Adopting the Euro in the New Member States?

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1. **Introduction**

The adoption of the euro in the candidate countries is an issue that has both an economic and a legal side to it. The economic side of the question deals with considerations related to the choice of an appropriate exchange rate regime for a particular country or group of countries. As for the legal aspects, these stem from the Treaty on the European Union, and the associated legal documents, which underlie the whole process of accession, including in the area of exchange rate policy. While the choice of exchange rate regime for the accession countries is based on theoretical economic considerations, these will have to match with the Treaty requirements.

The economic discussion, which is presented in section 2, does not only treat the accession countries, but more generally the exchange rate strategies of non-EU countries, belonging to the group of developing and emerging market economies, which includes the so-called economies in transition.

Section 3 deals more specifically with the candidate countries, analysing the institutional and legal principles underlying the choice of an exchange rate regime for these countries, as well as the transition-specific economic considerations affecting this choice. Section 4 offers some conclusions.

2. **The choice of an exchange rate regime**

The international financial crises of the 1990s have intensified the discussions about the choice of the most appropriate exchange rate regime. For the developing and emerging market economies, these crises have highlighted the new challenges created by globalisation and the development of international financial markets, which accentuate both the benefits of sound economic policies and the costs of policy mistakes. In this environment, the consistency of the macroeconomic framework, including the exchange rate regime, is of paramount importance. It is therefore not surprising that renewed attention is being devoted to issues such as which exchange rate regime to adopt and how to adapt it to changes in the domestic and external macroeconomic environment.

Moreover, the international monetary system has seen the European integration process maturing in the creation of a single currency that has the potential to become a pole of attraction for emerging market and developing countries, which may consider the use of the euro as an element of their exchange rate strategy.

2.1 **The nature of exchange rate regimes**

Exchange rate regimes are usually classified along a continuum depending on their degree of flexibility, starting from currency union, as the extreme form of fixity, and ending with pure float at the other end of the spectrum. Various forms of intermediate, or pegged, regimes try to compromise between fixity and flexibility. Before entering the discussion on the merits of the various arrangements and the criteria that could guide policymakers in their choice, let us define the existing models starting from the least flexible one:
Ultra fixed regimes:

Currency union: this arrangement, with a common central bank, represents the ultimate economic, institutional and political commitment to fixity for the participating countries. In a less formal way, a currency union can also be the result of a voluntary or involuntary “dollarisation” process.

Currency board arrangements (CBA) involve almost the same level of commitment to fixity than currency unions. However, they generally do not imply any co-operation from the peg.

Pegged regime or regimes with limited flexibility:

Peg to a single currency: the country pegs to another currency, often a major reserve one, with the option of infrequent adjustment of parity.

Peg to a basket: the country pegs to a weighted composite of currencies of its major trading or financial partners. Currency weights are generally country-specific and reflect the geographical distribution of trade, services or capital flows but can also be standardised, such as the SDR. The adjustments of parity can thus be frequent.

Limited Flexibility vis-à-vis a single currency: the value of the currency is maintained within certain margins of fluctuation around a de facto peg.

Crawling peg: is a variant that allows resetting the peg periodically according to a pre-announced path or to adjust it quasi-automatically in response to changes in selected quantitative indicators.

Limited Flexibility within co-operative arrangements: this regime (for example, the exchange rate mechanism (ERM) of the European Monetary System (EMS)), which is difficult to classify along the continuum, merges a peg of each currency to others within the system and a joint float of the system with the rest of the world currencies.

Flexible regimes:

Managed float: the central bank supports the rate through frequent interventions aimed at achieving a ”equilibrium level” that depends on a set of broadly judgmental indicators, such as the balance of payments position, international reserves, or parallel market developments. Adjustments are thus not automatic.

Independent or Pure Float: rates are market-determined, with limited official intervention aimed only at smoothing out adjustments, rather than at trying to establish a specific level. In its purest form, the float is unfettered: rates are market-determined without intervention and economic policies are pursued with benign neglect for the exchange rate.

2.2 Recent evolution

Over the past two decades, many countries have forsaken currency pegs for mainly more flexible exchange rate arrangements but also for ultra fixed regimes. This trend has even intensified during the nineties. In 1975, a vast majority of developing countries had some type of pegged exchange rate regime; by 1999, only a bit more than a third maintained this kind of arrangement. When the relative size of economies is taken into account, the shift is even more pronounced. The shift towards flexibility has been gradual and its

1 Even this extreme form of fixity can be reversed as shown by the Czech-Slovak and by the FSU experiences.
reasons vary widely. After the breakdown in 1973 of the Bretton Woods system, many countries continued to peg to the same currency. Later, with the sharp exchange rate movements among major currencies, in particular the strong appreciation of the US dollar in the early 1980s, countries started to abandon single-currency pegs for a basket. The acceleration of inflation in many developing economies during the 1980s also played a key role by compelling countries with inflation rates higher than their main trading partners to devalue to prevent a severe loss of competitiveness. In the 1980s, many developing countries also experienced external shocks (steep rise in international interest rates, marked slowdown of growth in the industrial world, and the debt crisis) that often forced them to adjust the exchange rate level and/or to adopt more flexible arrangements.

More recently, the trend towards more flexible exchange rate regimes has been associated with more open and outward looking trade and investment policies and increased reliance on international capital flows, and hence market determined prices and interest rates. In such an environment, the most advanced developing economies, the so-called emerging market ones, have often deemed that they were ill equipped to defend a peg.

The recent financial crises has lent some credence to this view since most of them occurred in countries with pegged regimes and having important links to global financial markets. This has caused some academics and policy-makers to argue that, in a world of free capital movements, only “corner solutions”, namely either let the currency float or fix the exchange rate in a nearly irrevocable way, are sustainable. In their view, flexibility is one route since several emerging market countries with floating regimes succeeded in absorbing the shock wave. The other option of an ultra fixed regime is also viable since a few emerging market countries, with a very rigid exchange regime, also weathered the financial turmoil relatively well, e.g. Hong Kong, Argentina, Bulgaria, Estonia and Lithuania. In parallel, there has been increasing interest in official dollarisation or euroisation. This means the official adoption of the dollar of the euro as a legal tender in a third country.

2.3 Theoretical considerations

There are several theoretical considerations underlying the choice of a particular exchange rate regime. While this is an old debate, new developments during the 1990s have led to a renewed interest in the exchange rate question. Today’s literature on the factors guiding the choice of an exchange rate regime by developing and emerging market countries (henceforth called third countries) focuses on the merits of exchange rate based stabilisation in a high inflation environment, on the new constraints imposed by the globalisation and integration of capital markets, and on some political considerations, in particular in the framework of trade integration.

A fixed exchange rate, by providing an unambiguous anchor, can help establish the credibility of a disinflation program. Fixing the exchange rate is tantamount to placing an international constraint on national economic policies. It eliminates the possibility of using discretionary monetary policy to insulate the economy from the rest of the world. While this lack of monetary flexibility can be costly, it can also borrow credibility from outside. However, the credibility that authorities hope to gain from maintaining a fixed rate has to be backed by a readiness to act according to the requirements of such a choice. Monetary
policy is subordinated to the requirements of maintaining the peg, and fiscal policy must remain consistent with the peg, thereby “tying the hands” of the authorities. The more fixity, the stronger the constraints. Under an ultra fixed regime, the government may no longer (de jure or de facto) finance its deficit at the central bank. This disciplining should produce stronger fiscal positions.

Credibility of the commitment to fixity can have other advantages than limiting inflation. It can be perceived as limiting the exchange rate risk, thereby encouraging trade and investment. This perceived absence of a foreign exchange risk could also help reduce sovereign spreads and thereby contribute to limit foreign debt service.

However, fixed exchange rate regimes pose a number of challenges for emerging market economies engaged in a catching up process. Productivity gains in these countries may exert pressures for a real exchange rate appreciation, which can be achieved either through a nominal exchange rate appreciation or domestic price inflation. Inflationary pressures may be compounded by the capital inflows necessary to fuel GDP growth and to facilitate the transfer of technology. The tension between inflation and nominal exchange rate appreciation exacerbates the risk of a sudden turnaround in market sentiment. These countries would probably benefit from adopting a more flexible exchange rate regime.

By definition, the main advantage of flexibility is that it allows a country to pursue an independent monetary policy. It allows discretion by keeping national economic policy free from international constraints. In case of need, the authorities can use the exchange rate flexibility to adjust the economy. This brings more rapidly steam back in the economy than would the case under a fixed regime.

Some countries however are not prepared to bear the costs and economic consequences of a freely floating exchange rate. Small and open economies that can be highly affected by exchange rate fluctuations often prefer to opt for a pegged exchange rate regime, and rely on the flexibility of their fiscal policies, their labour and products markets and on a diversified production structure. They are generally relatively integrated to a country to which it is pegged and face shocks comparable to those faced by the country to which they peg. Of course high international reserves can help to reinforce the credibility of their peg.

2.4 The time dimension

It is important to include the time dimension in the choice of an appropriate exchange rate regime, including the idea of sequencing. In particular circumstances, e.g. in post-chaos economies with a strong need to import monetary stability, fixing the exchange rate can help in establishing the credibility of a disinflation programme. The resulting limitation of exchange rate risk should help in encouraging trade and investment, as well as in reducing sovereign spreads, thereby contributing to lowering foreign debt service.

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2 Though theoretically, excessive exchange rate variability seems at odds with a free-trade area or a single internal market, empirical studies have not been able to prove unambiguously that exchange rate volatility has adverse effects on trade and investment. It is probably a question of degree since the EMU experience of sharing a common currency is widely perceived as stimulating trade and economic integration.
For countries engaged in a catching up process, however, which become more integrated into global financial markets, there may be tensions resulting from the necessary inflow of capital and its impact on domestic inflation and international competitiveness. Also the productivity gains associated with the catching-up process may exert strong pressure on the price level in these countries, which would therefore benefit from a floating exchange rate regime.

More mature economies, in particular when they are highly integrated with their neighbours, may again benefit from greater fixity in the framework of a currency union. The choice of an exchange rate regime is the result of trade-offs that need to take into account the specific internal and external circumstances of a country. Given that these change over time, the appropriateness of an exchange rate regime should also take into account the extent by which regime changes are possible. The main conclusion is thus: no exchange rate regime is right for all countries or at all times. The optimal choice will vary from one country to another, depending on a number of economic characteristics. Given that these may change over time, also the optimal exchange rate regime for a particular country may evolve over time. It is thus important to opt for regimes which allow for such changes to take place rather smoothly.

3. Exchange rate regimes in the candidate countries

The exchange rate policy of the candidate countries is already now constrained by the fact that these countries will, in a couple of years time, join the EU. As such, they will adopt the whole acquis communautaire, which includes, eventually, the adoption of the euro.

3.1 No adoption of the euro upon accession

The process of monetary integration for the current and future Member States in the EU is defined in the Treaty and associated legal documents. A first, very important constraint is that since 1 January 1999, the EU is in the third stage of Economic and Monetary Union. This has a number of implications, and it means for example that an EU member state is either a member of the euro area, or a member state with a derogation. There are no other possibilities, as the EU is not prepared to grant any opt outs to the accession countries. These countries can not become member of the euro area upon accession, as this possibility is not allowed by the Treaty. The Treaty lays down the whole procedure that needs to be followed for a country in order to become member of the euro area (in art. 121 and 122). This procedure includes the requirement to observe the normal fluctuation margins of the ERM for at least two years. But a country can not join the ERM before it has become a member of the EU, so that, at least during two years, the candidate countries will not be in the possibility to become member of the euro area.

Besides these purely legalistic reasons, there are also economic reasons why the candidate countries should not adopt the euro immediately upon accession. The institutional and economic policy choices of the candidate countries must reflect the same economic rationale and sequencing as the one that was applied to

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3 The viewpoint on the optimal exchange rate policy for the candidate countries was adopted by the ECOFIN-Council in November 2000, and was endorsed by the Nice European Council in December 2000.
the existing EU Member States. This rationale pertains to the need for having achieved a sufficient degree of nominal convergence, before joining the euro area.

The participation in the euro area of the new Member States will take place when they comply with the conditions for the adoption of the single currency, i.e. the achievement of a high degree of sustainable convergence.

Although the economic criteria for accession demand a sufficient degree of macroeconomic stability to create a functioning and competitive market economy, too strict nominal convergence policies before accession would not always create the appropriate framework for rapid real convergence, especially for those countries where the necessary catching-up effort remains significant. The risks are that the candidates would rigidly orient their policies toward compliance with the convergence criteria in an effort to adopt the euro at the earliest possible opportunity after accession. Indeed, several of the candidates have already expressed an aspiration to adopt the euro very soon after accession. This is not in their interest, and the new member states will join the EU with the status of member state with a derogation.

3.2 A staged process for the adoption of the euro

Based on the treaty, one can identify three distinct phases for the monetary integration of current candidate countries:

(1) The pre-accession phase;
(2) The accession phase, covering the period from the date of accession to adoption of the single currency;
(3) The final phase of the adoption of the euro.

During the pre-accession phase, candidate countries carry out the economic reforms and policies needed to fulfil the Copenhagen economic criteria. The Copenhagen criteria relate to the existence of a functioning market economy in the country under consideration, as well as to its capability to cope with the competition in the Single Market. The Commission Services have developed a number of criteria on how to assess a country’s compliance with both criteria. These are not related to the exchange rate regime. That implies, that in principle these countries can adopt whatever exchange rate regime they wish to prior to accession.

They also adopt and implement the required EMU-related legislation to become a Member State with a derogation:

- Completion of the orderly liberalisation of capital movements (Art. 56).
- Prohibition of any direct public sector financing by the central bank (Art. 101) and of privileged access of the public sector to financial institutions (Art 102).
- Alignment of the national central bank statutes with the Treaty, including the independence of the monetary authorities (Art. 108, 109).

After accession, according to Article 122(2), a Member State with a derogation can request at any time the application of Article 121(1) to determine if it fulfils the necessary conditions to adopt the euro, and to
abrogate the derogation. Otherwise, according to the same Article, the procedure will be applied at least once every two years.

In view of the proper sequencing of economic integration, it is important to stress that participation in EMU presupposes participation in the Single market. The establishment of the Single market preceded the completion of EMU and the adoption of the euro, for present Member States. By the time of accession, the full liberalisation of capital movements will be largely accomplished, except for any transition measures that may have been obtained during accession negotiations. Similarly, the free movement of goods, services and persons will be largely implemented except for any transition measures.

During the accession phase, the candidate countries will have to comply with the relevant Treaty provisions as a Member State with a derogation:

- Treatment of exchange rate policy as a matter of common interest and, at some stage, participation in the exchange rate mechanism (Art. 124).
- Treatment of economic policies as a matter of common concern and co-ordination of economic policies between the Member States through participation in Community procedures (Arts. 98 and 99).
- Avoidance of excessive government deficits and adherence to the relevant provisions of the stability and growth pact (Art. 104).
- Further adaptation of the national central bank's statutes with a view to integration in the ESCB (Art. 109).
- Progress towards the achievement of a high degree of sustainable convergence (Art.121).

From the point of view of economic and monetary integration, the policy sequencing should be oriented first to a completion of market reforms with progressive integration in the Single market and gradual adoption of the rules pertaining to it. When this stage is completed, the accession will happen with participation in the single market and in EMU as a country with a derogation from the adoption of the euro. Adoption of the euro will follow when a high degree of sustainable convergence has been demonstrated within the Single market. These policy considerations should therefore be the overriding concern of the candidate countries in the definition of their strategies.

3.3 Shifts in exchange rate strategies to date

There has been already an extensive evolution in the candidate countries in exchange rate arrangements and regimes to date. Practically all countries have experienced at least one exchange rate regime change during the transition. Some countries have experienced a spectrum of different regimes during that period, either through progressive and orderly adaptations (Poland) or through forced exit (Bulgaria, Czech Republic, Slovak Republic).

While it is difficult to detect a clear pattern, there seems to have been a shift away from the more intermediate regimes towards “corner solutions”, mostly in the direction of more flexibility. However, given that the types of exit have differed significantly (orderly or through exchange rate crisis or failed stabilisation attempts), and that some countries have experienced successive changes while others have successfully maintained long-standing arrangements, it is difficult to identify a pattern or a trend in regime
shifts. This in itself supports the premise that exchange rate regimes are not the key policy element for success.

Moreover, candidate countries with differing exchange rate regimes and monetary frameworks but committed to structural reforms and fiscal accountability have managed to record success in economic performance and in reducing inflation. This achievement emphasises that the importance of exchange rate regimes should not be overestimated.

### 3.4 Factors determining the exchange rate regime choice

There are specific, transition-related factors, that affect the exchange rate regime choice in the pre-accession phase in the ten candidate countries going through transition.

#### 3.4.1 Changing disinflation strategies

In the initial stage of transition, when markets are non-existent, relative prices distorted, and hyperinflation and macro-economic instability require urgent solutions, a fixed exchange rate regime can be a useful instrument by anchoring the price of tradables to prices prevailing abroad. The peg of the exchange rate to that of a country with low inflation will tend to produce low domestic inflation. In such a chaos economy, monetary policy is not effective in combatting inflation. The financial sector is still very weak and suffers from recurring banking sector crises, while the instability in the demand for money and other financial assets, together with strong real supply-side shocks, make it impossible to accurately forecast money demand. Also the actual tools to regulate money supply are inappropriate in such circumstances. Another argument for initial exchange rate pegs is the likelihood of exchange rate overshooting during money-based stabilisation. In addition, a peg bolsters the government's commitment to the stabilisation effort by establishing clear targets and by tying the government's own hands, especially when public finances are still weak. Exchange rate stabilisation has been most successful in countries with hyperinflation and it has produced, as an added benefit, the reduction of nominal rigidities and backward looking indexation. The Baltic countries, particularly Estonia, and more recently Bulgaria are such examples in the candidate countries.

However, policy priorities can change once this initial stabilisation is accomplished. When inflation is no longer at hyperinflation levels, but a lower level of 10-30% is reached, real money demand can stabilise significantly and the underlying equilibrium real exchange rate can appreciate substantially, both because of a reversal in the early real depreciation (all pegs in the candidate countries were established following a very sizeable nominal devaluation of the exchange rate) and because of structural reforms leading to productivity improvements. In that stage, the limits of external anchoring become evident and disinflation strategies can sometimes outlive their usefulness. A number of candidate countries have abandoned their fixed peg for a more flexible regime.
3.4.2 Exchange rate flexibility, relative price adjustment and trend real exchange rate appreciation

For some time to come, all countries will exhibit differences in the average price level and price structure with the EU and some will still undergo relative price adjustments. They could experience real exchange rate appreciation and some real exchange rate variability in the years ahead, as they continue to go through transition reforms and a catching-up phase. This fact has consequences for the choice of exchange rate regime. Indeed, real appreciation could be achieved through nominal appreciation rather than through higher domestic inflation. Reaching low inflation may thus require some nominal exchange rate appreciation.

Later on, as the productivity and investment gap narrows in a more mature phase of the catching-up, there may be the opposite need for some real downwards exchange rate flexibility, to give room for their enhanced production and export capacity.

The trade-off will then be between nominal depreciation and lower domestic inflation. However, at this stage of the transition, concerns over competitiveness should not be overplayed, specially in those countries with flexible input and output markets, as there is no harmful evidence. With respect to CPI-based real exchange rates, most of the countries are showing real appreciation, as they have higher inflation rates which are not compensated by nominal devaluation. However, ULC-based real exchange rates are often showing depreciation, as a result of improved productivity and moderate wage developments. Therefore, in general, their competitiveness is not negatively influenced by real exchange rate developments. Moreover, there are historical examples in the EU in which real appreciation has actually worked as an incentive to upgrade the quality of exports.

In any case, certainly during this phase of the transition, there are therefore sound economic arguments which would plead in favour of a more flexible exchange rate regime.

3.4.3 The nature of shocks and the nominal exchange rate

The traditional criteria for exchange rate regime choice are obviously relevant for the candidate countries in the pre-accession phase. Among these criteria, the type of random disturbances that an economy undergoes is a factor for determining an appropriate exchange rate regime. Indeed, the effectiveness of exchange rate policy as a tool for adjustment will depend primarily on the nature of shocks and on the existence of other adjustment mechanisms.

A fixed exchange rate is generally superior if the disturbances to the economy are predominantly domestic nominal shocks, such as money market imbalances, whereas a flexible rate is preferable to deal with foreign shocks or domestic real shocks, such as productivity shocks or shifts in the demand of domestic goods. These results are however based on downwardly rigid costs and price models of output determination.

The nature of the shocks of a domestic origin that are likely to characterise, in the next few years, the candidates' economies, are obviously of both types. Clearly, a shift in the exchange rate regime in response
to the nature of each shock is an unworkable choice. Certain types of nominal shocks, such as banking and financial sector crisis, cannot be ruled out all together, in any of the candidate countries, particularly in those where reforms have lagged.

With progress towards market reforms and economic integration and greater credibility, the possibility of real asymmetric shocks vis-à-vis the euro zone is likely to become less frequent. Nevertheless, real shocks could be more frequent than domestic nominal shocks.

In essence, it is the ability of the economy to deal with shocks which determines whether or not the exchange rate is an indispensable tool for adjustment. A country characterised by flexible wages and prices, does not need exchange rate flexibility since movements in relative prices occur relatively easily. Under such conditions, fixing the exchange rate imposes the stability of nominal magnitudes, but does not lead to a loss of real flexibility.

Countries with unresolved rigidities in wage and price determination and poor credibility might find a fixed exchange rate regime excessively difficult to sustain, as long as they do not correct these problems.

### 3.4.4 Small and open economies in the candidate countries and fixed exchange rates

Many of the candidate countries are small open economies, and all the traditional arguments which are used to determine the appropriate exchange rate regimes in small open economies apply also here. The standard conclusion on small open economies is that they benefit greatly from pegging their exchange rate to that of the main trading partner, as this helps to promote foreign trade by reducing uncertainty about import and export prices. In these cases, it is the real exchange rate which adjusts to changing economic circumstances and shocks, not through changes in the nominal exchange rate, but through changes in wages and prices. For these countries, the flexibility of wages and prices is therefore even more important. To date, Estonia’s successful experience with a Currency Board Arrangement provides a credible example of the combination of these factors with a sustained track record.

### 3.4.5 Dealing with capital flows

A determining factor in exchange rate regime choice will be its appropriateness in dealing with accession-related capital inflows and the movement towards capital liberalisation that is part of the Single Market acquis.

As accession nears, it can be expected that the attractiveness of the candidates as a destination for foreign direct investment will increase, but also that portfolio flows and short term capital inflows, sometimes of a speculative nature, increase as interest rates are bid down, but still higher than those prevailing in the euro area. In the future, such flows could also increase due to financial innovation and the development of more sophisticated financial products on their domestic financial markets.

Generally, capital inflows are easier to deal with under more flexible exchange rates. Exchange rate uncertainty can be expected to discourage the more volatile, speculative flows. Furthermore, under a fully flexible exchange rate system, capital inflows will lead to an appreciation of the currency, a drop in the
relative price of imported goods, and a shift of consumption away from non-tradables, all of which tend to alleviate inflationary pressures.

Therefore, all other things being equal, the more flexible the exchange rate, the less likely it is that capital inflows will have an inflationary effect. However, faced with large and persistent capital inflows, a tightening of fiscal policy is generally the only way of containing inflation and avoiding real appreciation, under any exchange rate regime. Moreover, fiscal adjustment will lead to relative price changes when markets are flexible.

All these different considerations again do not lead to an unequivocal choice for one regime or the other. The conclusion is, again, that no single exchange rate regime is to be preferred for all countries at all times. The ultimate choice, therefore, depends on country-specific factors, and may change over time. For this last reason, it is very important that countries do not opt for regimes without a realistic exit option. Finally, it should be stressed that the consistency of economic policies is more crucial than the choice between fixed and floating exchange rates for the candidate countries today. Sound fundamentals are needed to underpin a credible commitment to any exchange rate regime. These fundamentals include fiscal discipline, an adequately supervised and regulated financial system, well-functioning labour markets, the rule of law, and an adequate level of international reserves in the case of a fixed exchange rate.

Furthermore, given the liberalisation of capital inflows that integration to the EU requires, it is clear that fiscal policy adjustment is the most effective instrument to reduce internal and external imbalances. Capital flows are sensitive to the level of interest rates. This puts the onus on fiscal policies to limit excess domestic demand and moderate real appreciation pressures, resulting from successful economic transformation and the attraction of foreign investment. In addition, while the financial system is fragile and/or underdeveloped – and this is still the case perhaps in all candidate countries – tight fiscal policy would be the only safe and robust route to stabilisation.

3.5 The participation of future member states in the ERM2

The ERM2 is a system with a very wide standard fluctuation band, which offers scope for significant exchange rate movements around central rates vis-à-vis the euro. In comparison with the EMS, the realignment of central rates is facilitated. Participating countries can also establish “closer links” with the euro by negotiating narrower fluctuation margins on an individual basis. These features, and in general the flexibility provided for by the ERM, could constitute an advantage for the future participation of the candidate countries.

The ERM2 could offer future Member States two types of benefits:

- benefits linked to credibility deriving from a bilateral link to the euro, e.g., in terms of providing an anchor for macroeconomic policies, lowering interest rate premia, attracting capital inflows etc.
- benefits linked to the flexibility of the mechanism, deriving from the width of the standard bands, timely realignments and the possibility of closer exchange rate links when appropriate.
The transition path to the adoption of the euro would be likely to vary among the candidate countries and a series of steps (implying possibly different exchange rate arrangements for each country which would evolve over time as economic convergence is achieved) toward a more and more stable exchange rate with the euro can be envisaged. A rather diverse set of regimes, within a single broad framework of the ERM2, is more likely to prove optimal. The ERM2 framework seems to provide sufficient flexibility to incorporate these diverse regimes.

It can be expected that, by the time of accession or shortly after, most candidate countries will have achieved levels of inflation, which would allow for a credible entry in the ERM2. It should be noted that many candidate countries have already indicated, in the context of the accession negotiations, that they intend to join the mechanism as soon as possible after accession, with the anticipation that they can sustain a period of participation without realignments to qualify for the adoption of the euro within a minimum period of two years. While it is impossible at this stage to assess whether such anticipations are credible, it can be expected that some countries will need more extensive exchange rate flexibility or even realignments, which could delay their fulfilment of the exchange rate criterion.

All this points to the conclusion that the ERM2 will be an appropriate instrument for the economic situation of most candidate countries after accession.

4. Summary and conclusions.

The exchange rate policy choice from pre-accession to the adoption of the euro must take into account several factors. Among these are: facilitating growth and real convergence, helping integration to the EU, adjustment to real shocks, maintaining external balance, and containing exposure to reversible capital flows, while preparing for entry in the ERM2 and, in due course, for the full adoption of the euro. There is clearly a case for diversity of the exchange rate regimes between now and accession, and possibly also beyond. The institutional framework of the Treaty for the progressive monetary integration of the candidate countries in EMU should allows for such diversity. The Treaty identifies three distinct phases for the full monetary integration of candidate countries: the pre-accession phase; the accession phase, covering the period from accession to adoption of the single currency; and the final phase of the adoption of the euro. The implication of each phase for exchange rate policy is:

1. Prior to accession there is no formal restriction on the choice of exchange rate regime.
2. Upon accession, new Member states must adopt an exchange rate policy as a matter of common interest (Article 124).
3. After accession, although not necessarily immediately, join the ERM2. When the convergence criteria are satisfied, the country will adopt the euro.

The open issue in this sequence is the integration in the ERM2. The key features of the ERM2 are the stable but adjustable central rate with standard fluctuation band and that it uses a common procedure for the main decisions relating to the conditions of the participation of a country in the mechanism. The
multilateral nature of this procedure implies that, prior to the request for participation, it is difficult to
determine under what conditions a particular currency will be allowed to participate. Moreover, these
decisions will have to be taken on a case-by-case basis at the time of entry in the mechanism. The ERM2
could accommodate different situations, and its design will help to avoid unnecessary adaptations or exits
from current exchange rate regimes provided that the countries’ commitments and objectives are credible
and in line with those of the ERM2.