an appreciation of the nominal exchange rate. That is why most discussions of the Balassa-Samuelson effect say that it poses a choice for the accession countries. They can opt for an increase in their inflation rates, which may jeopardize their ability to meet the price stability requirement described in box 1, or opt for an appreciation of the nominal exchange rate, which

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***Euroization has been ruled out by the EU authorities as being “inconsistent with the rationale of EMU.” One reason has to do with the euro conversion rate at which a country enters EMU, which, like the exchange rate chosen for entering ERM II, must be approved by the EU authorities. The second objection reflects the European Union’s views about the integrity of the convergence process.***

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may jeopardize their ability to meet the exchange rate requirement. Few discussions, however, explain how the accession countries can exercise this choice—how they can engineer the nominal appreciation required to preclude an increase in the inflation rate. In order to do that, they must pursue tight monetary policies to hold down the general price level and count on the resulting increase of domestic interest rates to attract capital inflows that will, in turn, drive up the price of the domestic currency on the foreign-exchange market.<sup>12</sup>

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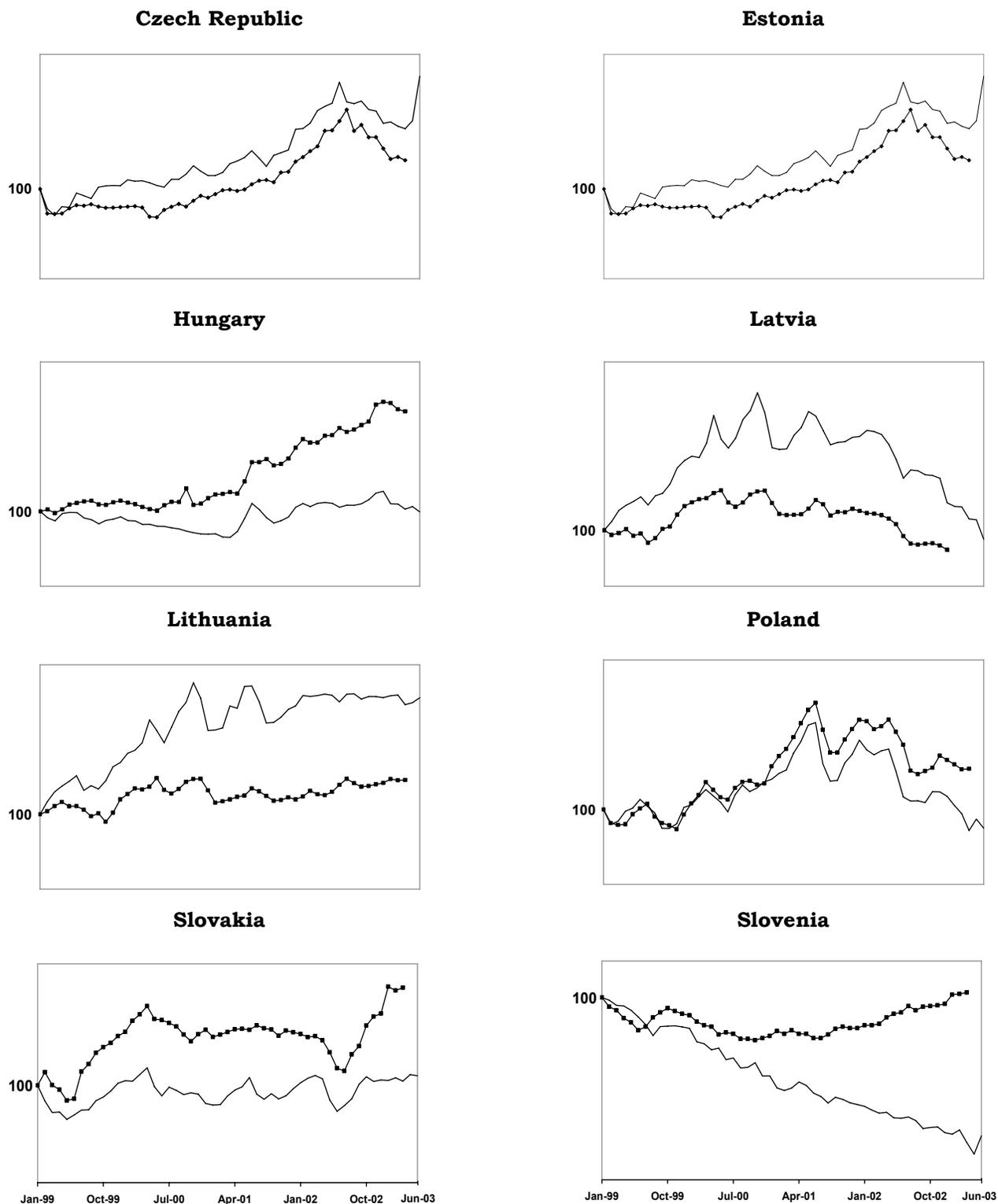
<sup>10</sup> On these matters, see, e.g., Redonnet (2002), Padoa-Schioppa (2003), and Stark (2003), all of whom stress the progress already made by the accession countries and warn against using the income gap to measure the need for more structural adjustment. The accession countries, says Padoa-Schioppa (2003, 133), “are considerably more similar to EU member states than suggested by per capita income levels alone,” and he draws attention to the fact that the accession countries have grown faster than the euro area countries during the global economic slowdown—a fact confirmed by the data on GDP growth shown in table 2. All three authors, however, stress the need to strengthen financial systems and prudential supervision; see also Begg et al. (2003), von Hagen and Zhou (2003), and the discussion in Baudino et al. (2003) of the role of foreign banks in the accession countries.

<sup>11</sup> In most cases, however, the amounts of real appreciation exceeded the amounts that can be ascribed to the Balassa-Samuelson effect, given the size of that effect cited in box 2. Here are the annual percentage rates at which their currencies appreciated in real terms over the eight-year period ending in 2002: Lithuania (6.26), Estonia (4.67), Poland (3.79), Latvia (3.67), Czech Republic (3.62), Hungary (3.57), Slovakia (1.39), and Slovenia (0.47).

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<sup>12</sup> Those who urge the accession countries to adopt the euro unilaterally and thus forgo the option of nominal appreciation acknowledge that their recommendation could jeopardize the ability of the accession countries to achieve the degree of price stability required for EMU entry. Therefore, they suggest that the European Union should waive the price-stability requirement insofar as a country's inflation rate can be ascribed to the Balassa-Samuelson effect or should recast that requirement by looking only at traded-goods inflation; see Bratkowski and Rostowski (2002a, 2002b), and Buiters and Grafe (2002). Although Padoa-Schioppa (2003) opposes unilateral euroization, he likewise acknowledges that price increases reflecting the Balassa-Samuelson effect should not be viewed as violations of price stability, but he doubts the feasibility of identifying clearly the statistical counterpart of the Balassa-Samuelson effect.

**Figure 1. Nominal and real effective exchange rates** (January 1999–June 2003, January 1999 = 100)



*Note:* The thin black line represents the nominal exchange rate; the other line represents the real effective exchange rate. Appreciation equals increase.

*Sources:* International Monetary Fund and national central banks.

Unfortunately, this policy prescription poses two problems, apart from the possibility that a tight monetary policy will depress real economic activity and slow the growth of GDP. Its feasibility depends on the amount of exchange rate flexibility allowed by the exchange rate requirement for EMU entry. Its soundness depends on the willingness of the accession countries to expose themselves to capital inflows and the potential volatility of those inflows—which brings us right back to the matter of exchange rate flexibility. The accession countries have already experienced large inflows of foreign direct investment (FDI). They have not experienced comparable inflows of portfolio investment, which tend to be more volatile. In fact, the volatility of portfolio flows and of other short-term capital flows has been a major cause of the currency and financial crises that have beset many emerging-market countries in recent years, and it is widely agreed that insufficient exchange rate flexibility has been a root cause of their vulnerability to that volatility. When entering the European Union in 2004, moreover, the accession countries must dismantle all of their remaining controls on cross-border capital flows.

The Balassa-Samuelson effect and the impending liberalization of capital account flows have important implications for the exchange rate policies of the accession countries in the years between EU accession and EMU entry. They likewise have important implications for the way in which the European Union should interpret the exchange rate requirement for EMU entry. This policy brief deals first with the interpretation of the exchange rate requirement, then with the ways in which the accession countries should manage their national currencies before they enter EMU.

### **The Key Role of the Exchange Rate Requirement**

In 1991, when the Maastricht Treaty was drafted, ten of the twelve EU members adhered to ERM I.<sup>13</sup> Each one was required to keep its exchange rate within a narrow band by purchasing its currency in the foreign-exchange market to keep its currency from depreciating by more than 2¼ percent vis-à-vis the strongest currency. The obligation was symmetrical, moreover, in that the strong-currency country was required to sell its currency in the foreign-exchange market to keep its currency from appreciating further or, alternatively, to lend unlim-

ited amounts of its currency to the weak-currency country in order to finance that country's purchases of its own currency. The 2¼ percent band thus defined the "normal fluctuation margins" cited in Article 121 of the Treaty (quoted in box 1).

In 1992, however, a currency crisis erupted in Europe, beginning with an attack on the Italian lira and spreading quickly to other currencies. Italy and Britain were forced to drop out of ERM I, and some of the other participating countries were forced to devalue their currencies. In July 1993, moreover, the French franc came under strong speculative pressure, and the remaining participants in ERM I agreed to widen the fluctuation margins from 2¼

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***The European Commission should recast the benchmarks used to assess compliance with the inflation-rate and interest-rate requirements. These should be based on the inflation rate and average long-term interest rate prevailing in the euro area, not those prevailing in the "three best-performing" EU countries.***

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percent all the way to 15 percent. This was portrayed as a temporary measure, not as a permanent change in the normal margins.

When therefore it was time to decide which countries were eligible to enter EMU, the European Commission based its assessment on their adherence to the normal margins of ERM I, while conceding the validity of "the presumption that the wider margins could be exploited, at least temporarily" (European Commission 1998). There were very few instances, however, in which a currency had strayed far from the normal band. The Italian lira had done so briefly but only in the early part of the relevant two-year period, before Italy had re-entered ERM I. The Irish punt had done so persistently, but by appreciating rather than depreciating. Hence, the commission concluded that all of the countries then being assessed for EMU entry had met the exchange rate criterion.<sup>14</sup>

<sup>13</sup> Greece and Portugal had not yet adhered to ERM I, and three of the countries adhering to it (Britain, Italy, and Spain) were allowed to employ a 6 percent band rather than the normal 2¼ percent band.

<sup>14</sup> By that time, the European Union had 15 members, but Greece did not adhere to ERM I until March 1998, while Denmark and the United Kingdom had exercised their opt-outs from EMU.

In 1997, however, the EU countries had decided that, once EMU was in being, ERM I would be replaced by a new arrangement, ERM II. It would involve the ECB and be based on “standard” margins of 15 percent on each side of an agreed central rate vis-à-vis the euro.<sup>15</sup> Two countries, Denmark and Greece, adhered to this arrangement, which entered into force in January 1999, concurrently with EMU. This new regime posed a problem for the commission when it had to assess the eligibility of Greece, which had entered ERM I in March 1998 but had adhered to ERM II in January 1999 and was thus subject to the 15 percent band thereafter. Although the commission took note of the new “standard” band, as well as the widening of the ERM I band in 1993, it decided without any extended explanation to apply the 2¼ percent “normal” band when assessing the behavior of the Greek drachma. The drachma was outside that narrow band for much of the period under review but, like the Irish punt, it was strong, not weak. The commission therefore concluded that Greece had met the exchange rate requirement for EMU membership.

Why is this history relevant now? Precisely because it has been forgotten. Academics and EU officials alike have told the accession countries that they can and should avail themselves of the exchange rate flexibility afforded by ERM II, not only to achieve the nominal appreciations that may be required to keep the Balassa-Samuelson effect from raising their inflation rates and preventing them from meeting the inflation criterion but also to cope with the volatility of cross-border capital flows and with other shocks.<sup>16</sup> And though officials have often invoked the principle of equal treatment, they have not spelled out its implications for the assessment of exchange rate stability. In fact, only one exception

has come to our attention. In a note on the report of the ECOFIN Council to the 2000 Nice Summit (European Commission 2001), Denis Redonnet made this strong statement:

Following the principle of equal treatment, exchange rate stability for future Member States will be judged against significant variations from the *narrow bands* around the central parity, and not against the wide standard bands. In light of the Irish precedent, however, pressures towards appreciation or re-valuation are less of a problem. (Redonnet 2002, 10; emphasis in original)

But this was his personal view. It was not stated or clearly implied in the ECOFIN Council report he was discussing.<sup>17</sup>

Then came Pedro Solbes’s statement, cited at the start of this policy brief, which changed dramatically the trade-offs and options facing the accession countries. They must join ERM II to qualify for EMU entry, but they cannot exploit the flexibility it affords to cope with the price pressures produced by the Balassa-Samuelson effect or the exchange rate pressures resulting from volatile capital flows. Unless the European Commission decides to interpret “equal treatment” in a more sensible way, taking account of the fact that the normal band of ERM I could not survive the exchange rate turbulence of 1992–93 and had to be replaced by the standard band of ERM II, the accession countries will find themselves facing the same problem as the child in the ancient rhyme:

Mother, may I go out to swim?  
Yes, my darling daughter,  
Hang your clothes on a hickory limb,  
But don’t go near the water!

The accession countries must not defy mother’s warning. When the European Commission decided in 1998 to use the 2¼ percent band for assessing the eligibility of the first group of countries seeking EMU membership, it did so retrospectively. Therefore, its decision could not affect market participants’ expectations about the probability that a

<sup>15</sup> The new regime was established by a 1997 resolution of the European Council, and its features were spelled out in a 1998 agreement between the ECB and the national central banks of the countries outside the euro area; both documents are reprinted in ECB (1999). Article 2.5 of the council’s resolution says that the standard bands “shall not prejudice” the interpretation of the exchange rate convergence criterion in Article 121 of the Treaty. We have searched in vain for any reference to this sentence in subsequent official documents, although it would appear to provide the juridical basis for the commission’s 2000 decision regarding Greece, discussed in the next sentences of the text.

<sup>16</sup> Among the academics, see, e.g., Begg et al. (2003) and Wyplosz (forthcoming 2004) who fear that the wide “standard” band may not afford enough flexibility to cope with volatile capital flows once capital controls are dismantled completely, and von Hagen and Zhou (2002) who produce calculations showing that fluctuations in the exchange rates of the accession countries have typically exceeded those allowed by the “normal” band but not those allowed by the “standard” band. Among the officials, see Solans (2002), Padoa-Schioppa (2003), and Stark (2003).

<sup>17</sup> Redonnet also asserts that most accession countries “envisage a form of participation in the ERM II which would not make use of the flexibility built into the mechanism. This is the case for the possibility to realign, but also for the use of standard bands” (Redonnet 2002, 10). If this were true, it would be hard to understand the furor created by Pedro Solbes’s subsequent statement predicting use of the 2¼ percent band for assessing exchange rate stability.

**Table 2. Indicators of macroeconomic performance, 1995–2002**

Country	1995	1996	1997	1998	1999	2000	2001	2002
<b>Consumer price inflation, national indexes</b>								
Czech Republic	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8*
Estonia	29.1	23.1	11.2	8.1	3.3	4.0	5.8	3.6*
Hungary	28.2	23.6	18.3	14.3	10.0	9.8	9.2	4.8*
Latvia	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9*
Lithuania	39.6	24.6	8.9	5.1	0.8	1.0	1.3	0.3*
Poland	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.7*
Slovakia	9.9	5.8	6.1	6.7	10.6	12.0	7.3	3.3*
Slovenia	13.5	9.9	8.4	7.9	6.1	8.9	8.4	7.5*
<b>Growth rate of real GDP</b>								
Czech Republic	5.9	4.3	-0.8	-1.0	0.5	3.3	3.1	2.0
Estonia	4.3	3.9	9.8	4.6	-0.6	7.1	5.0	5.0
Hungary	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.3
Latvia	-0.8	3.7	8.4	4.8	2.8	6.8	7.9	6.1
Lithuania	3.3	4.7	7.3	5.1	-3.9	3.8	5.9	5.9
Poland	6.8	6.0	6.8	4.8	4.1	4.0	1.0	1.3
Slovakia	6.5	5.8	5.6	4.0	1.3	2.2	3.3	4.4
Slovenia	4.9	3.5	4.6	3.8	5.2	4.6	3.0	2.9
<b>Current account deficit as percent of GDP</b>								
Czech Republic	2.6	7.1	6.7	2.2	2.7	5.3	4.6	5.3
Estonia	4.4	9.2	12.1	9.2	4.7	5.7	6.2	12.6
Hungary	5.6	3.7	2.1	4.9	4.3	2.8	2.2	4.2
Latvia	0.4	5.5	6.1	10.7	9.8	6.9	9.5	7.8
Lithuania	9.9	9.2	10.2	11.9	11.2	6.0	4.8	4.8
Poland	-4.5	1.0	3.2	4.4	7.5	6.3	4.0	3.6
Slovakia	-2.1	10.6	9.6	9.7	5.5	3.7	8.8	8.2
Slovenia	0.4	-0.3	-0.3	0.6	3.5	3.0	-0.2	-1.8

\* = preliminary.

Sources: European Bank for Reconstruction and Development, and International Monetary Fund.

particular country would qualify to enter EMU. That was likewise true in the case of Greece, because market participants could not know in advance that the commission would decline to use the standard 15 percent band of ERM II that was then applicable to the Greek drachma. In the present case by contrast, the commission's intentions will be known in advance, unless it decides and announces soon that it will abandon the precedent set in the Greek case and apply the 15 percent band when assessing the eligibility of the accession countries. Therefore, market participants' expectations will be affected if an accession country's currency breaches the 2¼ percent band after the country adheres to ERM II, and the accession countries will *not* be free to exploit the flexibility afforded by the 15 percent band.

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***The exchange rate requirement should be assessed by applying the 15 percent standard band of ERM II, not the 2¼ percent normal band of ERM I.***

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To complicate matters, the accession countries cannot count on help from the ECB in keeping their currencies within the 2¼ percent band. Under ERM II, the ECB is not obliged to intervene or provide short-term financing unless a participating currency has reached the edge of its 15 percent band vis-à-vis the euro.<sup>18</sup> And there is also the risk of contagion. If the currency of one accession country breaches the 2¼ percent band, market participants are apt to revise their expectations about the EMU outlook, not only for that country but also for other countries. Finally, a country courting a currency crisis by failing to keep its currency within the 2¼ percent band may also face a banking crisis.<sup>19</sup>

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<sup>18</sup> See Article 3 of the 1998 agreement reprinted in ECB (1999). The ECB is not precluded from engaging in intramarginal intervention or providing short-term financing for such intervention, but is not required to do so. Under Article 15, however, the ECB can agree formally to a request by the other country concerned to adopt a band narrower than 15 percent, in which case the ECB is obliged to intervene when that country's currency reaches the edge of the narrower band. Danish participation in ERM II is governed by an agreement of that sort, but no one has advised the accession countries to exercise that option, which would deprive them of any significant exchange rate flexibility.

<sup>19</sup> Kaminsky and Reinhart (1999) found that banking crises frequently cause currency crises, but many currency crises also produce banking crises, especially when a country's banks have large foreign-currency debts.

### **Options for the Accession Countries**

Assume that compliance with the exchange rate criterion will be evaluated on the basis of the 2¼ percent band and that the evaluation procedure will be well understood in financial markets. What options are then open to the accession countries? Deviations from the central rate, particularly in a downward direction, will put them at risk of violating that criterion, and there is little margin for error with such narrow bands. Although a country may adopt a 15 percent band, market participants will know that the European Commission plans to evaluate the country's performance on the basis of a much stricter test, and they, in turn will assess its chances of entering EMU in light of its ability to pass that test.

This section describes the current exchange rate regimes of the accession countries and their experience with capital flows, then turns to an evaluation of currency boards and unilateral euroization as regimes that may serve as sensible substitutes for participation in ERM II, discussing in some detail EU objections to unilateral euroization.

The accession countries have run large current-account deficits in recent years (table 2), and these have been financed by large net capital inflows relative to GDP (table 3). Thus far, FDI has dominated those capital inflows, but the size and composition of capital flows may change in the years ahead. As the accession countries dismantle their remaining restrictions on capital movements, as required by the *acquis communautaire*, they are likely to attract larger amounts of portfolio investment, which tends to be more volatile than direct investment. Therefore, they run the risk that capital inflows will dry up or reverse abruptly, and this risk will be magnified if they adopt exchange rate arrangements that invite market participants to make costless one-way bets on future exchange rate changes. Reviewing the experience with capital flows and financial crises in the 1990s, Begg et al. (2003) suggest that the onset and virulence of the 1992 ERM crisis reflected the intrinsic fragility of ERM I, with its narrow band, combined with the increase in the size and volatility of capital flows resulting from adherence to the Single European Act, which required the lifting of all capital controls by 1990.

Current practices in the accession countries with respect to exchange rate and monetary policies are summarized in table 4. At present, four countries—the Czech Republic, Poland, Slovakia, and Slovenia—have floating exchange rates and are therefore completely outside the framework of ERM II. Their participation in ERM II would necessitate a reorientation of their monetary policies in order to target exchange rate stability, and this may be a

more difficult adjustment than the one facing other accession countries that already use the exchange rate as a nominal anchor. Currency boards in Estonia and Lithuania are at the other end of the spectrum of exchange rate regimes, along with Latvia's strict peg to the SDR (the unit of account of the International Monetary Fund). Those "hard" regimes can be fitted into ERM II, a matter discussed later. Hungary's exchange rate regime already resembles ERM II; the forint fluctuates within a 15 percent band on each side of a central rate vis-à-vis the euro. In fact, Buiters and Grafe (2002) describe Hungary as "shadowing" ERM II. During much of 2003, however, Hungary has experienced intense currency speculation and volatile capital flows, reflecting the inconsistency between its target for the forint and its target for inflation—a problem similar to the one posed by the need for the accession countries to satisfy simultaneously the convergence criterion pertaining to price stability and the one pertaining to exchange rate stability.

One option for the accession countries, particularly those with floating exchange rates, is to retain their current exchange rate arrangements for the foreseeable future and thus delay attempting to conform to the requirements of ERM II. This is the scenario favored by many EU officials, who have urged the accession countries to put EMU membership on the back burner until they have traveled further down the road to real convergence. Jürgen Stark (2003) argues that "the greater flexibility of

the exchange rate before ERM II entry could be an advantage for the acceding countries, as flexible rates offer a certain protection from speculative capital inflows." Hence, he cautions those countries against moving quickly into ERM II. Otmar Issing (2003) and Jürgen Kröger (2003) make the same recommendation. Underlying their advice is an assumption about the time required to achieve real convergence. As that process will take much more time, it is argued, rapid entry into ERM II followed quickly by EMU membership would be premature.

Within the accession countries, by contrast, there has been strong support for rapid adherence to ERM II so as to achieve EMU membership as soon as possible after accession. Thus, Leszek Balcerowicz (2003) views rapid entry as complementary to structural reform, noting "that the idea of introducing the euro is popular in the accession countries as an additional argument in favor of these [structural] reforms." On this view, the catching-up process would be facilitated by adopting the euro, and there are "serious risks of staying outside the EMU" because the volatility of capital flows and exchange rates "would complicate the conditions for economic growth."<sup>20</sup>

<sup>20</sup> Following the Solbes statement, however, some officials in the accession countries have been rethinking their support for the early EMU entry scenario. See "Patience, patience: Don't rush into the euro, central bankers say," *The Economist* (July 24, 2003).

**Table 3. Net capital inflows** (percent of GDP)

Country	1999	2000	2001
Czech Republic	13.9	13.0	12.9
Estonia	8.0	7.9	5.7
Hungary	9.9	4.7	1.2
Latvia	11.6	6.9	12.4
Lithuania	9.9	6.2	6.5
Poland	5.6	5.4	2.5
Slovakia	8.7	7.6	n.a.
Slovenia	2.9	3.8	6.4

n.a. = not available

Sources: European Bank for Reconstruction and Development and International Monetary Fund.

**Table 4. Exchange rate regimes and monetary policy frameworks**

<b>As of December 31, 2001</b>			
<b>Country</b>	<b>Exchange rate regime</b>	<b>Monetary policy framework</b>	<b>Current practice</b>
Czech Republic	Independent float	Inflation target	No change since 2001
Estonia	Currency board based on the euro, 1 euro = 15.6466 kroons	Exchange rate target	No change since 2001
Hungary	Peg to euro within horizontal band, central parity 1 euro = 276.1 forints, band width of +/- 15 percent	Exchange rate target, inflation target	Central parity changed in June 2003, 1 euro = 282.36 forints
Latvia	Conventional peg to the SDR, 1 SDR = 0.7997 lats	Exchange rate target	No change since 2001
Lithuania	Currency board based on the US dollar, 1 US dollar = 4 litas	Exchange rate target	Currency board based on the euro since February 2002, 1 euro = 3.4528 litas
Poland	Independent float	Inflation target	No change since 2001
Slovakia	Managed float	No explicit nominal anchor; monitors variety of indicators	No change since 2001
Slovenia	Managed float	Monetary aggregate target	No change since 2001

SDR = special drawing rights

Sources: International Monetary Fund and national central banks.

If the goal is to enter EMU as soon as possible after accession in May 2004, how soon could it be achieved? The assessments of convergence with respect to inflation, fiscal policy, and long-term interest rates require a single year's data. The assessment of exchange rate convergence, however, applies to the two-year period preceding the assessment, although the treatment accorded to Finland and Italy in 1998 suggests that a somewhat shorter period may suffice in the case of a country that will have spent two full years in ERM II prior to actual EMU entry.<sup>21</sup> Putting it all together, an accession country that adheres to ERM II in the fall of 2004

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***The larger accession countries should delay their adherence to ERM II until they are confident that they are ready to satisfy quickly all of the other convergence criteria—pertaining to price stability, fiscal sustainability, and long-term interest rates—in order to minimize the amount of time in which they will be at risk of breaching the exchange rate criterion.***

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could qualify for assessment in the spring of 2006 and, with adequate preparation, could adopt the euro in January 2007.

What then is the best strategy for a country that wishes to adhere to ERM II in 2004? For a country to enter ERM II with the implied obligation to keep its currency within a 2¼ percent band would be like donning a straightjacket. The country might be unable to achieve the price stability required to enter EMU because it could not permit its currency to appreciate sufficiently to keep the Balassa-Samuelson effect from raising its inflation rate. But this is not the most worrisome problem. In the Irish and Greek cases, the European Commission was rather tolerant of currency appreciation and, in the Irish case, of outright revaluation. Like Charles Wyplosz,<sup>22</sup> we

attach much greater weight to the familiar problems posed by a narrowly pegged exchange rate. It cannot help an economy adjust to exogenous shocks, including fluctuations in capital flows, and it invites speculative attacks when market participants start to doubt that the currency peg will survive. Thus, we consider two possible alternatives to entering ERM II in the conventional way—a currency-board regime and unilateral euroization.

When considering the merits of a currency board, it is important to distinguish between the Baltic countries, which already have currency boards or have come close to having one, and the other accession countries, which have very different regimes. The Baltic States are small, do not have large financial markets, and, importantly, have probably earned the credibility required to safeguard a currency board against speculative attack. Furthermore, EU officials are prepared to treat a currency board as a regime consistent with adherence to ERM II. They view it as constituting “a unilateral decision augmenting the relevant countries’ obligations under ERM II while not implying additional commitments for the ECB” (Solans 2002).

This official endorsement may owe much to the fact that the Baltic countries with currency boards have had long-lasting success with them, and the EU authorities are therefore hesitant to ask that they undertake a “double regime shift” in order to join EMU. Yet there is another reason to endorse a currency board as being consistent with ERM II. It does not deprive the EU authorities of their legal right to approve the central rate at which a country enters ERM II. As Solbes (2003) puts it, “The new Member State wishing to keep the currency board will be subject to the common procedure established by the European Council Resolution of June 1997 on the establishment of ERM II, which means that the central rate parity will have to be agreed multilaterally.” As a practical matter, however, any change in the parity, whether on entering ERM II or thereafter, could impair the credibility already earned by a currency board.

A move to a currency board, however, may not meet the needs of other accession countries that have more sizable financial markets and more flexible exchange rates. A newly created currency board would not earn instantaneous credibility and could therefore be inferior to an even stricter regime—unilateral euroization. Because it is virtually irreversible, euroization would serve as a device to borrow credibility from the ECB—the issuer of the euro. For this and other reasons, unilateral euroization has been advocated by Andrzej Bratkowski and Jacek Rostowski (2002b) for Poland and by Willem Buiter and Clemens Grafe (2002) more generally, as a way

<sup>21</sup> Finland entered ERM I in October 1996 and Italy reentered it in November 1996, 15 and 16 months, respectively, before the evaluation of March 1998. Buiter and Grafe (2002) and von Hagen and Zhou (2003) have also noted this distinction between the two-year Treaty requirement and the somewhat shorter stay before the evaluation.

<sup>22</sup> See “Do Not Impose a Currency Crisis on Europe,” *Financial Times*, June 16, 2003.

station between a floating exchange rate and full EMU membership. Yet euroization has been ruled out by the EU authorities as being “inconsistent with the rationale of EMU” (Solans 2002).

One possible reason for the objection to unilateral euroization has to do with the choice of the euro conversion rate. Like the exchange rate chosen for entering ERM II, the conversion rate at which a country enters EMU must be approved by the EU authorities. Yet this requirement could be met if euroization were to occur as an agreed alternative to joining ERM II—what Buiter and Grafe (2002) describe as “consensual” euroization. The EU authorities could be asked to approve the equivalent of the ERM II central rate (i.e., the rate at which euroization would take place) on the explicit understanding that this would likewise be the conversion rate at which the country would enter EMU later. (Although different procedures and bodies are involved in making the two decisions, there is no insuperable obstacle to integrating them.) A subsequent revaluation would not be feasible under this arrangement, but would be equally difficult in the case of a currency board. In short, the European Union’s need to maintain control over the euro conversion rate is not a compelling obstacle.<sup>23</sup>

The European Union has raised a second objection to euroization, reflecting its views about the integrity of the convergence process:

. . . any unilateral adoption of the single currency by means of “euroisation” would run counter to the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the *endpoint* of a structured convergence process within a multilateral framework (European Commission 2001, 2; emphasis added).

This policy brief has taken a different, more pragmatic view of the rationale for the convergence process. It was meant to ensure that the countries joining EMU would bear the costs of adjustment prior to EMU entry rather than shifting that cost onto the nascent euro area. The European Commission’s view, by contrast, implies that the convergence process is meritorious in itself, although circumstances are different today than they were before EMU began. We find it somewhat odd, moreover, that EU members are barred from adopting the euro with-

out partaking of that process, whereas countries outside the European Union are free in principle to adopt the euro. It may be appropriate to insist that EU members achieve convergence before entering EMU, acquiring influence over ECB policies, and expecting the ECB to add them fully to its policy domain. It is less obviously appropriate to bar them from adopting the euro unilaterally.

### Recommendations

Earlier parts of this brief made several recommendations. Some were addressed to the European Union and, in the first instance, the European Commission. Others were addressed to the governments of the accession countries. Here is a summary:

The European Union should modify the way in which it applies the principle of equal treatment to take explicit account of the important difference between conditions prevailing before EMU came into being and those prevailing today:

- (1) It should recast the benchmarks used to assess compliance with the inflation-rate and interest-rate requirements contained in Article 121 of the Maastricht Treaty. These should be based on the inflation rate and average long-term interest rate prevailing in the euro area, not those prevailing in the “three best-performing” EU countries.
- (2) Now that ERM II has replaced ERM I, the exchange rate requirement contained in Article 121 should be assessed by applying the 15 percent standard band of ERM II, not the 2¼ percent normal band of ERM I. To persist in the practice adopted heretofore would deny the accession countries full use of the standard band when, as required, they adhere to ERM II in order to qualify for EMU entry.

These recommendations may require amendments to the text and protocols of the Maastricht Treaty.<sup>24</sup> The small number of changes needed, however, could be made quickly by the intergovernmental conference (IGC) that will soon convene to consider the new EU Constitution drafted under the leadership of Valéry Giscard d’Estaing. The amend-

<sup>23</sup> von Hagen and Zhou (2003) have also objected to the inconsistency of opposing euroization on these jurisdictional grounds while endorsing the use of a currency board based on a rigidly fixed exchange rate that is almost certain to serve as the conversion rate.

<sup>24</sup> Article 6 of the Protocol on the Convergence Criteria says that the Council of Ministers, acting unanimously, shall adopt language to replace the protocol itself, and some have taken this to mean that changes like those proposed in the numbered paragraphs above could be made without amending the language of the Treaty itself. But that is not true, because some of the relevant language in the present protocol replicates language used in Article 121 of the Treaty, and it would thus be necessary to modify that language too.

ments, moreover, should apply not only to the accession countries but also to other EU countries that have not yet entered EMU, such as Sweden and the United Kingdom.<sup>25</sup>

If these amendments are adopted, some of the accession countries may be able to qualify for EMU entry in little more than two years after they join the European Union itself in May 2004. If the amendments are not adopted, it may take them much longer to qualify for EMU entry, mainly because of the risks and costs posed by early adherence to ERM II, if exchange rate stability is to be assessed using the narrow 2¼ percent band rather than the wide 15 percent band of ERM II itself.

The problem may not be serious for the Baltic countries; they can fit their currency-board regimes

into ERM II without risk of breaching the 2¼ percent band. The problem may be very serious for the larger accession countries, which are more likely to experience sudden fluctuations in capital flows that could destabilize their pegged exchange rates. Hungary's recent experience is particularly relevant; it began "shadowing" ERM II a couple of years ago and has already experienced capital-account fluctuations that have driven the forint beyond the 2¼ percent band.

The larger accession countries should therefore delay their adherence to ERM II until they are confident that they are ready to satisfy quickly all of the other convergence criteria—those pertaining to price stability, fiscal sustainability, and long-term interest rates—in order to minimize the amount of time in which they will be at risk of breaching the exchange rate criterion. It is especially important that they reduce their budget deficits because market participants are apt to monitor closely the countries' progress on that front. It would be imprudent and counterproductive for a country to enter ERM II and then fail to keep its currency within the narrow band. That would greatly impair its credibility, and it would then have to make a second attempt under adverse circumstances; market participants might well believe that it would fail again. Early entry might be better, but later would be safer if the European Commission does not adopt a different way of assessing compliance with the exchange rate requirement.

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<sup>25</sup> The ECB has already proposed that the IGC amend the exchange rate criterion quoted in box 1. Instead of requiring "the observance of the normal fluctuation margins. . . , without devaluing against the currency of any other Member State," the ECB would require "participation in the exchange-rate mechanism for at least two years without severe tensions, in particular without devaluing against the euro" (ECB 2003). Deletion of the reference to the "normal" margins might be deemed to undermine the case for applying those narrow margins to the accession countries. But the ECB warns explicitly against that interpretation, which "would not be in line with the way in which the exchange-rate criterion has been applied in the past . . ." In other words, the amendment proposed by the ECB would not achieve our objective.

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