EMU strategies: Lessons from Greece in view of EU enlargement

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EMU strategies: Lessons from Greece in view of EU enlargement[1]

Introduction

This paper, after reviewing briefly the early steps of European monetary integration and key elements of the EMU project as reflected in the Treaty of Maastricht, analyses the monetary integration strategy and convergence experience of member states, notably that of Greece, in the 1990s which led to the adoption of the euro. From this analysis, a number of key lessons are drawn which may be useful to future candidates to euro membership -in view of the enlargement- in designing their economic and monetary convergence strategies. In this context, the role of ERM II is examined, while particular attention is paid to policy issues, and risks, associated with the free movement of capital. The paper concludes that the existing Community institutions, rules and mechanisms provide a helpful framework to guide the convergence effort of accession countries towards EMU and ensure the implementation of sound economic policies thereafter.

1.Early steps in European Monetary Integration

The Werner Plan and the 'Snake'

Practical efforts at monetary cooperation among member states of the European Community started in 1971 as part of a plan to adopt a single currency within a decade. Subsequent to political direction given in the EC Summit meeting of The Hague, in December 1969, a High Level Group under Pierre Werner, Prime Minister of Luxembourg prepared a programme for achieving EMU, in three stages. A key aspect of the programme was the 'parallelism' between developments in economic and monetary policy co-ordination and progress towards political union.

International economic and monetary developments at the time were seen as elements supporting such an initiative. The mounting tensions in the Bretton Woods system of fixed exchange rates and the growing

[1] The present analysis applies to all Member States, candidates for euro membership. It is, however, particularly relevant to acceding countries on the basis of the issues treated in the paper.
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instability of the international monetary system, stimulated member states' interest in progress towards EMU.

In March 1971, the Council gave its approval to the introduction of EMU in three stages. The Council invited the central banks of the Member States *'from the beginning of the first stage, and on experimental basis, to hold exchange rate fluctuations between the currencies of Member States within margins narrower than those resulting from the application of the margins in force for the US dollar, by means of concerted action with respect to that currency'*. In April 1972, the "Basle Agreement" between EC central bank governors was concluded, giving birth to the "Snake" by which the margin of fluctuation between participating currencies would be limited to 2.25%[2].

With the collapse of the Bretton Woods system[3] and the highly unstable international economic environment, further progress towards EMU proved to be extremely difficult. Compliance with the 'Snake's' exchange rate commitments was weak, and quitting it was frequent[4]. However, in assessing this performance, the economic framework at the time has also to be taken into account. The oil price increases[5] sharply aggravated inflationary pressures and balance of payments problems. Such problems were more acute in some member states, depending mainly on the economic policies followed and reactions to external shocks.

Although the Werner Plan was not implemented as scheduled, it nevertheless left a valuable legacy in terms of institutions and mechanisms. The exchange rate commitments, together with the credit facilities and the legislative framework laid down the framework for further steps towards monetary integration.

The European Monetary System

Efforts to establish an area of monetary stability were renewed at the end of the seventies. At the instigation of France and Germany, the creation of the European Monetary System was decided in December 1978 and started operating in March 1979. According to the conclusion of the European Council of 4 and 5 December of 1978:

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[2] The agreement remained in force until the setting up of the EMS on 13 March 1979.
[3] In August 1971, the dollar was declared inconvertible, marking the end of the Bretton Woods system established in 1944 and involving the pegging of currencies (the Bretton Woods system involved the US dollar pegged to gold, and the other currencies pegged to the dollar).
[4] It can be noted, indicatively, that Italy withdrew from the "Snake" in February 1973, while France withdrew in January 1974, rejoined in July 1975 and abandoned the "Snake" definitively in March 1976. Denmark and the UK joined in May 1972 only to withdraw in June (Denmark rejoined in October of the same year).
[5] Due to the first oil shock, in 1973.

'the purpose of the European Monetary System is to establish a greater measure of monetary stability in the Community. It should be seen as a fundamental component of a more comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonisation of living standards and the lessening of regional disparities in the Community…'.

The EMS was based on the concept of fixed, but adjustable exchange rates and had two main components: the Exchange Rate Mechanism, ERM, and the European Currency Unit, ECU. The ERM set a central exchange rate towards the ECU for each participating currency. On the basis of such rates, bilateral "central rates" were established. The fluctuation margins around bilateral central rates were fixed at 2.25% for all currencies except the Italian lira for which it was set at 6%.

During the first eight years of its operation, the EMS had seen realignments every year. After the 1987 re-alignment, the system was supported by improved convergence of prices and costs and behaved as a quasi-monetary union, without currency realignments until 1992. Nevertheless, with the passage of the years since 1987, deteriorations in competitive positions and cumulative inflation differentials began to build up, particularly in countries initially respecting the wider margins. These economic developments, combined with uncertainties related to the ratification of the Maastricht Treaty[6], led to EMS disruption by a currency crisis during 1992-93. The British pound and the Italian lira left the ERM in September 1992, and in November of the same year the Spanish peseta and the Portuguese escudo were devalued by 6% against the other currencies. In January 1993 the Irish pound was devalued by 10%. In May the peseta and the escudo were again devalued.

In an effort to restore currency stability and remove potential 'one-way bets' facing speculative investors, the decision was taken to widen temporarily the ERM margins to +-15% from 2 August 1993. Germany and the Netherlands agreed bilaterally to keep their currencies within the +- 2.25% margins.

Despite the problems encountered and its shortcomings, the EMS achieved, to a large extent, its main objectives. Countries participating in the ERM achieved a zone of increasing monetary stability in parallel with gradual relaxation of capital controls. The EMS responded to changing conditions in the financial environment by strengthening its mechanisms, as was the case with the Basle/Nyborg agreement[7]. It provided also valuable lessons for designing the further steps of economic and monetary union and served as a starting point for higher

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[6] Following the rejection of the Treaty in Denmark and difficulties in its ratification in France.

[7] Refers to decisions taken by the Governors Committee in Basle, and approved by the Ecofin at Nyborg, aimed at strengthening the rules governing the operation of the EMS [12.9.1987].

co-ordination of monetary policy, providing also the basis for multilateral surveillance in the Community. On a more technical level, the ERM crisis confirmed that interventions alone –whether intra-marginal or at the margin- have limited effectiveness in containing tensions if markets perceive them as being of a lasting character. Timely increases in interest rates remain the most effective course to counter market pressure. However, if interest rates have to be kept at very high levels over a prolonged period of time, they may not be sustainable in the light of domestic economic and financial conditions.

2. EMU: a regime change in Europe's money

A key development, which underlined the need for further steps towards monetary integration, was the liberalization of capital movements within the Community[8]. Free movement of capital made the EMS more difficult to manage in the absence of the stabilizing influence of a concrete programme, and a timetable, towards monetary union. In this context, the 1992-93 ERM crisis worked as a catalyst, strengthening member states resolve to pursue progress towards monetary union on the basis of the EMU project of the Maastricht Treaty.

The EMU project, comprising well-determined objectives, institutions, policy instruments and deadlines, clearly constituted *a regime change* marking an important qualitative improvement compared with previous Community monetary arrangements. Weak elements of the pre-1992 EMS, and in general of previous Community monetary arrangements, were the absence of clear objectives and appropriate institutions – notably a European central bank- and mechanisms to achieve them.

Monetary Union, involving a single currency issued by an independent Central Bank, whose principal mandate is to ensure price stability, was therefore clearly *a superior regime* to preceding Community monetary arrangements which were pursuing exchange rate stability within the Exchange Rate Mechanism of the EMS.

The EMU project benefited, in most of the cases, from the *strong commitment* and support of governments, the business community and European citizens. Also, the large cost of non-participation in this major project from the start, as perceived notably by founding members of the European Community, helped mobilize domestic constituencies in support of EMU.

The importance of the qualitative change involved in the EMU project, reflected in an enhanced credibility of the whole exercise, becomes

[8] The capital movements directive 88/361/EEC of 24 June 1988 stipulated complete liberalisation of capital movements by 1 July 1990, with some temporary derogations for Greece, Ireland, Spain and Portugal.

evident if one compares the currency crises within the 'Snake' and the EMS, with the rather smooth transition to the euro of the eleven currencies in 1999 and, subsequently, of the Greek drachma. The 1992-93 crisis can be seen as the last major currency turbulence of the old system before the drive towards the single currency was firmly on track. Once the political and institutional situation concerning the candidate countries for the monetary union was clarified[9], the convergence process had been generally smooth, streamlined within a reformed ERM.

The Community institutional framework, which helped member states formulate, test and adapt their economic policies, was the reformed[10] *Exchange Rate Mechanism* of the EMS from August 1993 until the end of 1998. From the start of the third stage of EMU, the 1st January 1999, ERM II has been the framework which guides the policies of candidate countries for euro-area membership. The operation of the reformed EMS and ERM II should be also seen within the broader Community economic policy provisions and rules, which encourage and support the design and implementation of sound economic and financial policies[11].

In conclusion, EMU supplied the necessary focus, during the 1990s, to prospective members enabling them to mobilize broad support and overcome difficulties in pursuing this major objective of monetary union. If that objective were missing, it would have been very difficult to obtain such a broad support, as past experience had shown. Euro area membership provides a similar -and even stronger- incentive for acceding countries, as it is now the reality of the euro, and not simply a project, which is the objective to attain.

3. Lessons from convergence experiences

An essential element of the strategy towards EMU pursued by EU member states within their convergence programmes was its *comprehensive character*. The respect of the exchange rate stability criterion -within the specified fluctuation bands- was not pursued in isolation, but as one component of a coherent approach incorporating targets for the government balance and debt, the inflation rate and the interest rate[12].

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[9] The Maastricht Treaty entered into force on 1.11.1993, after ratification by all member states [Denmark ratified the Treaty, following a positive second referendum in May 1993, after having obtained an opt out of participation in the final stage of EMU and a common defense policy].

[10] Involving wider fluctuation margins of 15%.

[11] These provisions are the Broad Economic Policy Guidelines (Article 99 of the EC Treaty), the Multilateral Surveillance, the Excessive Deficit Procedure, Prohibition against assuming the commitments of other Member States and Prohibition of privileged access (covered by articles 98 to 104 of the Treaty).

[12] In addition to four convergence criteria, qualification for euro membership requires also central bank independence (Article 121 of Treaty).

Macroeconomic, monetary and financial policies were supported by *structural reforms* of the labour, goods and capital markets. However, the implementation of such reforms was not always satisfactory and adaptations proved necessary, in several cases, in particular through the strengthening of adjustment measures in order to keep the convergence momentum and make possible the achievement of the objectives set.

Of particular interest is the convergence effort of *Greece*, which was the first successful attempt by a member state to join the euro area after the first wave of the 11 founding members. Such a single effort involved increased difficulties to manage the convergence operation, both because the "distance" Greece had to cover in order to comply with the convergence criteria was significantly greater than was the case for most of the other member states but, also, because in the case of the eleven member states of the first wave *the risks involved in their convergence operation were "pooled"* [13] within the joint effort.

A number of *lessons* can be drawn from Greece's successful convergence strategy to join the euro area from 1 January 2001:

- (i). The *right setting of priorities* in achieving nominal convergence, taking into account the situation regarding the convergence criteria, available policy instruments to achieve the goals set, and the time-horizon for the planned convergence. More specifically, in 1995, when a new thrust was given by the Greek authorities to the convergence effort, it was decided that a rapid disinflation of the economy was central to the convergence effort. Inflation was high, at around 11% in 1994, and its steady fall conditioned the progress to meeting the rest of the convergence criteria, notably the exchange rate stability criterion and the government deficit criterion, given the high government debt ratio and, therefore, the high interest payments. The "hard drachma policy", by which the exchange rate was used as a nominal anchor, was at the centre of the disinflation operation from the double digit figure of 1994 to euro qualification inflation levels of 1999[14], and was an essential element of the whole macroeconomic and budgetary adjustment effort as was specified in Greece's convergence programmes[15].

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[13] There were, indeed, no notable cases of speculative attacks against currencies of the eleven countries during the crucial two-year period before adopting the euro on 1.1.1999. This can be largely attributed to both progress achieved in meeting the convergence criteria and the high political commitment to the EMU project, a situation that deterred speculators from attacking the currencies of the countries of the first wave.

[14] More information about Greece's monetary policy strategy during that period is provided in Annex 2, drawing on "Garganas N. and Tavlas G." (2001).

[15] Greece presented a revised convergence programme for the period 1994-99 in June 1994, which was subsequently updated in 1997, 1998 and 1999. From 2000 onwards, after joining the euro area, Greece started presenting a stability programme, updated annually.

- (ii). A *safety margin* was maintained when reducing interest rates in order to keep the yield of drachma denominated assets attractive to domestic and international investors and ensure orderly convergence to euro area interest rates (Graphs 3 and 4). Such a policy[16] was also compatible with the disinflation strategy.

- (iii). The appropriate *sequence of capital movements liberalization* was followed (tested in many occasions and in several countries) involving first, long-term and trade-related capital movements and last, purely financial operations[17]. This approach, combined with the safety margin maintained in reducing interest rates, contributed to *avoiding reversals* in capital movement liberalization. Such reversals, whenever they occurred elsewhere in the world, proved very damaging for the credibility of economic policies.

- (iv). The liberalization of capital movements was implemented in parallel with the strengthening of *the financial system*, through reforms and adaptations of the legislative and regulatory framework to Community legislation and by improving the supervision of banking and capital markets.

- (v). There was no significant *uncovered foreign currency exposure* of the corporate sector, although borrowing in foreign currency increased significantly since 1995 (Graph 11), as foreign currency borrowing was covered, to a large extent, through "natural hedging" i.e. by receipts in foreign currency, mainly by companies engaged in tourist, shipping and other export-oriented activities.

- (vi). The Greek drachma entered the ERM once *substantial progress had been achieved* towards nominal convergence. Entry into the ERM was effected at a central rate involving a 12.3% devaluation of the drachma against the ECU, a development that enabled recuperation of competitiveness losses due to the hard drachma policy. Furthermore, Greece agreed that the stabilization and structural reform efforts had to be strengthened in order to contain the inflationary impact of the devaluation and complete the remaining distance to meeting the convergence criteria. Indeed, entry of the Drachma to the ERM, in March 1998, was accompanied by a programme agreed with the Greek government including reinforcement of the adjustment effort in public finances as well as structural reforms in order to improve the performance of the economy.

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[16] Although not explicitly stated, such prudent policy of interest rates reduction was followed in practice, and proved appropriate in considerably limiting disruptive capital flows and avoiding reversals in the capital movements liberalisation process.

[17] The liberalisation of capital movements was completed in May 1994 with the removal of the last restrictions on short-term capital movements.

- (vii). A crucial aspect of the convergence effort of Greece was the fact that economic activity remained relatively high enabling the authorities to maintain the "hard drachma" policy and high interest rates to support such a policy, without serious adverse effects on the economy (Graph 2). This development was mainly the result of the credibility of policies, which made possible declines in nominal and real interest rates (despite occasional rises in short-term rates) and the maintenance of a stable economic environment and positive prospects. Also, important was the contribution of Community funds to real GDP growth[18].

- (viii). The credibility of the convergence objective and the determination for euro membership was reflected in *wage moderation* in the private sector[19], a phenomenon noted also in other EU countries in their drive to EMU. This development can be attributed to the desire of social partners to preserve competitiveness and employment in the European monetary union, realizing that the devaluation option would not be available anymore.

- (ix). The broad *political support* for the EMU project was important. The support of the large majority of the Greek political parties and public opinion was an important positive factor in stabilizing expectations and deterring speculation in difficult times. It should be noted in this respect that in the past, sharply diverging views of main political parties on the EMU project was a destabilizing factor for the currency in some Member States. In general, strong political support for the project -based on the broad support of public opinion- has proved decisive in avoiding speculative attacks or in fending off such attacks when they occurred.

4.The ERM II as a framework for guiding convergence

Acceding countries will enter the EU as Member States with a derogation. This means, inter alia, that they are expected to join ERM II,

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[18] Convergence of Acceding Countries' economies to the EU average will be also supported by funds allocated through the Community budget. At the Copenhagen Council on 13 December 2002, agreement was reached on the package of financial measures proposed for the entry of the new member states. In all, the financial package for the years 2004-2006 amounts to some 41 billion euros in commitments for the new members for infrastructure, agricultural and internal institution building programmes. Discussion on the post-2006 financial perspective for the EU will start in 2004.

[19] Wage developments in the private sector were also influenced by wage moderation in the public sector, as incomes policy served as an example for wage agreements in the private sector.

although not necessarily immediately after accession, and eventually the euro[20].

This section reviews a number of *key aspects of ERM II* and draws a number of, tentative, conclusions about its expected role in guiding acceding countries in their drive to EMU, on the basis of past experience from the operation of the mechanism under its various forms, taking account of the present Community institutional framework and other relevant factors.

ERM II was established by a Resolution of the European Council in Amsterdam in 1997[21], as a replacement for the European Monetary System as from 1 January 1999. The Central Bank Agreement of 1st September 1998 lays down the operating procedures of the mechanism. ERM II is based on a central rate of the participating currencies against the euro, with standard fluctuation bands of +- 15%, although narrower bands can be agreed. Central rates, fluctuation bands and realignments are set by common procedure involving Finance Ministers, the ECB and NCB Governors and the Commission. Interventions at the margins by the ECB and the central bank concerned will in principle be automatic and unlimited, unless they are deemed to conflict with the price stability objective.

ERM II should be seen as *a mechanism testing the consistency of policies*, encouraging necessary adjustment and helping to achieve convergence. It provides both more flexibility and stability compared with earlier versions of the mechanism; with the wider fluctuation bands it offers *more policy flexibility* and acts as a buffer against one-way bets, discouraging speculative attacks (For further analysis on the use of fluctuation bands in assessing compliance with the exchange rate criterion see Box in the next page); it offers also more *stability* as the objective of euro membership, made credible by appropriate economic policies and Community multilateral surveillance mechanisms, supports convergence efforts.

ERM II rules are flexible enough so that they can accommodate a number of exchange rate regimes followed by acceding countries (a summary of exchange rate regimes in accession countries in Annex 5). However, some regimes have been already identified at this stage as incompatible with ERM II namely free floating, crawling peg and exchange rates fixed to currency other than the euro. In particular, currency board regimes linked to the euro could, in principle, be accepted as special

[20] "Member States shall treat exchange rate policies as a matter of common interest" (article 124 of the Treaty). This notably includes avoidance of competitive devaluation and implementation of appropriate economic and financial policies.

[21] Resolution of the European Council on the establishment of an exchange rate mechanism in the third stage of economic and monetary union; Amsterdam, 16 June 1997, OJ C 236, 2.8.1997, p. 5.

arrangements within the ERM II fluctuation bands[22]. Unilateral euroization is not considered compatible with the Treaty[23].

Box

ERM II: Narrow or broad bands are relevant?

How are the arguments about greater flexibility of ERM II reconciled with the alleged position of the European Commission that acceding countries should respect the narrow margins of 2.25% vis-a-vis the euro (see article by Ch.Wyplosz: 'Do not impose a currency crisis on Europe' referring to announcements by Commissioner P.Solbes on this issue)? A tentative answer is as follows: ERM II provides, indeed, greater flexibility compared to earlier, more rigid versions of the mechanism. The Commission's views on this issue seem to be more nuanced than those reported in the above article and in the press and, broadly, in line with its position taken in convergence reports on Greece in 2000 and, previously, on the eleven founding members of the euro in 1998. For the sake of equal treatment, the same approach should apply in the case of the new member states (and of course to existing members, for example in the case of Sweden). The Commission's position, in sum, seems to be that, taking account of the 15% fluctuation margins defined in the ERM II Resolution, an assessment has to be made in each case about the "exchange rate stability" requirement stipulated in the Treaty, as well as that of "avoiding severe tensions", a situation related to currency devaluation. If a currency has stayed within the 2.25% fluctuation margin from its central rate during the relevant two-year period, it can be assumed that the requirements of exchange rate stability and absence of severe tensions are met. In the event of depreciation greater than the 2.25%, there will be no automatic presumption of instability or severe tensions, but an examination of other relevant aspects will be made in order to form a judgment on these issues. As was also the case in past assessments, exchange rate movements above the 2.25% margin (i.e. involving an appreciation) would be acceptable. In conclusion, there is adequate scope for judgement in each case, while respecting the provisions of the Treaty and the ERM II Resolution regarding the exchange rate criterion.

The *guiding principle* which should govern the EU approach to acceding countries' exchange rate strategies within ERM II, is that their exchange rate regimes must be adapted to the requirements of the ERM II and not vice versa. In practice, this would imply that although every effort should be made to accommodate specific exchange rate regimes (such as, for example, euro-based currency board regimes which have proven

[22] The ECB does not consider currency boards to be a substitute for participation in the ERM II but rather as a unilateral commitment on the part of the countries concerned, specifying that such arrangements will be assessed on a case-by-case basis (in ECB's paper "Policy position of the Governing Council of the ECB on exchange rate issues relating to the Acceding Countries", 18.12.2003, scheduled for publication]. This position seems to be the same as those of the Commission and the Ecofin Council on this specific issue, only articulated in more detail.
[23] See ECOFIN report, Athens, 5 April 2003.

their sustainability) this must be done on the condition that these regimes are supported by appropriate economic and financial policies agreed by all parties concerned. This would preserve both the credibility of the mechanism and the long-term interest of the country concerned.
Acceding countries have made significant progress towards a fully-fledged open economy system, in reforming the economic and financial system and the institutions in general and in liberalizing capital movements. However, *the sustainability of these reforms* have not yet been tested under the competitive pressure implied by the full membership in the EU and, further, under the rigorous framework of ERM II. This is an additional reason why the convergence effort, including structural reforms, must be designed and implemented with care in connection with the timing of ERM II entry and the length of stay in the mechanism.

The *timing of entry into ERM II* is a key issue in the convergence process. It may be useful in tackling this sensitive issue to examine, first, the substance of the needed adjustment and then see what would be, in each case, the optimal timing of entry. It is evident that the first period of EU membership will be the time to introduce/complement necessary reforms[24] in key markets and institutions and test the capacity of the economy to implement them successfully. In a second period, policies and reforms will be corrected or/and strengthened in the light of the experience gained during the first period and of external developments. The whole (first plus second) period could be about *five years*, and may be shorter or longer depending on the situation in each country.

The above period(s) of adjustment and reform could coincide, fully or partly, with that of ERM II participation. The criteria for such participation would be both, the interest of the member state concerned and, also, the need to preserve the credibility of the ERM II. In practice, this requires a sufficient degree of progress towards sustainable convergence, ensuring that the objective of meeting the convergence criteria remains on track[25].

This second part of the adjustment effort, which could correspond to the final stage of ERM II participation, should represent the conditions that will, in general, prevail in the euro area. It is, as a consequence, important that ERM II membership not be seen as a waiting room for euro-area membership, but as a useful framework providing the *opportunity to make valuable adjustments and introduce reforms* which would form the basis for real convergence and sustainable nominal convergence. This is the reason why in some cases, notably if the

[24] Such reforms could be introduced before entering ERM II. Indeed, in some cases this could present an optimal situation both for the credibility of the system and for the medium to long term interest of the country concerned
[25] As was seen above, this was the approach followed by Greece.

success of certain major reforms is uncertain, early participation in the ERM II may not be an optimal option.

In *conclusion*, if the following elements are in place:

- clear definition of policy priorities in connection with the convergence criteria
- sustainability of policies and adequacy of budgetary resources for their implementation, and
- commitment to implement the adjustment and reform programme

then experience shows us that a country will be able to participate successfully in ERM II. On the other hand, if the member state concerned feels that a higher degree of freedom in setting priorities is preferred or/and no consensus exists for the implementation of major reforms, it may be better to delay the entry into the ERM II.

How long should a country stay in the ERM II? There is no a predetermined, optimal duration period for such participation, between the two-year legal minimum and a longer time period. Even more than in the case of the timing of ERM II entry, examined above, the decisive element should be that adequate progress was made by the member-state concerned in achieving sustainable convergence[26]. . However, the participation period should not be too long as, in such a case, there is a risk that convergence momentum is lost and the commitment to the euro fades. It is, therefore, necessary that the convergence effort keeps its momentum and once a critical mass of reform and convergence progress has been achieved, entry to ERM II may be sought. As was already noted, this requires a careful design of the convergence effort, notably the setting of priorities and policy instruments to achieve them, thus avoiding any reversals in the convergence effort.

The provision concerning *conditional intervention*[27] was considered by some analysts as introducing uncertainties about the ECB's commitment to defending ERM II central rates[28]. However, this provision is a direct consequence of ECB's mandate defined in the Treaty to give priority in maintaining price stability. As a consequence, the provision about conditional intervention should be interpreted as implying that the ECB would, in general, intervene to defend a specific central parity provided that the country concerned follows the economic and financial

[26] A high degree of sustainable convergence is an objective explicitly mentioned in the relevant Treaty provisions (convergence criteria) and as essential element for sustainable exchange rate stability in the ERM II Resolution.

[27] "Intervention at the margins will in principle be automatic and unlimited. However, the ECB and the central banks of the other participants could suspend intervention if this were to conflict with their primary objective". Resolution on the establishment of the ERM II.

[28] A.Folsz (2003), for example, argues that "the defensive system would be stronger if the commitment of the ECB to intervene was free of all uncertainties".

policies agreed through the ERM II framework, or adaptations to these policies decided with the same procedures.

A specific issue concerns *the Balassa-Samuelson (B-S) effect*, namely whether the ERM II provides enough flexibility to allow for an appreciation of the real exchange rate resulting from higher productivity in the trade-goods sector in high growth, catching-up economies.

It emerges from the examination of the provisions of the mechanism, as well as past assessments of compliance with convergence criteria, that the ERM II, indeed, provides enough flexibility to accommodate phenomena of nominal appreciation (which may result from higher productivity growth of the tradable sector, or for other reasons) as this would not be an obstacle in meeting the requirements of the exchange rate convergence criterion[29].

Probably more important than the possibility of accommodating the eventual B-S effect through a currency appreciation is the capacity of new member states to adjust the exchange rate through a depreciation in order to *recover lost competitiveness*, in the event of price increases not justified by productivity growth. Although such adjustments could be made within ERM II, sizeable exchange rate adjustments might better be made before the currency in question enters the mechanism (see, also, the discussion about the timing of ERM II entry, above).

Concerning *fiscal adjustment*, new member states must respect the provisions of the Treaty about general government balances and debt ratios, as well as those of the Stability and Growth Pact about a budgetary position of close to balance or in surplus in the medium term[30]. A key issue is how these obligations can be reconciled with the need for most of acceding countries to undertake important investment projects in order to improve infrastructure and make progress towards

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[29] Real appreciation could be realised through nominal appreciation, increased inflation or a combination of both. A nominal appreciation is considered as complying with the exchange rate criterion of the Treaty, following an interpretation applied in the 1998 and 2000 convergence reports of the EMI (1998), the ECB (2000) and the Commission (1998 and 2000). On the other hand, higher inflation due to wage equalization across tradable and non-tradable sectors could pose a problem. However, the size of such an effect should not be overestimated. According to J. Von Hagen and J.Zhou (2003) the inflation differentials between EU and accession CEE countries attributed to the B-S effect (estimated in the literature between 1 and 4% in each year) should be qualified, as a number of factors may reduce such an effect a) The B-S effect is a long-run tendency, which may be less prominent over a shorter time horizon, b) productivity growth of the service sector, which is the main constituent of the non-tradable sector, can be very fast in the accession countries, as it is developing essentially from a very low starting level, c) productivity growth of the tradable sector will gradually lose its momentum as it reaches higher level, and d) the pressure of high unemployment rates may prevent the wage rate from equalizing at a level compatible with tradable-sector productivity growth.

[30] It is recalled that the SGP applies to all member states of the EU. However, member states that have not yet adopted the euro cannot be subject to the possible sanctions provided for by the Treaty.

real convergence. This is, indeed, one crucial aspect of the adjustment process of new member states and underlines how important it is that they pursue a policy of sound public finance, controlling current primary expenditure so that adequate budgetary resources can be allocated to the necessary investment in order to improve infrastructure. It suggests also the need to consider carefully the strategy of convergence towards EMU, the right setting of priorities and the timing of ERM II membership and accession to the euro area.

How do *Commission proposals* for fiscal consolidation, as approved by the Council[31], affect acceding countries convergence strategy? The proposals aim was to clarify certain provisions of the Stability and Growth Pact and put the focus on the cyclically-adjusted fiscal balance as well as the long-term sustainability of public finances[32]. They are helpful to the acceding countries by putting the emphasis on sustainable fiscal adjustment, including through structural reforms which raise the growth potential of the economy, and on the need of running down public debt at a satisfactory pace towards the 60% of GDP reference value (this approach increases the margin of action of the acceding countries as their government debt ratio was estimated, on average, at 42% of GDP in 2003, much lower than that of the EU average, 64% of GDP).

A related issue to fiscal consolidation is whether *macroeconomic stabilization*, pursued in order to achieve the nominal convergence criteria, is also compatible with real convergence i.e. the capacity to obtain, in parallel, high enough rates of real GDP growth rates in order to maintain progress towards real convergence. The example of Greece examined above showed that the two processes can be mutually re-enforcing, notably if the process of nominal convergence acquires enhanced credibility affecting the formation of key variables such as interest rates, wages and prices.

The *"exit strategy"* is a key issue of exchange rate arrangements in relation to ERM II membership. The issues covered under this concept concern both exit from current exchange rate regimes to ERM II and from ERM II to the euro. In analyzing this issue, a number of situations can be distinguished:

a) currency board arrangements, CB, based on the euro,
b) pegs to the euro, and
c) managed float and free float regimes.

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[31] Commission Communication on "Strengthening the co-ordination of budgetary policies", COM(2002) 670 final, 27.11.2002 and decision of ECOFIN Council of 7 March 2003.

[32] As was noted both by the Commission and the Ecofin Council, these clarifications were made within the framework established by the Treaty (article 104, on excessive deficits) and secondary legislation in the form of the Stability and Growth Pact and the "Code of conduct" on the content and format of stability and convergence programmes.

The above situations involve large differences, concerning also the policy options available in each case. For example, CB regimes can find their place in the ERM II as arrangements involving (very) narrow fluctuation bands, provided that the corresponding central rate in each case is judged appropriate. “Pegs to the euro” regimes can fall more easily in the normal fluctuation bands of +-15% of the ERM, notably if they have been shadowing ERM II fluctuation bands already. “Managed” and “free float” regimes can also be relatively easily adapted to the ERM II rules provided that they are supported by appropriate policies. *Despite the differences that exist in the above situations, the basic policy requirement for ERM II participation is, in all cases, the same: an appropriate and sustainable central rate must be chosen in each individual case, supported by the right economic and monetary policies.* This basic requirement must guide decisions on central rates, including in those cases where the continuation of the pre-ERM II exchange rate regimes seems attractive, in view of the complications of alternative solutions.[33]

Regarding, exit from the ERM II to the euro, it seems advisable to follow the same approach adopted in the case of the eleven member states in 1998 and, subsequently, of Greece in 2000: when the Council decided that these countries fulfilled the convergence criteria, the conversion rate of each currency was also determined[34]. Any other option (e.g. postponing decision on conversion rates until the last day before entry in the euro area) would increase uncertainty about the sustainability of central rates, inciting speculative attacks in the currencies.

5.Capital Mobility and ERM II: an adversary or an ally in the drive to euro membership?

This chapter examines, on the basis of existing evidence, *firstly*, the policies by which the risks of destabilising capital movements can be

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[33] This last remark, referring notably to CB regimes, does not necessarily imply that the merits of the continuation of existing parities should be overlooked. It only means that if the risks of imbalances, or serious economic problems are considerable, the necessary adjustments and reforms must be introduced in order to strengthen the sustainability of currency parities.

[34] Strictly speaking, the Council determined only the bilateral central rates (and not the final conversion rates) when decided, in May 1998, which member states will adopt the euro from 1.1.1999. This was necessary for technical reasons as explained in the Joint Communique issued on 2 May 1998: “Since the ECU was a currency basket, which included the Danish krone, the Greek drachma and the pound sterling, it was not possible to announce before the end of 1998 the irrevocable conversion rates at which the euro would be substituted for the participating currencies. However, it is possible to announce the bilateral rates of the currencies participating in the euro area which will be used on 31 December 1998 in computing the exchange rates of the official ECU and thus in computing the irrevocable euro conversion rates for these currencies.” Of course, no such technical constraints existed when a decision was taken about Greece’s participation in the euro area, as the euro was already in place.

considerably reduced and, *secondly*, how to deal with such massive capital movements when they, eventually, occur.

Speculative capital movements had often been associated with currency instability and crises under fixed or quasi-fixed exchange rate regimes. This was the case within the EMS in the past, as well as in many instances elsewhere in the world.

How can capital mobility be best managed within the ERM II framework and what are the policy measures which could turn capital movements from an adversary to an ally in the convergence effort? Some tentative answers can be given to this question on the basis of past experience within the EMS as well as from international evidence. They include the following elements:

- (i) Sound and sustainable economic, monetary and fiscal policies in order to enhance confidence in the prospects of the economy and avoid a situation which might incite an attack on the currency. A solid financial system and implementation of reforms in the labour, goods and services markets are indispensable elements of the policy package.

- (ii) Clear and unambiguous commitment to the objectives of convergence and euro membership and readiness to take corrective measures, if needed, to ensure their achievement; capacity to mobilize all available policy instruments to this end.

- (iii) Transparency in economic policy-making and openness in dealing with Community and international institutions, the business community and the general public.

The factors under (i) above are indispensable elements of a consistent and credible convergence strategy. Also, readiness to adapt and take corrective measures is also essential; in this respect, *the signals conveyed by capital movements and asset prices* may be useful as early indicators of emerging difficulties. Furthermore, transparency and openness mentioned under (iii) above, reduce uncertainty about policies and intentions of policymakers and affect positively expectations (important factors in modern economies) exerting, thus, a stabilizing influence.

As already noted, *the ERM II provides a helpful framework* in limiting speculative pressures –notably through the wider fluctuation margins which make one-way bets less likely - compared to the earlier, pre-1993 EMS. Furthermore, by focusing on the implementation of sound and sustainable policies, including structural reforms, the mechanism encourages timely policy action and adjustments, reducing thus the risk of central rates misalignments. Both these elements enhance the

usefulness of the ERM II as a tool to streamline stabilization and convergence.

In addition to appropriate economic policies, *a sound financial system* is necessary in order to limit the risks of instability or delays in the convergence process. A fragile financial system may prove a serious constraint if, for example, a policy of high interest rates considered necessary to defend the currency could create problems for domestic banks in case of weak balance sheets.

Extensive borrowing in foreign currency by *the banking and/or the corporate sector*, not hedged or unmatched by receipts in foreign exchange (natural hedge) could also create problems for the banking sector, and affect the performance of the economy more generally, putting at risk the implementation of the convergence process and exchange rate policy. Although enterprises make their commercial and financial decisions freely and assume the corresponding risks, vigilance should be exercised the potential impact of foreign currency exposure on the corporate sector and, in turn, on the banking system.

The above constitute indispensable elements of policies aimed to contribute to a safe drive towards EMU. They are, therefore, *preventive* factors of destabilizing capital movements. However, speculative capital movements may occur for a number or reasons, including inappropriate policies, international factors beyond the control of the authorities or a combination of factors. See Gibson H. and Tsakalotos E. [2003] for a discussion of this issue.

The authorities should be in a position to cope with speculative capital movements when they occur[35]. Indeed, the authorities are not deprived of means of action in such situations despite general perceptions to the contrary. Experience shows that monetary authorities do have ways to dealing effectively with the undesirable effects of massive capital movements, "speculative" or other. Such instruments include, in

[35] It may be useful in this regard to clarify that *Community legislation*, which provides for complete freedom of capital movements [CM] within the EU does not distinguish between *"speculative"* and *"non-speculative"* CM [although it recognized -in the CM liberalization process within the EU, in the past, and in negotiations with associated countries-the different implications of each category of CM by favouring the liberalization of trade-related and long-term CM ahead of purely financial and short-term transactions]. However, for analytical reasons, and because of the policy implications of certain capital movements, a distinction of capital operations may be useful. For example, inflow of capital to domestic debt securities in order to profit from high interest rates cannot be considered as purely speculative, neither capital outflow from financial placements denominated in a given currency when investors perceive a risk of depreciation of the currency. "Pure" speculative capital movements can be considered those involving borrowing in domestic currency with simultaneous selling against foreign exchange, in an attempt to force a devaluation of the domestic currency. If the devaluation takes place, speculators repay the loan and gain the difference.

particular, interest rate changes, sterilization operations or imposition of reserve requirements and prudential measures within, of course, the margins allowed by Community law on free movement of capital and free provision of financial services.

It is, however, true that some of such measures *do not, usually, provide a lasting solution* to the problem of destabilizing capital flows - which are often inherent to the convergence process. They, nevertheless, make possible to cope with a difficult situation, gaining time in order to develop more sustainable solutions, by adapting economic policies and improving the policy mix.

The challenges monetary authorities face in dealing with massive capital movements largely emanate from the unwelcome effects, on monetary conditions and the economy, of measures taken to defend the exchange rate. Such difficulties arise from the well-known *incompatibility* of independent monetary policy with fixed exchange rates and free capital mobility. This implies, in practice, that interest rates are primarily used to defend the exchange rate -notably in case of massive capital outflows- and cannot at the same time be used to adapt monetary policy to changing economic and monetary conditions, if such actions are not compatible with the exchange rate target.

Also, in the case of massive *capital inflow* pushing for an appreciation of the currency, a reduction in interest rates to render domestic financial assets less attractive to foreign investors, can lead to an undesirable loosening of monetary conditions. The unwelcome effects of capital inflows on the monetary base and liquidity can be met by sterilization operations, through the sale of domestic for foreign currency securities. Changes in reserve requirements can also be used. Despite the limits and cost of sterilization operations, they are useful tools in the short-term enabling the authorities to gain time and adapt the policy-mix. The main drawbacks of sterilization are firstly, the fact that, if successful in absorbing excess liquidity, it maintains domestic interest rates unchanged continuing thus to attract foreign capital, perpetuating the excess liquidity problem which gave rise to the sterilization operations in the first place. Furthermore, sterilization may be costly as replacement of domestic securities for foreign currency securities in the balance sheet of the central bank implies loss of interest revenue for the bank.

Although both situations pose difficult problems for the monetary authorities, *massive capital outflows* present often a more acute problem, as may lead to the depletion of foreign reserves to defend the currency and they also necessitate rises, sometimes sharp, in interest rates, an operation that could adversely affect economic activity and the financial situation of companies and financial institutions.[36]

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[36] It might look somewhat paradoxical, but the more sophisticated is its financial sector, the more exposed seems to be the currency of the member state concerned to speculative attacks, as it is more easy to borrow the domestic currency in domestic or

In the event of balance of payments difficulties, often taking the form of massive capital outflows and pressure on the currency in the foreign exchange markets, member State(s) concerned may use the Community balance of payments facility foreseen in Article 120 of the Treaty. The facility, providing medium-term financial support accompanied by economic conditions, may be used only by members with a derogation (i.e. member states not having adopted the euro) as participants in the monetary union are by definition not concerned, individually, by balance of payments problems[37]. An analysis of the BOP facility is provided in Papaspyrou (1993).

In conclusion, free movement of capital provides useful and timely information to the authorities about inconsistent or unsustainable policies enabling timely action to remedy the situation. To fully exploit such precious early signals, a policy of openness and transparency about policies, data and future plans should be in place. This includes full co-operation and openness, including about eventual difficulties. Such openness and transparency avoids incomplete information, which often leads to mis-information. As expectations are central in the operation of today's internationalized economies, where the role of financial markets is crucial, the best way to stabilize expectations and render them a stabilizing instrument is openness and transparency.

6. Concluding remarks

The experience from the successful convergence efforts of existing members of the euro area, in particular that of Greece, the most recent member, and international evidence on the interaction of economic policy and capital movements, could provide helpful lessons for new EU members in preparing for EMU.

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offshore financial markets (see footnote no. 23). It was for this reason (regardless of other aspects related, for example, to how strong was the commitment to euro membership) easier to attack the sterling pound during the 1992 EMS currency crisis than other currencies; an additional argument, in the same vein, is that a member state with an international financial centre, such as London, is very reluctant to introduce measures which, although not incompatible with rules about freedom of capital movements or prudential ones, could be perceived as restrictive by the international financial community and thus not compatible with the reputation of an open financial centre. It emerges from the above that it is excessive to evoke, as some analysts do, the sterling pound's example during the 1992/93 EMS crisis, as a typical case of speculative attack related to risks acceding countries could face during their participation in the ERM II.

[37] The facility for Medium-Term Financial Assistance for member states balance of payments (Council Regulation No 332/2002, 28.2.2002) should be distinguished from the Very Short-Term Financing Facility, which is part of the ERM II arrangements and whose purpose is intervention in euro and in the participating non-euro area currencies.

An essential element of a strategy towards EMU pursued by existing members of the euro area –element which remains at the core of the present institutional and policy framework- was its comprehensive character, as the respect of the exchange rate stability criterion was pursued as one component of a coherent approach incorporating targets for the government balance and debt, the inflation rate and the interest rate. The convergence effort was also supported by reforms in the labour, goods and capital markets. It emerges from past experience that a strong commitment to the objective of euro membership reduces uncertainty, mobilizes human and financial resources to the goals set and stabilizes expectations. Also, the right setting of priorities in pursuing the convergence criteria ensures positive interactions and facilitates achievement of targets set. Furthermore, the maintenance of a safety margin in reducing interest rates, the appropriate sequencing of capital movements liberalization and a sound financial system are factors contributing to continued progress in the convergence process by limiting the risk of reversals, that may prove destabilizing.

The ERM II should be seen as a mechanism testing the consistency of policies, encouraging necessary adjustment and helping to achieve convergence. It provides, both, more flexibility and stability compared with earlier versions of the mechanism. ERM II rules are flexible enough to accommodate a number of acceding countries' exchange rate regimes except those of free floating and currency boards based on currencies other than the euro. It is noted in this respect that the alleged merits of free floating regimes -notably the extra degree of monetary and economic policy freedom- must be carefully weighed against the risks involved, i.e. loss of external nominal anchor and the risk that the exchange rate drifts away from fundamentals. The choice of exchange rate regime should be made, in each case, not on grounds of facility -e.g. to avoid the ERM II constraint or because the current regime served well the country concerned in the past- but only as part of a plan to achieve specific policy objectives, before opting for ERM II membership.

Decisions on the timing of ERM II participation will largely depend on whether convergence and structural reform is well on track, or important uncertainties remain which might necessitate sizeable economic policy adjustments, including in the exchange rate. In acceding countries, the sustainability of progress made in these areas has to be tested under the competitive pressure of full membership in the EU and, further, under the rigorous framework of ERM II. Therefore, in taking a decision about the timing of ERM II participation, the situation in each country in the above areas will have to be carefully examined. It cannot be excluded that in certain cases, a delay of entry would be to the benefit of both the country concerned -by allowing a higher degree of freedom in setting policy priorities- while also preserving the credibility of the ERM II.

There is no, a priori, optimal duration period for ERM II participation, between the two-year legal minimum and a longer time period. The decisive element should be progress made by the member-state concerned in achieving sustainable convergence. However, the participation period should not be too long as, in such a case, there is a risk that convergence momentum is lost and the commitment to the euro may fade.

Macroeconomic stabilization, pursued in order to achieve the nominal convergence criteria, is also compatible with real convergence i.e. the capacity to achieve, in parallel, high enough rates of real GDP growth rates in order to maintain progress towards real convergence. Experience has shown that the two processes can be mutually re-enforcing, notably if the process of nominal convergence acquires enhanced credibility, affecting thus the formation of key variables such as interest rates, wages and prices. Moreover, convergence of Acceding Countries economies to the EU average will be supported by funds allocated through the Community budget.

Risks of destabilising capital movements can be considerably reduced by the implementation of sound and sustainable economic policies; furthermore, transparency and openness in economic policy reduce uncertainty about current policies and future plans, contributing to a stable economic and financial environment. Capital movements provide also useful and timely information to the authorities about inconsistent and unsustainable policies, enabling timely corrective action. However, massive short-term capital movements may occur and the authorities should be in a position to cope with such a situation. Monetary authorities have at their disposal ways to deal effectively with the undesirable effects of massive capital movements; such instruments include, in particular, interest rate changes and sterilization operations. Such measures may not constitute lasting solutions but make it possible to cope with a difficult situation, gaining time in order to develop more sustainable solutions by adapting economic policies and improving the policy-mix.

Finally, available evidence from the operation of monetary union so far - notably the persistence of relatively high inflation, fiscal imbalances and public debt in some member states - suggest that the effort to improve the performance of the economy and its competitiveness must be a permanent process and not be limited to satisfying the Maastricht convergence criteria.

Annex 1

Key dates of European Monetary Integration

1969: 2 December: The Council adopts the Werner Plan to strengthen coordination of economic policies.
1972: 10 April: Balse Agreement sets up the 'Snake': The Six (B,D,F,IT,L,NL) agree to limit the margin of fluctuation between their currencies to 2.25%.
19 & 20 October: The Paris meeting of Heads of State and Government reaffirms the 1980 deadline for the achievement of EMU.
1973: 3 April: Creation of the European Monetary Cooperation Fund (EMCF)
1978: 6 & 7 July: The European Council meeting at Bremen agrees with the French-German proposal to launch the European Monetary System (EMS)
5 December: The Brussels European Council decides to set up the EMS
1979: 13 March: The EMS comes into force; the eight participating Member States (the UK stays outside) are required to maintain their exchange rates within a fluctuation margin of +-2.25% (+-6% for the lira). Creation of the European Currency Unit (ECU)
1987: 1 July: The Single European Act, which reforms the EEC Treaty, comes into force. Its objective is the completion of the Internal market by the end of 1992.
1988: 24 June: The Council Capital movements directive is adopted eliminating all restrictions by 1 July 1990, with temporary derogations for E, GR, IR and P.
1989: 19 June: Peseta enters EMS exchange rate mechanism (ERM).
26 & 27 June: Madrid European Council decides to convene an Intergovernmental Conference before 1990 on Economic and Monetary Union.
1990: 1 July: The first phase of EMU comes into force. It involves the removal of most of remaining restrictions on capital movements, increased coordination of economic policies and more intensive cooperation between central banks.
6 October: Pound sterling enters ERM with a 6% fluctuation margin.
1991; 9 & 10 December: Maastricht European Council reaches agreement on draft Treaty on European Union: completion of EMU and introduction of the single European currency by 1999, at the latest.
1992; 4 April: Escudo enters ERM with a 6% fluctuation margin.
17 September: Intense speculative pressure forced the UK and the Italian authorities to suspend participation of pound and the lira in the ERM.
1993: 1 January: The Single Market enters into force.
2 August: Fluctuation margins of ERM currencies widened [temporarily] to 15%.
1 November: The Treaty on European Union enters into force.
1994: 1 January: Stage II of EMU begins and European Monetary Institute is established.
1995: 9 January: Austrian schilling enters the ERM.
15 & 16 December: Madrid European Council names the European currency unit 'Euro' and confirms the introduction of the single currency on 1 January 1999.
1996: 14 October: Finnish markka enters the ERM
25 November: the Italian lira rejoins the ERM.
1998: 1 June: The European Central Bank (ECB) is established. The EMI, having competed its tasks, ceases to exist.
1999: 1 January: the third and final stage of EMU enters into force with the irrevocable fixing of the exchange rates of the currencies of 11 Member States and the conduct of a single monetary policy under the responsibility of the ECB.
2001: January: Greece enters the third stage of EMU and adopts the euro.
2002:1 January: Introduction of euro notes and coins.

Annex 2

Greece: Monetary policy strategy during 1995-2000

In Greece, a significant tightening of monetary policy has taken place in 1994, which laid down the foundation for the disinflation of 1995 and beyond. The tightening of monetary policy was part of a re-orientation of economic and monetary policies specified in the revised convergence programme of Greece, 1994-99. To focus expectations, beginning in 1995, the Bank of Greece adopted a "hard drachma policy" under which the exchange rate was used as a nominal anchor. For the first time the Bank announced a specific exchange rate target.[38]

In 1995, the Bank of Greece announced that the main objective of monetary policy would be to contribute to a further deceleration of inflation, while at the same time supporting the anticipated growth in economic activity. To attain this goal the Bank set two intermediate targets (i) to limit the year-on-year depreciation of the drachma against the ECU to 3 percent, a rate that would not fully offset inflation differential between Greece and its EU partners, and (ii) to contain monetary expansion, as measured by the growth rate of M3, to 7-9 per cent. The Bank aimed to reduce inflation to 8 percent in 1995, from 10.8 per cent in 1994. To this end the exchange rate target was assigned preeminence. The Bank also monitored the evolution of supplementary indicators, including M4 and total domestic credit. In the event, M3 rose by 10.3 per cent in 1995, but the exchange rate target and the supplementary indicators were attained. Inflation, at 8.9 per cent, was somewhat above the Bank's objective.

Similar objectives were set for 1996 and 1997. Thus, during the first three years of the hard-drachma policy, inflation was more than halved. Indicative of the stance of monetary policy and of the large, but declining (as a per cent of GDP), fiscal deficits in the three years through 1997, nominal and real interest rates remained at very high levels. Correspondingly the real effective exchange rate (measured on the basis of relative unit labour costs) appreciated by about 17 per cent, which may have reduced competitiveness. Although inflation fell sharply, real growth accelerated. Real GDP growth averaged about 2.8 per cent during 1995-97 compared with 1 per cent during 1991-94.

No specific inflation target was set for 1998 in view of the lags with which monetary policy affects inflation and of the uncertain impact of the devaluation on inflation. Instead the Bank stated that it would seek to achieve price stability by end-1999. Its intermediate target would be to maintain a stable exchange rate defined as an average annual exchange rate within 2.5 per cent of the central rate. In striking a balance between the objectives of disinflation and exchange rate stability, the Bank clearly affirmed that priority in policy implementation would be given to achieving the inflation target and, consequently, the drachma could appreciate to a point outside the narrow margins of fluctuation.

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[38] The decision to use the exchange rate as a nominal anchor was, in part, based on the belief that the adoption of a visible anchor could enhance the credibility of the disinflation effort. By pegging the exchange rate to the currency of a low-inflation country, inflation could be brought down rapidly, because (1) the traded goods component of the price level can be stabilized, (2) of the attendant restraint imposed on wage-setting and price-setting behaviour, and (3) of the restraint imposed on aggregate demand, especially government spending

Annex 3

Greece:
Key dates in the convergence effort towards the euro

1994	Revised convergence programme of Greece, 1994-99 First update of convergence programme, 1994-99. 1997 confirmed as year for meeting convergence criteria
1995	Announcement of “hard drachma” policy
1998 March 16	Entry of GRD in the Exchange Rate Mechanism of the EMS at a central rate of 357 GRD per ECU corresponding to a 12.3% devaluation against the previous exchange rate.
1998 June	New convergence programme of Greece, 1998-2001, taking account of the conditions created by the entry of the GRD into the ERM and setting 1999 as target-year for meeting convergence criteria.
1999 Jan 1	Starting date of third stage of EMU. Monetary Union entered into force with 11 founding members. The ERM II replaced the ERM of the EMS. The GRD joined the ERM II.
2000 Jan 17	GRD central rate was revalued by 3.5% to 340.75 GRD per euro in order to limit the degree of depreciation that would be required for the market rate to reach its central rate.
2000 June 19	The Council decided that Greece fulfils the necessary conditions for the adoption of the single currency from 1 January 2001.
2001 Jan. 1	Greece joined the euro area at a central rate of 340.75 GRD per euro.

Annex 4

Exchange Rate Criterion

Article 121 (1), third indent, of the Treaty requires:

“The observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State.”.

Article 3 of the Protocol on the convergence criteria referred to in Article 121 (1) of the Treaty stipulates that:

“The criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121 (1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System without severe tensions for at least two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against any other Member State’s currency on its own initiative for the same period”.

Annex 5

Exchange rate and monetary regimes in Accession countries

	Exchange rate strategy	Currency	Features
Cyprus	Peg to the euro, with +-15% Fluctuation bands	Cyprus pound	The CP has de facto fluctuated within a range of +-1.1% during the last two years
Bulgaria	Currency board to the euro	Bulgarian lev	Introduced in 1997
Czech Republic	Free float	Czech koruna	Inflation targeting 25-45 by end-2005
Estonia	Currency board to the euro	Estonian kroon	Introduced in 1992
Hungary	Peg to the euro, with +-15% fluctuation bands	Hungarian forint	ER regime combined with inflation targeting: 2.5-4.5% by end 2003
Latvia	Peg to the SDR (euro weight 29%)	Latvian lat	ER band +-1%
Lithuania	Currency board to the euro	Lithuanian litas	Introduced in 1994; Repegged from the US dollar to the euro in February 2002
Malta	Peg to a basket	Maltese lira	Currency basket (euro:70%, US dollar, pound sterling) ER band: +-0.25%
Poland	Free float	Polish zloty	Inflation targeting: 3% with tolerance +-1 pp by end-2003.
Romania	Managed float	Romanian leu	Currency basket (US dollar, euro) is used informally as reference
Slovakia	Managed float	Slovakian koruna	Hybrid strategy Combined with implicit inflation Targeting
Slovenia	Managed float	Slovenian tolar	Prominent role of monetary Aggregates; the euro Is used informally As reference currency

Sources: ECB Annual Report 2002, based on IMF and national central banks

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