

Towards the euro-zone through the ERM II – Countering Fallacies

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This paper sheds light on and, subsequently, rebuts the arguments often quoted by the opponents of the early euro-zone enlargement. In particular, the issues of overheating, structural and real convergence are touched upon. Next, the exchange rate mechanism II (ERM II) is scrutinized, with a special focus on its susceptibility to capital flows disturbances. In this part, credibility of the ERM II framework, its disciplining role and flexibility are dealt with. Moreover, adjustment mechanism of this exchange rate regime is set against alternative options, a floating exchange rate

system and a currency union in particular. Against this background the dispute over whether the ERM II should serve as a “useful framework” or merely a “waiting room” is settled, with the latter view deemed to correspond more closely with the facts. This is followed by the list of the ambiguities to be cleared up and indeed feasible amendments to this framework – the measures aimed at making the “waiting room” a more useful solution. The final section concludes.

Introduction

Recently, we have witnessed a lively debate on whether the accession countries (ACs) should enter the euro-zone at their earliest convenience or maybe defer that decision until the moment when they have achieved a sufficient

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real convergence with the current EMU members. In the case of the latter scenario, the issue has been raised that the ERM II may serve as a useful framework, within which the candidate countries might be advised to remain for more than the required period of two years.

The aim of this paper is to counter the fallacies both supporting delayed membership of the ACs in the euro-zone and extolling the seemingly favourable nature of the ERM II. In the first part we intend to show that the arguments against fast introduction of the euro seem to be weak. In the next step various drawbacks and risky nature of the ERM II are brought to light. Finally, concluding remarks are drawn, followed by some suggestions for possible amendments to and interpretation of the so far unclear rules of the ERM II.

1. Should euro-zone participation be postponed?

1.1. The risk of overheating

In this part of the paper some allegations related to the lack of preparedness of the ACs to adopt the euro are discussed. One of the quoted arguments deals with the issue of overheating, which prospective euro-members would suffer from. It would result from an abrupt easing of credit conditions in the ACs, subsequent to entering the euro-zone. In this context, however, some qualifications need to be made.

Firstly, the distinction between overheating – understood as an unsustainable and excessive increase in domestic expenditures – and the state of merely inflationary country-specific pressure should be made. The ACs on their way to the euro-zone will most likely continue to maintain some current account deficits, not excluding their deterioration. It will mirror relatively high domestic spending, in terms of both investment and consumption. Current account deficits will then be financed by capital inflows. This would reflect a typical situation in the catching-up economies. Domestic expenditures might therefore exceed the domestic product and its potential level. A country in such a situation, however, should not be doomed to collapse prematurely, for it may simply reflect both good investment opportunities and inter-temporal welfare optimization. Nevertheless, it is difficult to evaluate *ex ante* whether such a state is sustainable and the real exchange rate has reached its long term equilibrium. Therefore, this is a starting point for allegations that an adoption of the euro too early might lead to excessive domestic expenditures and, subsequently, inflationary pressures and excessive fluctuations of the real exchange rate, which would entail significant economic costs (in particular in the case of real depreciation at fixed nominal rate).

Secondly, it would be useless to question mere a possibility of overheating – or at least country-

specific inflationary pressures – in the euro-zone. In fact, according to the European Commission (2001), it has already taken place in some member countries, Portugal, Ireland, and Finland in particular.

Thirdly, real appreciation reflected in inflation differentials should not be prejudged in a negative way. Balassa-Samuelson effect might be one of the explanatory factors. Moreover, even though inflation in some new euro-members might be higher than the area average level, their economic weight will be too low to compel the “old members” to tighten a single monetary policy to the extent that would be too restrictive for them (Welteke, 2002). Therefore, it would seem little justified to prevent the ACs from entering the euro zone under the pretext of their inflation running somewhat above the average euro-zone level, for it might simply reflect their more dynamic economic growth.

The abrupt convergence of nominal interest rates is considered to add considerably to the risk of overheating. If real interest rates fell below the natural interest rate, it would lead to higher inflation in such a country (Brzoza-Brzezina, 2003a). According to the European Commission (2001), in some countries, interest rates needed to come down from high levels to converge to the core euro-area level in the run-up to the start of Stage 3 of EMU on 1 January 1999. Due to this monetary policy convergence, interest rates were brought down rapidly in Ireland, Spain and Portugal. Nominal short-term interest rates were brought down from 5 to 6% levels at the start of 1998 to 3% in January 1999. This monetary easing has significantly influenced GDP growth and inflation in 1999 and 2000 (...) Moreover, increasing inflation rates lower real interest rates further as the extent of overheating increases, thereby providing a destabilizing factor. Furthermore, secondary effects of the low interest rates and the financial cycle reinforce macroeconomic cycle, most notably increasing asset prices”. Similar arguments are put forward by Kroger (2002): Since the interest rates would in nominal terms be pushed down to that of eurozone, but would in real terms lie far below, there would be serious distortions in behaviour at a microeconomic level. Too many investment plans would be profitable, too much consumer spending would be brought forward. The financial markets, being completely liberalized, would not be in a position to help allocate capital efficiently.

Although under a single monetary policy some inflation differentials are inevitable, as already admitted, it does not “automatically” imply that lower real interest rates in the countries experiencing higher inflation will lead to excessive expenditures and, in particular, capital misallocation.

Let us consider this problem in more detail. If a country's competitiveness improves, it may lead to its currency nominal appreciation and appreciation

expectations. Provided that the interest rate parity holds, such a situation, *ceteris paribus*, should result in domestic nominal interest rates staying below the level abroad. Domestic interest rates fall should not therefore be perceived as a potential source of capital misallocation, for it would simply reflect expectations of higher profitability of investment in terms of foreign currency, being the result of the domestic economy's competitiveness enhancement and expectations of its currency subsequent appreciation.

If nominal appreciation were not an option, as under fixed exchange rate regime, some real appreciation would take place through relative increase of inflation while domestic and foreign nominal interest rates would be maintained at the same level. Capital allocation would still meet the condition of equalizing the rates of return in the country and abroad in terms of both domestic and foreign currency. Consequently, there would be no scope for a capital misalignment argument.

To illustrate that in a different way, let us notice that when nominal interest rates converge (assume that exchange rate is fixed), the nominal cost of capital will be equal both in the home country and abroad, and so would be the rates of return in these countries. Although the real cost of capital deflated with a respective domestic price index would be lower in a country experiencing relatively higher inflation, the same would apply to the real rate of return (deflated with the same index). The crucial point is that both the cost of capital and the rate of return deflated with the same (either a national or an area average) price deflator would be internationally equal.

The conclusion to be drawn from the foregoing arguments is that differences in real interest rates do not necessarily lead to capital misallocation.

However, when inflation expectations turned out to be misguided, this would result in a misperception of both the eventual real interest rate and future rates of return¹. In this case, capital misallocation might take place. In particular, in a flexible exchange rate regime, mistaken inflation expectations might reflect in the wrong formation of nominal exchange rate expectations and *ex post* interest rate disparity².

Therefore, it is false expectations and not inflation and real interest rates differentials that constitute a source of misallocation. Misguided expectations, mirrored in nominal exchange rate or inflation misjudgment, may take place in any exchange rate

regime. However, the euro-zone, a framework "endowed" with credibility and stability, should be conducive to more accurate investors expectations. It is rather a "fixed but adjustable" exchange rate regime, ERM II included, that is to be numbered among the least favorable systems in terms of expectations accuracy enhancement³.

Above-outlined train of thought is supported by findings of Juha Tarkka on the Finnish experience. In particular, he indicates that (...) *far from being neutral in terms of the real economy (...) the accommodative exchange rate policy encouraged inefficient industrial investment because devaluations in recessions shifted the downside of the firms' profit uncertainty to their creditors and workers. All in all, it was believed to have introduced powerful moral hazard effects into the investment decisions of export industries, in particular. Moreover, (...) considering the very high growth rates, which have been achieved concurrently with the decrease in investment ratio, it appears that the productivity of fixed capital has improved significantly. An interesting aspect of this is that the investment rate has remained low even though real interest rates have declined markedly after Finland's convergence to the stability oriented monetary policy regime.* Therefore, this statement seems to confirm the view that a shift to the environment of exchange rate stability and of lower interest rates should enhance effectiveness of investment against a background of more predictable economic processes.

In case of fast growing economies, such as the ACs, the catching-up process should be accompanied by relatively high investment expenditures. In particular, rates of return may be higher in these countries than abroad, largely due to relatively low labor costs. When most profitable investment opportunities have been exploited or/and there has been a sufficient labor cost (wages) increase, the rates of return would equalize internationally and investment spending would decline. Therefore, initial high investment spending reflects a process of equalizing rates of return rather than capital misallocation.

While focusing on consumption expenditures, there is also little reason to associate the convergence of nominal rates with a surge in spending. Consider that in terms of inter-temporal optimization. Consumption expenditures are subject to utility maximization:

$$U = u(c_1) + u(c_2),$$

where U is utility, β is a time-preference parameter and c_1 and c_2 are real consumption in period 1 and 2 respectively. Consumption distribution is subject to the lifetime budget constraint:

$$c'_1 + c'_2/(1+r) = y_1 + y_2/(1+r),$$

where c'_1 and c'_2 are nominal consumption

¹ In the presence of inflation, the rationale underlying misguided rate of return expectations and resulting real business fluctuations may be found in Lucas (1981, 1983). This could, however, influence production and investment decisions in the opposite direction than the misperception of the real interest rate. In practice, the impact of inflation expectations on misguided assessment of future incomes and costs should not prematurely be generalized.

² In this event, misallocation would apply to portfolio investment as well.

³ This issue will be developed in part two of this paper.

expenditures in period 1 and 2, r is the nominal interest rate on date 1 and y_1 and y_2 are nominal income in period 1 and 2 respectively. To turn equation 2 into real categories one has to divide c_2 , $(1+r)$, and y_2 by $(1+i)$, where i is expected inflation rate⁴. Assume that nominal future (period 2) incomes (wages) are given: due to wage contracts or – as in the case of Balassa-Samuelson effect – nominal wage increase reflecting productivity growth under a fixed exchange rate regime. Therefore, the level of expected inflation i does not affect c_1 and c_2 – whatever inflation is expected, given nominal future incomes and the nominal interest rate, nominal consumption spending remains unchanged⁵. As a result, falling real interest rates do not lead to the consumption boost and, subsequently, to overheating. Moreover, if actual inflation and thus *ex post* real interest rates turned out to differ from expectations, this would not change the rationality of prior consumption decisions, given the assumptions.

On the premise of the above reasoning the real interest rate would not affect consumption decisions. Moreover, even if it did influence consumers' spending (most likely reflected in consumption increase), this would still mirror consumers' optimization and, therefore, it would not be excessive.

Above-outlined train of thought indicates that lower real interest rates do not have to lead to excessive consumption spending. This could happen in case of misjudged inflation or income expectations, in particular if expectations turned out to be too optimistic with regard to nominal income growth, given the rate of inflation. Similarly to investment expenditures, consumption spending may lead to overheating not as a result of inflation differentials and ensuing real interest rates gap, but due to misguided expectations. As already emphasized, claiming that such market inefficiencies become more likely in a common currency area would be a feeble argument.

Another reason for excessive consumption spending might be loose credit conditions. However, this should not be associated with participation in a common currency area either.

1.2. Still more obstacles on the way to the euro – how relevant they are?

When raising an objection against early enlargement of the euro-area various other arguments are quoted. And

⁴ $c_2/(1+i) = c_2$, $c_1 = c_1$

⁵ The example presented here is little sophisticated. However, making it more complex does not change the conclusion (given the assumptions). Quoting Maurice Obstfeld and Kenneth Rogoff (1996, p. 232): "Notice that, for a given P_t (price level at time t – A.K., M.R.) *ceteris paribus* changes in real interest rates due to changes in future P_s have no wealth effect on C_t (consumption at t – A.K., M.R.). (...) A rise in P_s , say, lowers the real interest rate between dates t and s , raising the present real value of real income to be received later; but it also lowers the real consumption value of net date s income in proportion. The result is a wash, analogous to the effect of higher expected CPI inflation on the value of a CPI-indexed bond".

thus, it is often stressed that ACs' financial markets are still underdeveloped and insufficiently integrated with the world markets (Kroger, 2002). In fact, all these countries had fully liberalised capital flows by the Copenhagen Summit in 2002, for this factor constituted a prerequisite for EU membership eligibility. Therefore, in the ACs there remain no formal stumbling blocks to unconstrained both domestic and cross-border flows of capital. As for the development of their financial markets, transactions turnover on the forex market, e.g. in Poland, exceeds several times that of Greece or Ireland. Moreover, in Poland there are well developed inter-bank derivative markets (e.g. FX SWAP, FRA, and IRS), which are in fact an integral part of the international financial market. Notwithstanding that, shallowness of the ACs' financial markets cannot be entirely denied. Yet, it should not serve for the argument against fast enlargement. For whereas the EU entry will undoubtedly initiate acceleration in the process of financial integration of the new members with the EU internal market (yet itself still not completely integrated), the introduction of the euro currency should provide most powerful impetus for the desired development in this area (Galati and Tsatsaronis, 2001)⁶.

As for an allegation related to non-market functioning of the ACs' economies (Kroger, 2002), it both does not correspond with the facts and stays in contradiction with the official stance of the European Council, which has already recognised fulfilment of the Copenhagen Criteria by prospective EU members.

Another reproach concerns allegedly high share of bad loans in the ACs' banking sector (Kroger, 2002; European Commission, 2002a). In fact, in some of the candidate countries, notably in Hungary or Slovenia, the NPL ratio in 2001 (3.4% and 5.39% respectively – NBP, 2002) only slightly exceeded that for the EU countries in 2002, which amounted to 3.06% (ECB, 2003). Despite the fact that in other countries, Poland for instance, this ratio is higher, it should be borne in mind that it is often due to implementing much stricter rules for classifying a particular loan as a non-performing one⁷. And thus, in Poland the NPLs are fully covered with provisions. Accordingly, they do not cause an erosion of the banks' capital base. Therefore, despite the higher levels of the NPLs, the capital adequacy ratios for ACs' banking sector (e.g. in 2001: Czech Republic – 15.52%, Poland – 15.0%, Slovak Republic – 13.38%; NBP, 2002) have reached higher level than the EU average (12.29%, ECB, 2003).

As far as structural convergence is concerned, related to meeting the preconditions determined by the OCA literature, namely: real and financial openness,

⁶ This will be discussed in more detail in section 2.5.

⁷ There is no uniform definition for non-performing loans. National banking supervisory institutions, even within the EU itself, apply various criteria for calculating NPL ratio.

mobility of factors of production, high share of common trade, etc. (Gaspar, 2001), it is stated by the opponents of the fast euro-zone enlargement that before credibly fixing the exchange rate the ACs need to enhance labour and product market flexibility first. Moreover, they question the hypothesis about endogenous nature of the OCA criteria, according to which membership within a monetary union endogenously precipitates the process of generating the conditions, which are determinants for a successful participation in the common currency area (see: Rose, 2000; Frankel and A.K. Rose, 1998; Fidrmuc, 2001; Maurel, 2002). Therefore, the euro-sceptics uphold the conviction that the OCA criteria should maintain their relevance for the assessment of the ACs' suitability for a monetary union membership (European Commission, 2002a).

The foregoing reasoning, however, seems to overlook the fact that in the light of the OCA criteria some ACs are more suitable for monetary union membership than many current EMU members. And thus, *by 2001 the degree of the ACs' trade integration with the EU has reached a level which is comparable with that of many EU countries [...] A number of the ACs appear to have reached a high degree of cyclical co-variation with the euro area, which exceeds in some cases that of the less integrated current members of the euro area* (European Commission, 2002a). When measured by the share of exports of goods to the EU countries in the overall export volume, the Polish (68.7%), Czech (68.3%) and Hungarian economies' (75.1, OECD) convergence with the EU exceed that of the most of the current EU members, let alone the EU average (61.6%) (Eurostat/Comext 2003). As for flexibility of factors of production, many EU countries are characterized by more rigid labor markets than those of the ACs. In fact, it is most prominent national authorities that have currently admitted that. In particular, that the German economy is hampered by *the rigidity of the labour market and the tendency to over-regulate and to impose bureaucracy on government and corporate sector processes, which calls for greater flexibility in the institutional structures of the wage-formation process and in working conditions* (Deutsche Bundesbank, 2003). And thus, the EPL ratio⁸ for, *inter alia*, the Czech Republic, Hungary, Poland, Slovak Republic amounts to respectively: 2.1, 1.7, 2.0, and 2.4, whereas for Germany, France, Italy, and Portugal it equals 2.6, 2.8, 3.4, and 3.7 respectively (Knogler, 2002; Worldbank, 2002). Moreover, various additional reforms have been being implemented in the candidate countries, which should further enhance flexibility of their labor markets. Furthermore, if nitpickers persist, as the ACs are predominantly perceived as small open economies, it is claimed that

⁸ A measure of strictness of Employment Protection Legislation – indicators range from 0 to 4.

the costs of foregoing an independent monetary policy should not constitute too big a sacrifice for them (De Grauwe, 1997; Mundell, 2000).

The opponents of the fast euro-zone enlargement sometimes resort to the argument of insufficient real convergence, understood as a persisting income gap between the ACs and the EU-average. They stress that real appreciation of the currency relative to other countries should constitute a necessary means going in parallel with a successful real-economy catching-up process. However, if currency flexibility were constrained, they argue, real appreciation of a currency would have to be achieved through a higher rate of inflation. This in turn sheds light on the contradiction between the simultaneous achievement of nominal criteria, namely stable exchange rate and low inflation, and a successful catching-up process. In this context the above-outlined trade-off between fulfilling the Maastricht criteria and the goal of real convergence should discourage the ACs from joining the euro-zone in the near, allegedly too early, stage (Kroger, 2002). In this spirit, though not directly referring to real income factors, the EC (2002a) has stated that *due to the nature of the catching-up process, the BS effect [...] could make the combination of nominal exchange rate stability and low price inflation very challenging, and therefore achieving the inflation rate of the best-performers in the EU plus 1.5 pp could thus be inconsistent with the need for further catching up*. The similar attitude has been adopted by some prominent representatives of various institutions, Bundesbank in particular. Recognising that focusing too much on nominal convergence might postpone real convergence progress, they stress the need to comply with a latter process before entering the euro-zone by the ACs. At the same time they admit that the catching-up would be a lengthy process, for per capita income (in terms of purchasing power parity) in the candidate countries stands at around merely 40% of the EU level on average (Stark, 2003).

The above-outlined approach, however, lacks substance, for on both the theoretical and empirical grounds the real income level cannot serve for an argument against entering the currency union. If the BS effect turned out to be stronger than 1.5 pp "safety margin", it would simply reveal the short-run incoherence of the nominal criteria rather than provide for any relevant argumentation against euro-zone membership of the country in question⁹. The ECB, however, has repeatedly emphasised not very

⁹ In fact, the 1.5 p.p. safety margin relates not to the EU average but to its three best performers. After forthcoming EU enlargement, the group of potential "reference countries" will expand from a number of 15 up to 25. And thus, in October 2003 of 25 EU countries the lowest inflation was recorded in Lithuania (-1.0%), the Czech Republic (-0.2%), and Poland (0.6%). So far no formal decision has made it clear that countries with zero or negative price growth would not be numbered among "the best performers". If one applied the ECB's definition of "price stability" (related to the ECB's monetary policy

significant and diminishing importance of the BS effect. In addition, it has taken the position that *real and nominal convergence are complementary and should be pursued in parallel. [...] While the catching-up process may be a source of some upward pressure on prices through, for example, the Balassa-Samuelson effect and price liberalisation, structural reforms that improve the supply side of the economy and enhance growth potential are in general conducive to an environment of lower inflation and interest rates. Conversely, by anchoring inflation expectations and providing a more stable macroeconomic environment, nominal convergence is likely to have a positive impact on trade and investment, thereby supporting real convergence* (ECB, 2002b). Provided that real convergence, understood as a GDP per capita equalisation, has been legally binding, then – bearing in mind the current average pace of convergence – closing the “development gap” would seem to be a matter of decades rather than years, as admitted by the EC (European Commission, 2002a). In 2001 GDP per capita ratio for Poland, Hungary, and Slovak Republic amounted to 40%, 53% and 48% of the EU average respectively. Therefore, achievement of the less developed EU members’ level of income (in the year preceding their euro-zone accession), i.e. of Spain (79%), Portugal (72%), or Greece (65%), would undoubtedly constitute a long-term process (Eurostat Database). Postponing the moment of the euro-area enlargement, however, would give rise to a serious threat that incentives and commitment to implement necessary, but costly, not least politically, reforms may be weakened. As a result, such tightening of the criteria might be counterproductive as the real convergence progress might be scaled back.

Getting back to the issue of a potential inconsistency between nominal and real convergence, it is stressed that aiming at immediate fulfilment of fiscal criteria may hamper the catching-up process (Kroger, 2002). The underlying reason is that rapid structural changes incur immense expenditures, e.g. those related to high infrastructure investment. An extra burden imposed on public budgets of the ACs, and consequently – a high fiscal deficit, may be a necessary

strategy and not necessarily equivalent to the Maastricht price stability term), this would exclude deflation and 0% HICP inflation growth countries and thus, Lithuania and the Czech Republic, from the reference group. However, even that solution would not be free of drawbacks, for if a formerly deflation (or 0% HICP growth) country gets back to the positive price growth, thus becoming a new “best performer”, this would result in a plummet of the reference value. Moreover, the inflation criterion would become a very volatile figure, which would increase uncertainty as to the eligibility of an AC for euro-zone membership (Chmielewski and Rozkrut, 2003). As the ECB conducts monetary policy for the euro-area exclusively, and not the whole EU, one might argue that the reference group should comprise euro-zone members only. Although largely diminishing, it would not eliminate completely the above-outlined volatility problem. Therefore, other solutions may be suggested – compare: Rozkrut, M. IBnGR, 2003.

by-product of the successful catching-up process. Therefore, subjecting budgetary policy to the goal of nominal convergence might result in a sub-optimal policy assignment (European Commission, 2002a).

The above-stated reasoning, however, seems to overlook a very important aspect that at the moment of entering the European Union new members will become subject to the Stability and Growth Pact (SGP) rules. Recognising the fact that fiscal requirements imposed by the SGP are consistent with those that the Treaty entails, brings to light the fact that pursuit of fiscal criteria constitutes nothing but fulfilment of obligations enforced by the EU authorities. Moreover, imposed fiscal discipline may exert pressure on the reduction of mandatory expenditures, not least social transfers. This would be a win-win strategy, for while the just-outlined measures would be conducive – through investment-savings balance improvement – to a long-term economic growth of the ACs, the EU members would be ensured that the candidate countries would be economically stable and dynamic.

To close the discussion on the alleged undesirability of pursuing nominal criteria, it is worth to notice that majority of the ACs either have already fulfilled or are to fulfil in the near future most of the Maastricht requirements. Therefore, discouraging the candidate countries from completing the nominal criteria might be at variance with the SGP rules and would be equal to giving up an already achieved stage of nominal convergence, which would otherwise – through entitling the ACs to early euro-zone membership – help them accelerate the real catching-up process.

2. ERM II – a useful framework or merely a “waiting room”?

Recently, we have witnessed a lively debate on the role the ERM II should play in the new members’ run-up to the euro-zone. On the one hand, there are those (the ECB in particular), who extol the virtues of this mechanism pointing that *ERM II offers a meaningful framework for combining nominal and real convergence and should therefore not be seen as a mere “ante-chamber” before the adoption of the euro* (ECB, 2002). On the other hand, however, its drawbacks and risky nature are brought to light by others. Whether the ERM II is actually a useful framework or merely a highly inconvenient “waiting room” is the issue that should be brought up for discussion. This is what this paper deals with in what follows.

2.1. ACs’ exposure to unconstrained capital flows

Casting light on the pros and cons of the ERM II arrangement is inherently related to capital flows and their potential impact on the viability of intermediate

exchange rate systems. Therefore, the issue on capital flows should be fleshed out first before getting into the ins and outs of the ERM II framework.

Since the arrival of the age of free capital movements and financial innovations there has been a radical change in the world of financial markets and their potential impact on currency crises. Freeing capital flows has been accompanied by a simultaneous increase in the volatility of both FX and money markets (Garber and Spencer, 1995). Financial innovations have in turn provided market participants with a wide range of instruments for both speculative and hedging operations, which bear the risk of adding to the financial markets' volatility by facilitating leveraged speculation (Papaioannou, 2002). Destabilizing force of massive capital flows has taken its toll during many exchange rate crises, in the 1992-93 ERM currency turbulence in particular (Eichengreen and Wyplosz, 1993; Eichengreen, Rose, and Wyplosz, 1995; McKinnon, 1997). Fragility of the soft peg arrangements has been exposed once faced with high capital mobility. It is especially disturbing when taking into account that while *fiscal discipline and sound prudential regulation of banks [...] are important and helpful [...], they may not be sufficient, not least because multiple equilibria and financial contagion are prevalent* (CEPR, 2003).

Participation in the ERM II does not bring much change in this respect either. Within this framework the ACs, having removed barriers on capital flows, will be exposed to destabilizing force of massive capital movements. It may occur due to various reasons.

One underlying cause may stem from some market imperfections, related to the risk of overheating, as discussed in section 1.1. However, even sound investment and consumption decisions may not rule out the possibility of high exchange rate volatility. In particular, prospects of higher returns on investment in the catching-up economies with relatively low domestic savings would continue to encourage capital influx. Moreover, to the extent that EU membership holds out the prospect of entry into the euro-zone, increased credibility and the belief in prospective exchange rate stability and interest rate convergence – that overall optimism – may boost consumption spending and further capital inflows. A shift from tight domestic credit environment to the realm of the enhanced access to global financial markets would add to that process. Moreover, privatization process has not yet been completed in the ACs and therefore will attract still more foreign investment in a limited time span. Last but not least, relatively high levels of natural interest rates in the ACs (Brzoza-Brzezina, 2003b) and the need to stabilize inflation expectations at a low level might imply maintenance of high interest rates, which would encourage further capital inflows.

At some point, however, when the most profitable opportunities stemming from financial integration have been exploited, investment would decline, and so would capital inflow. Another factor, which might influence current accounts and add to exchange rate volatility could be time pattern of consumption spending. As a result, some volatility of a local currency might be expected. This could be a corollary of behavior based on sound microeconomic rationale. However, if the above-outlined developments took place in their extreme form, even wide fluctuations bands within the ERM II might not contain the resulting currency plummet.

Within the ERM II, if nearing the “strong band”, the scope for monetary tightening would be limited. Interest rates rise would only add to capital inflows, exacerbating currency pressures. Moreover, the nearer euro-zone membership, the more mid and long term interest rates are guided by markets, and thus the less efficient interest rate policy (Borowski et al., 2003). Under such circumstances, when faced with credit expansion, and thus inflationary pressures, the Bank of Greece had to resort to credit control measures. Relying on the interest rate tool turned out to be insufficient (Bank of Greece, 2001; Garganas and Tavlas, 2001), for it fuelled appreciation pressures exerted on drachma. In addition, current research highlights that inflation reacts much faster to exchange rate changes than to interest rates shifts (Łyziak, 2001). Finally, given existing price rigidities, the scale of the necessary appreciation to contain inflationary pressures is likely to outstrip the estimated magnitude of the BS effect (Borowski et al., 2003). Therefore, should the need for restraining inflation arise, it might give rise to speculative inflows driven by expectations that inflation could be reduced to, or maintained near, the Maastricht reference value only by revaluing the band.

The above-outlined sequence of events might lead to currency appreciation, not excluding revaluation of the parity. This would most likely be combined with growing current account deficit. Such state of affairs, however, might not be consistent with fundamentals, and, therefore, in the medium and long run would not be sustainable. If positive market sentiments persisted, such deviations might tend to be prolonged and exchange rate fluctuations excessive (Papaioannou, 2002). Moreover, expectations of a defense of the parity would incline market participants to underestimate growing balance of payments problems. In this context, the parity constitutes an implicit exchange rate guarantee – eventually weak or false – and becomes a source of moral hazard¹⁰. If that process leads to a prolonged and excessive appreciation, it may badly affect competitiveness of the economy, constrain its

¹⁰ Compare: Burnside, Eichenbaum, Rebelo, 1999.

growth in output, and thus in government revenues, which would add to pressures hampering fiscal adjustment. Although wide bands increase exchange rate flexibility, and thus encourage hedging, they do not resolve the moral hazard problem sufficiently and therefore cannot refute the view that *the combination of soft pegs and high capital mobility increases the cost of crises if and when they occur* (CEPR, 2003).

At some point, however, the sentiment may turn negative. It can be due to market uncertainties regarding inflationary pressures or export competitiveness; or political tensions can arise; or external shocks, including a major shift in cross exchange rates, may take place; or persistent fiscal or current account deficits may serve as ready signals of possible misalignments (Papaioannou, 2002); or, finally, mere capital account changes may give rise to a hasty retreat. As a result, the currency may rapidly depreciate and hit the floor, just 2.25% or 15% below the parity¹¹. Tightening of the monetary policy would be rightly perceived as highly inconsistent with major growth targets. Therefore, any attempts undertaken by governments to defend exchange rate levels being at variance with fundamentals, would often add to volatility of the markets, and precipitate an exchange rate crisis (Papaioannou, 2002). As a result, depreciation pressure may not be weathered and resorting to the parity devaluation, or at least breaching the 2.25% weak fluctuation band, may turn out inevitable.

To a certain extent the above-outlined risky scenario might be mitigated by a sound, disciplined fiscal policy and prudential regulations of the banking sector. The former, in particular, would not only reinforce the government's commitment to fulfill the Maastricht requirements (which would diminish the risk of a sudden capital outflow), but would also subdue inflationary pressures. Therefore, in the circumstances interest rates might be maintained at a lower than otherwise level, which would in turn reduce capital inflows, thereby mitigating appreciation pressure and lessening the risk of the ensuing financial markets tensions. However, the so-far experience teaches that the foregoing measures may be insufficient, for even countries pursuing sound policies have suffered from currency crises, just because market views about their economies changed in an abrupt way. The risk of contagion should not be underestimated especially in the case of the ACs, for the assumption that market assessments of their economies are highly correlated seems more than plausible. Therefore, any financial disturbances originating in one country may then affect investors' views about "similar" countries,

thus leading to funds withdrawal from entire regions rather than just from the "culprit country". Under such circumstances even reasonably strong macroeconomic fundamentals may not suffice to preserve a country from crisis when faced with larger, unstable financial environment (CEPR, 2003). Moreover, the potential impact of contagion on the ACs is largely reinforced by the shallowness of their financial markets, which makes them even more vulnerable to the above-outlined sequence of events. Therefore, *whatever prudential supervisory arrangements are adequate for western European financial institutions may not be sufficient for financial institutions in ACs during the accession process* (CEPR, 2003).

The conclusion that can be drawn from the above emerging picture is that it is hard to guarantee viability of soft pegs when faced with high capital mobility. ERM II as a "fixed but adjustable" exchange rate regime with no capital control measures constitutes an interim stage beset with dangers on the road to the euro-zone.

2.2. ... but maybe the ERM II does provide some shelter ... ?

The advocates of the ERM II, however, take the position that this mechanism equips its members with additional instruments and support, with credibility and flexibility. Altogether, these "extra facilities" are to make this framework a useful one. And thus, the ECB (2002) argues that *ERM II will provide for a certain degree of exchange rate stability and macroeconomic policy discipline, while still leaving room for adjustments to shocks and market developments. Moreover, its multilateral nature – with both the accession country's central bank and the ECB being involved – will enhance its credibility*. In the context of this statement, however, some qualifications need to be made.

Although the exchange rate stability constitutes the requirement within the ERM II framework, the system hardly offers any useful instruments to promote this stability. The only "extra" facility provided within that mechanism is the ECB's support in the foreign exchange intervention conduct. Even that measure, however, is subject to various constraints¹². As far as interventions at the margins are concerned, due to their in principle unlimited and automatic character, they may seem to provide for some credibility of the exchange rate stability. Notwithstanding the importance of the "psychological effect" provided by the ECB's support, it might be stated that in fact it hardly enhances the actual ability of a single country to stabilize or defend its exchange rate. Such a view is based on the well-justified belief that foreign exchange interventions could help stabilize the market only in terms of offsetting short-term pressures exerted on the domestic currency. In this case, however, foreign

¹¹ Discussion on the implicit asymmetry of the fluctuation bands will be developed in section 2.4.

¹² This will be discussed in more detail in part three of this paper.

reserves of the candidate countries seem to be even in excess of their reasonable use for this purpose. By contrast, in case of exchange rate misalignments, i.e. when fundamental factors underlie the inappropriateness of the parity, foreign exchange interventions aimed at defending the currency may become nothing but useless and costly waste of resources. And the ECB could not help much in this respect.

Moreover, *the ECB and the participating non-euro area NCBs could suspend automatic intervention if this were to conflict with their primary objective of maintaining price stability* (Agreement ... Art. 3.1., 1998; see also: *Resolution ...2.1.*, 1997). Lack of any objective criterion justifying application of that “escape clause” makes the intervention rules too discretionary, and thus insufficiently transparent. Furthermore, *the debtor central bank shall make appropriate use of its foreign reserve holdings prior to drawing on the facility* (Agreement ... Art. 7.2., 1998). This is another vague statement that makes it unclear to what extent an AC’s central bank has to intervene first and how “appropriate” these interventions should be. So far, the ECB has not taken a stand on that issue. These uncertainties become especially disturbing when recalling the fact that transparency constitutes a basic requirement for a successful crisis management if and when it occurs.

Finally, the ERM II rules constrain recourse to interventions within margins, carried out by a national central bank unilaterally, by imposing daily limits on their use. Breaching that ceiling requires the ECB’s prior assent. Therefore, these rules may even diminish the ability to withstand speculative pressures an AC could otherwise stand up to if remaining outside the ERM II framework. In the light of the foregoing arguments, ERM II instruments’ support may appear weak, thus questioning credibility and stability of this mechanism, especially when faced with sudden and volatile capital flows.

2.3. ... is the ERM II the unique measure towards the achievement of required discipline?

The followers of the ERM II are said to favor this mechanism because it forces discipline upon its members, for it is the only way to handle such a difficult intermediate peg (Padoa-Schioppa, 2000). However, there are other, and often more viable, reasons supporting the belief in the right conduct of policy in the accession countries – and these are not related to ERM II membership. One is an internal rationale for stability¹³; the political will to fulfill the

Maastricht criteria and join the euro-zone being another; these, combined with the rules imposed on the economic policy of the EU members, constitute fairly good incentives to pursue and maintain macroeconomic discipline. While the ECB stresses that the ERM II framework supports the right policy conduct, for it requires a set of continuously consistent economic policies, including sustained fiscal policy discipline (ECB, 2002), such reasoning, however, passes over the fact that ACs will become subject to the Stability and Growth Pact already at the moment of joining the EU. The SGP rules will oblige new EU members to maintain sufficient fiscal discipline under threat of i.a. reduction of the Cohesion Fund resources they would otherwise receive. The “SGP stick” will take effect irrespective of whether an accession country enters the ERM II or remains outside that mechanism.

2.4. The ERM II and its flexibility

Those advocating the ERM II as a useful framework for new member countries point out the virtue of exchange rate flexibility within that system, including realignments of a central parity. According to the ECB (2002), *it is important to set a central parity that corresponds to the best possible assessment of current economic fundamentals, knowing that this will not prejudice the ultimate conversion rate*. Indeed, cooperative realignments of the parity conducted in a timely and frequent manner would keep exchange rates away from the edges of the band and, therefore, in times of a crisis the need for devaluations would be largely reduced. However, experience teaches that the realignment option is hardly used in a right way, thus implying that even with a wide band of +/-15% the ERM II may provide little effective room for exchange rate movements in one direction (CEPR, 2003). Moreover, the “parity-change” clause would give rise to speculations and the longer one were to stay within the ERM II, the stronger these speculations would be. Therefore, the central rate does not fulfil its function of stabilizing expectations. As a result, the need for sustained macroeconomic stability in the soft-pegging ACs calls for a different, non-exchange rate related, nominal anchor (CEPR, 2003). Of viable options the direct inflation targeting strategy seems the most preferable. At some point, however, pursuing inflation target may stay in contradiction with currency movements constraints imposed by the ERM II framework. And such a trade-off between inflation and exchange rate targeting was observed in the Hungarian economy at the beginning of 2003. Once again, the ERM II rules prove counterproductive in terms of enhancing credibility of the exchange rate system.

The argument that the ERM II leaves much room for exchange rate flexibility does not take into consideration the fact that – however the respective

¹³ In Finland, [c]ontrary to many other countries, the Maastricht criteria were never referred to as a justification for fiscal consolidation. The message was rather that fiscal consolidation is in the national interest because it is a precondition for lower interest rates and for longer-term financial stability – Mayes & Suvanto, 2002.

Maastricht criterion is very vague here – eligibility for euro-zone membership requires that ACs avoid large depreciation tensions as well as devaluation of a central parity. In particular, it seems that breaching the narrow band of 2.25% depreciation might negatively affect an assessment of the exchange rate stability criterion. Such conclusions might be drawn from the EC lots convergence reports (see also: Borowski et al., 2003). And thus, the EC states that in the assessment of the exchange rate criterion fulfillment the conditions to be respected should, *inter alia*, include that *exchange rate to have been maintained within a fluctuation band of +/-2.25% around the currency's central parity against the euro in the context of the ERM II. However, the extent to which a breach of the +/-2.25% fluctuation band would correspond to severe tensions would take account of a range of relevant considerations. A distinction is to be made between exchange rate movements above the 2.25% upper margin and movements below the 2.25% lower margin.* (European Commission, 2002b). Moreover, the ECB takes an even more ambiguous position in its report by claiming that *in the assessment of exchange rate developments the emphasis is placed on exchange rates being close to the ERM II central rates. [...] the issue of "severe tensions" is generally addressed by examining the degree of deviation of exchange rates from the ERM II central rates against the euro, by using such indicators as short-term interest rate differentials vis-a-vis the euro area and their evolution, and by considering the role played by foreign exchange interventions* (ECB, 2002a). If assumed interpretation that breaching 2.25% depreciation band constitutes a "severe tensions" yardstick turns out valid, taking advantage of the above-extolled flexibility provided by the ERM II may therefore stay in contradiction with eligibility for euro-zone membership. The fact that appreciation and revaluation would not be – as it seems – considered as an obstacle on the way to the euro-zone reveals an asymmetric nature of the ERM II +/-15% exchange rate band. This could induce new member countries to set the parity at a lower than otherwise desired value. Quoting Coricelli (2001): *As devaluations of the parity are ruled out, the only flexibility allowed is to revalue the parity. In a context of uncertainty, this implies a bias for a depreciated parity.* This, however, would bring about reinforced inflationary pressures and subsequent monetary tightening aimed at fulfilling the inflation criterion. In such circumstances, maintenance of the exchange rate within "depreciated" bands might turn out unfeasible due to excessive nominal appreciation pressures stemming from the initial undervalued parity level and due to capital flows attracted by high interest rates, which would add to volatility of the currency.

Followers of the ERM II emphasize that due to its flexibility the process of "finding" the equilibrium exchange rate will greatly be facilitated. In fact, within both narrow and wide fluctuation bands of the ERM II framework, massive flows of capital and the exchange rate shifts not strictly related to fundamentals would be possible. *The experience of Greece has shown that rather than a useful test the ERM 2 gives rise to a convergence play in which short term capital flows are affected by expectations on the final parity chosen* (Coricelli, 2001). During its participation within the ERM and ERM II, the Bank of Greece had to intervene heavily in order to avoid excessive exchange rate fluctuations. In the period between the end of 1998 and 1999 interventions in the foreign exchange market mostly concerned foreign exchange purchases, which restrained the upward trend of the drachma. In the first half of 2000 capital outflows forced the central bank to intervene by selling a foreign currency in order to reduce the drachma's fluctuations. These latter tensions reflected mainly uncertainties regarding the feasibility of meeting the inflation criterion in time and, subsequently, as to whether the then central rate of the drachma would constitute the irrevocable drachma's euro conversion rate (Bank of Greece, 2001). In January 2000 the Bank of Greece revalued the parity by 3.5%, thus reducing the required convergence of the then-current rate on the central rate. The revaluation contained inflationary pressures that could otherwise emerge due to significant but necessary easing of monetary policy during 2000. The drachma's rate that preceded the revaluation of the parity seems to speak volumes about the market's expectations of the central rate shift.

2.5. Interest rates, risk premia and adjustment mechanisms

Advocates of the ERM II point out that within this framework convergence of nominal interest rates takes place not in an abrupt manner, which would increase the risk of overheating, but gradually. The foregoing statement upholds as long as the exchange rate is not credibly fixed and the currency remains charged with some exchange rate risk premium. In part one of this paper, however, it has been stressed that nominal interest rate convergence does not necessarily lead to capital misallocation and, subsequently, to a harmful overheating. The conclusion may stay valid even in the presence of real interest rates differentials. Moreover, while nominal interest rate convergence does not have to imply negative outcome, the lack of it may entail economic costs. In particular, higher nominal and real interest rates, and thus, higher cost of capital in the non-euro members prevent the exploitation of otherwise profitable investment opportunities in these countries. Interest rates differentials are therefore a source of capital misallocation, lowering

effectiveness of investment in the whole region (EU countries). In such a situation economic growth in the non-euro members would be hindered and real convergence postponed. A country which qualifies for the participation in the euro-zone should therefore join the monetary union at its earliest convenience, for it would enable an AC to cut the above-outlined economic costs. The Danish case is an example illustrating that even with a very stable and very credible fixed exchange rate domestic interest rates remain above the level in the common currency area¹⁴.

Furthermore, the introduction of the common currency, as distinct from ERM II participation, entails the elimination of macroeconomic risks related to exchange rate uncertainty. Benefits derived from that change are particularly significant for capital markets integration, which has been emphasized by Galati and Tsatsaronis (2001): *In the months before the introduction of the single currency, the majority of institutional investors, investment banks and asset managers started to disband their country desks and reorganize their equity analysis and trading operations on an area-wide basis around units with a sectoral focus. This reorganization is in line with a number of factors that have diminished the relative importance of country-specific macroeconomic factors affecting euro area equity prices. [...] The introduction of the single currency boosted this process by eliminating exchange rate risk across the EMU economies.* Indeed, to take full advantage of liberalized capital flows, a country must promote integration of its capital market with those of the rest of the EU. And it is a common currency that provides for a major and necessary stimulus to that process.

Another issue differentiating distinct exchange rate regimes is their role as an adjustment mechanism in the face of abrupt capital shifts. A change in the capital account of the balance of payments could, in particular, reflect a rising conviction of the market that domestic spending has become excessive (whatever reasons for overheating might be). Pervasive uncertainty and deterioration in a country's borrower position would entail necessary changes in domestic spending and current account position. In case of a floating exchange rate regime, however, consequences of capital outflows would be mitigated by the means of exchange rate adjustments. Although a turn away from the positive market sentiment would induce a necessary decline in domestic spending, it would not have to be as deep as in a situation when the contraction would have to support a fixed and, in the market's view, overvalued exchange rate. Tighter foreign credit conditions might also lead to some debt servicing problems. However, if markets are fairly

effective, both macroeconomic adjustment and microeconomic problems should not be acute. Therefore, a floating exchange rate regime in a way constitutes a self-regulating mechanism that through its flexibility mitigates balance of payments disturbances and diminishes the risk of a currency crisis.

The process of adjustment in the face of capital shifts takes a different form in the realm of a fixed exchange rate regime (or *quasi*-fixed – such as ERM II – where the authorities are determined to maintain the exchange rate at or near a certain level). It must be worked out wholly in the real area of an economy, with no improvement of its competitiveness provided by nominal exchange rate movements. At the same time, the need to defend the exchange rate at the predetermined level would imply tightening of the monetary policy in the form of raising interest rates in order to mitigate depreciation pressure exerted by shifts in capital flows. Moreover, foreign exchange interventions conducted by a central bank, i.e. sales of foreign and purchases of the domestic currency, might curtail the financial sector liquidity. Under above-outlined circumstances, a central bank could not ease the monetary policy stance nor perform freely its function of the lender of last resort, since it would contradict the goal of exchange rate stability. Consequently, financial sector might experience hard constraints, subsequent to which credit crunch and serious debt servicing problems might emerge. This in turn would badly affect credit portfolios and capital adequacy of the banking sector. Both macroeconomic adjustment and microeconomic shock would therefore be severe. If eventually the authorities resorted to currency devaluation, such a sudden change would considerably fuel disturbances at the microeconomic level. This new shock would be the more painful, the less debtors paid attention to hedging against exchange rate risk, which is related to the above-outlined moral hazard problem.

The adjustment mechanism would be still different within the common currency area. It would take place almost entirely on the micro-level. There would be little scope for macroeconomic shock, since there would be no exchange rate nor separate monetary system with a distinct interest rate policy. Local market participants would operate within the realm of the single financial market, including the access of domestic banks (with large banks acting as intermediaries for small banks) to the large money market of the euro-zone. Any turbulence at the local level would not expose market participants and financial institutions to disturbances related to the risk of exchange rate movements or interest rates shifts. Therefore, the assessment of individual investment projects would rest predominantly on the microeconomic rationale, with macroeconomic

¹⁴ Compare Hugo Frey Jensen (2001).

consideration receded into the background. Removing the macroeconomic source of a bias against investors running a business in a particular economy would constitute, as discussed above, a major factor contributing to the enhancement of effectiveness of capital allocation in that country. Although mitigating the costs that negative macroeconomic assessment would otherwise entail, the introduction of the common currency cannot entirely rule out the possibility that consequences of a widespread overheating, being the result of excessive spending and borrowing, might badly affect some enterprises and/or large groups of consumers¹⁵.

The important role of financial markets integration in curbing the effects of country-specific shocks and overheating has also been recognized by the European Commission (2002a): *Limited cross-border financial integration in EMU and significant home-market dependence of financial institutions imply still important financial sector exposure to country-specific shocks and overheating. The extent of the interactions and mutual reinforcement of financial and macroeconomic cycles depends largely on the degree of home-market dependence of the financial sector. The deepness of financial markets and their size, relative to the real economy, are other factors that determine the importance of their influence on real economic developments.* In case of current ACs, as already emphasized, it is the euro-zone entry that will provide a major impetus for their financial markets development¹⁶.

The above-outlined analysis has pointed to the virtues of exchange rate flexibility on the one hand, and to benefits derived from participation in a common currency area on the other. The conclusion to be drawn is that when faced with excessive investment and/or consumption, the consequences would be the most severe when maintaining one's national currency in a system of (*quasi*)fixed exchange rate regime.

3. ERM II framework – steps to be taken

Above discussed characteristics of the ERM II framework do not doom *ex ante* the ACs to failure once they have entered that mechanism. However, it does not change the view that this system is beset with numerous dangers and, therefore, should not be perceived as a form of a useful framework, within which the ACs should follow real convergence with the current euro-zone economies. The experience of the 1990s has shown that fixed (either rigidly or moderately) exchange rate regimes, when faced with

full capital mobility, often prove unstable. In addition, while sound fiscal policy conduct, strengthening financial sector, and prudential banking sector supervision may make this system more immune to exchange rate disturbances, in case of the ACs – as argued in section 2.1. – it may turn out insufficient to prevent the risk of exchange rate crises, not least due to contagion threat. Therefore, the ERM II should be treated as merely a “waiting room”, within which the ACs' stay should be shortened to the minimum required period of time.

A major purpose the ERM II should serve is to verify whether a central parity is consistent with a long-term fundamental equilibrium. As admitted by the European Commission (2002), however, although having succeeded in the ERM/ERM II, some of the members entered the euro-zone with their exchange rates either overvalued or undervalued. Therefore, this mechanism seems to be unreliable in terms of determining the most proper exchange rate conversion level. The ERM II thus seems to test one's ability to subdue exchange rate volatility rather than appropriateness of the central parity level. Bearing in mind that capital flows may be related to other than fundamental factors and that national currencies will be replaced by the euro anyway, imposing ERM II constraints on the ACs simply for verifying whether they are able to withstand pressures exerted on their currency is little justified.

Therefore, the most desirable and sensible solution would be to evade the responsibility of participating within the unfavorable framework of the ERM II. Such an attitude, however, would most likely clash with the official reasoning of the European Council, the European Commission, ECOFIN, and the ECB, that it would run counter to the Treaty's requirements. Consequently, abolishment of the ERM II mechanism seems to be unfeasible. Recognizing that, however, should not mean that absolutely no steps can be taken towards at least slight enhancement of the ERM II rules. In particular, the vagueness of the exchange rate stability criterion within this framework calls for a clarification of the EC's and the ECB's legal position on this matter. Moreover, ambiguity of the “severe tensions” term, fleshed out in section 2.4., should be cleared up. Furthermore, ERM II asymmetry drawbacks that convergence reports imply should be touched upon. Therefore, in the following part of this paper some amendments to, or rather an interpretation of, the ERM II rules are made.

The most desirable solution would be to make it clear-cut that staying on the weak side of the parity, but not breaching the –15% band, would meet the stability requirement. Consequently, tentative interpretation of –2.25% band as a “severe tensions” yardstick should be rejected. It is due to already-mentioned shallowness of

¹⁵ In the extreme event, if credit crunch spread throughout the large part of the banking sector, an initially microeconomic shock might ultimately evolve into a macroeconomic one.

¹⁶ For more about money market integration in the euro-zone, see: Gabriele Galati, Kostas Tsatsaronis (2001).

the ACs' financial markets and the risk of contagion that calls for the widest possible flexibility of the exchange rate. For even within wide fluctuation margins, let alone narrow depreciation band, sound policy conduct may not withstand exchange rate turbulence, being the result of massive and unconstrained capital flows. Finally, the more flexibility, the more scope for market forces to "search for" an equilibrium exchange rate. Prematurely forced interventions, as a consequence of adopting too narrow bands, would only disrupt this process.

If, nevertheless, the asymmetric interpretation of the "severe tensions" phenomenon prevailed and, consequently, the +/-15% flexibility turned out not to be a viable option, one might come up with an alternative solution, which is not free of drawbacks however.

It might be suggested that at least temporary fluctuations of the exchange rate below -2.25% depreciation band might be openly allowed. Therefore, the ECB and EC should clearly inform the markets that the assessment of the exchange rate stability within the ERM II +/- 15% band is based on qualitative criteria. These criteria should help to scrutinize whether an AC is able to maintain long-term equilibrium and competitiveness of its economy with the exchange rate at the parity level. This should dispel the tentative notion about the "mechanical" nature of the negative assessment stemming from any breaching of the -2.25% depreciation band; the notion that might otherwise encourage "testing" the central bank's ability to withstand market pressures exerted on the exchange rate. Moreover, qualitative assessment would be consistent with a market approach, according to which it is whether the authorities are in control of the course of action rather than exchange rate shifts that determines the markets' perception of the economy's stability. Such a view has been supported by the experience of various ACs, which shows that even significant exchange rate volatility does not have to be inconsistent with the overall economic stability.

The foregoing, however, would exclude the automatic and unlimited support of the ECB at the narrow level, for no formal agreement on the hard -2.25% band could then be established. Moreover, obscure and discretionary nature of such an arrangement might give rise to speculations as to whether a particular breach of the weak band should imply a negative assessment of the exchange rate stability and, subsequently, the loss of credibility leading to speculative attacks. The just-stated risks of incurring costs related to the lack of transparency are also valid in the current ERM II framework, for, as of today, it is anybody's guess what the criteria for the exchange rate stability assessment really are.

The conclusion to be drawn is that the above-outlined "qualitative solution" lags well behind the

leading option of unconstrained +/-15% fluctuation bands. If, however, neither the latter nor the former one turned out to be acceptable, one might argue that it might be better to stick to the current, though very vague, state of affairs than press for clarification of the "exchange rate severe tensions" term and land oneself in an even more rigid and risky framework of the narrow band.

Whatever attitude towards exchange rate fluctuations were adopted, the ECB's role in the multilateral ERM II arrangement should be clarified. As far as the intervention code of practice is concerned, the desired path of changes seems to be straightforward. It is enough to get back to section 2.2. to put some of them together.

For the sake of transparency, some statements of the *Agreement...* should be cleared up. In particular, to what extent an AC's central bank should intervene first before drawing on the very short term facility (VSTF)? what does it mean that interventions must be conducted in an appropriate manner? what is an objective measure of the threat to the primary goal of maintaining price stability, which would justify suspension of the ECB's automatic intervention?

Furthermore, numerous constraints on both intra-marginal unilateral foreign exchange interventions and access to the VSTF should be lifted, or at least mitigated. Intervening within margins may be of special importance, for having recourse to that tool may serve the purpose of smoothing exchange rate movements. This was particularly the case in Greece and Ireland. In this regard, it seems unfounded, unless justified by the price stability argument, to impose daily limits on the foreign exchange interventions carried out unilaterally by an AC, for it limits leeway of the central bank's monetary policy conduct.

Another reproach relates to the limits on the VSTF that can be drawn on while intervening within margins. In case of Bank of Greece and Danmarks Nationalbank, they were established at the level of EUR 300mln and EUR 520mln respectively. It has been estimated that for Poland that ceiling would amount to circa EUR 450mln (Bofinger and Wollmershauser, 2002). It is enough to set that against the EUR 28bln foreign exchange reserves in the possession of the National Bank of Poland to conclude that within margins VSTFs provided by the ECB constitute anything but support. This calls for lifting these limits or at least raising them significantly.

Finally, the maturity of the VSTF both within and at the margins should be extended beyond the current 3 months limit. Although one renewal of the borrowing up to another 3 months is possible, the amount of debt to be prolonged is restricted by the upper ceiling set by the just-mentioned tiny limits related to drawing on the VSTF within margins.

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In this paper the arguments against early euro-zone enlargement have been examined. When considered on the grounds of economic rationale, however, these arguments turn out to be either exaggerated or misplaced, and thus, little convincing.

As regards the ERM II, the emerging picture is that of a mechanism beset with numerous dangers the ACs will be exposed to. Although sound fiscal and monetary policies constitute a prerequisite for a successful participation within that exchange rate regime, it may not suffice to prevent the risk of destabilizing massive capital movements.

Implementing the above-advocated measures might improve effectiveness of the foreign exchange

interventions and increase transparency of the ERM II, which in turn would enhance credibility of this framework. It is, therefore, worth the effort to take steps to make this system more useful. These measures, however, would constitute only a slight amendment to that mechanism, for reforming it, let alone passing it over, seems to be unfeasible. Therefore, whatever concessions have been made, overwhelming drawbacks and risky nature of this framework make it merely a "waiting room", within which membership should not be required to exceed the period of two years.

Although the pros and cons of the early euro-zone membership have not been a subject of this paper, it has been shown indeed that the arguments supporting delayed monetary union enlargement and extolling virtues of the prolonged stay within the ERM II are mostly common fallacies.

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