

The monetary framework after accession – a political economy analysis of ERM2
Attila Fölsz
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Abstract
The paper discusses the framework of ERM2 (the exchange rate mechanism of EMU, the Economic and Monetary Union) and its suitability for accession countries / advanced transition economies. It analyzes the exchange rate mechanism from two aspects. First, it considers how ERM2 regulates the monetary cohabitation of "ins" (Eurozone members) and "outs" (non-Eurozone members of EMU). Second it reviews how ERM2 is conducive to future euro-zone membership of the accession countries. From the first point of view it discusses whether ERM2 sufficiently protects "outs" from speculative attacks, and "ins" from competitive devaluation of the "outs". From the second angle it examines whether ERM2 provides an appropriate environment for "outs" to fulfill the convergence criteria, and whether in this case "ins" open the door for the "outs" to enter the euro-zone. The principal argument of the paper is that the more ERM2 fulfils its first task, that is to regulate the relationship of "ins" and "outs" in a satisfactory way, the less it fulfils its second task, that is to lead "outs" in the Eurozone. Apart from that, the present framework of ERM2 and the convergence criteria together are not suitable for a fast and quick entry of the Central and Eastern European accession countries to the euro area. In order to overcome these pitfalls the author makes some proposals as well.
Kurzfassung
Das Papier diskutiert die Rahmenbedingungen für WKM2 (die Wechselkursmechanismen der WWU, der Europäischen Wirtschafts- und Währungsunion) und ihre Anwendbarkeit für die Beitrittskandidatenländer / fortgeschrittenen Transitions-Ökonomien. Es analysiert die Wechselkursmechanismen unter zwei Aspekten. Erstens wird überlegt, wie WKM2 die monetäre Kohabitation von "Ins" (Mitglieder der Eurozone) und "Outs" (Nicht-Mitglieder der WWU) reguliert. Zweitens untersucht es, inwieweit sich WKM2 für die zukünftigen Mitglieder der Euro-Zone unter den Beitrittsländern als förderlich erweist. Aus dem ersten Blickwinkel wird diskutiert, ob WKM2 die "Outs" ausreichend vor spekulativen Attacken und "Ins" vor wettbewerbsbedingten Abwertungen der "Outs" zu schützen vermag. Aus der zweiten Perspektive wird geprüft, ob WKM2 ein adäquates Umfeld für "Outs" darstellt um die Konvergenzkriterien zu erfüllen und ob in diesem Fall "Ins" den "Outs" die Tür zum Eintritt in die Währungsunion öffnen. Das hauptsächliche Argument des Papiers ist, dass, je mehr WKM2 seine erste Aufgabe, welche darin besteht, die Beziehung zwischen "Ins" und "Outs" auf zufriedenstellende Weise zu regulieren, erfüllt, es auch umso weniger gelingt, seiner zweiten Aufgabe, nämlich jener, die "Outs" in die Eurozone hinein zu führen, nachzukommen. Abgesehen davon, sind die gegenwärtigen Rahmenbedingungen des WKM2 und der Konvergenzkriterien zusammen nicht angemessen für einen schnellen und zügigen Eintritt der zentral- und osteuropäischen Beitrittsländer in den Euroraum. Um diesen Fallen beizukommen, macht der Autor ebenfalls eine Reihe von Vorschlägen.
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Introduction

After accession new members will not be allowed to opt out from the monetary union. Accordingly – as the Commission made it clear in its Composite Paper (EU Commission, 1998) – new members are obliged to participate in the monetary union. This obligation involves several requirements, among others treatment of economic policies (and exchange rate policies in particular) "as a matter of common interest" and progress towards the fulfilment of Maastricht convergence criteria. The Composite paper does not mention participation in ERM2 (the exchange rate mechanism of EM) as an obligation. However, Article 121 of the Treaty on European Union (TEU) defines fulfilment of the exchange rate criterion in the following way: "the observance of the normal fluctuation margins provided for by the exchange rate mechanism (...) for at least two years, without devaluing the currency (...)". (Treaty on..., 2002). Article 1.6 of the Council resolution on ERM2 prescribes, that "Participation in the exchange rate mechanism will be voluntary for the Member states outside the euro area. Nevertheless, Member States with a derogation (*the "outs" – A.F.*) can be expected to join the mechanism". (European Council, 1997). Thus, according to the legal texts for new members ERM2 membership is voluntary, but at the same time it is a necessary precondition of Eurozone membership.

Since ERM2 is a new institution, obviously its missing track record can not serve as a basis for

anticipating what a future EU member country might expect from it. The only country that was a member of ERM2 and before promotion to the Eurosystem is Greece. For several reasons the Greek case does not provide accession countries with valuable lessons. The only way to anticipate the transition period for Eurozone membership is to explore speculatively how ERM2 might function and how it might lead to the Eurozone membership of accession countries, based on the interests of "ins" and "outs" and the incentive system of EMU.

The minimal length of ERM2 membership is two years after accession. Independently of the aspirations of accession countries, however, one can expect that the "post-accession pre-euro period" will last longer for several reasons. Consequently, accession countries have good chances for staying a relatively long period in the anteroom of the Eurozone, ERM2.

The new exchange rate mechanism has two basic functions in the architecture of monetary integration in Europe. On the one hand it must *regulate the relationship between the "ins" and "outs"* of the monetary union. On the other membership in the ERM serves as *precondition of future Eurozone membership*. Therefore the new exchange rate mechanism must be analysed from both angles.

As for the former, it has also two major aspects. First, ERM must protect the "outs" from currency crises. Second, the exchange rate mechanism must protect the "ins" from the devaluating policies of the "outs". Thus it will be analysed to what extent ERM2 is capable of fulfilling its function from both aspects. Then it will also be analysed whether the exchange rate mechanism fulfils its second function that is leading the "outs" into the Eurosystem.

As for new members it is obligatory to set Eurozone membership as a target, participation in ERM2 can not be other but temporary. However the length of this phase is indeterminate, so it might be much longer than two years. According to the official statements it depends on when the "out" member is judged to be ready and prepared for the adoption of the single currency. The more and the earlier it complies with the convergence criteria, the earlier it can step forward to full-scale EMU membership. Therefore what comes from the canonical interpretation of the path towards EMU is that the length of ERM membership, a transitory phase, depends upon the convergence record of the country. From this perspective the basic question is *that to what extent ERM membership helps the convergence of the "outs"*.

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As the other principal function of ERM is the regulation of the coexistence of "ins" and "outs", it is a question whether ERM membership will really lead to the Eurozone, or it just may be regarded only as its surrogate. From this perspective the basic question is that *what are the advantages and disadvantages of ERM2 both for "ins" and "outs", compared to the membership of "outs" in the euro area*. Entry to the Eurozone requires Council decision. As a consequence, mostly independently of the convergence record of the "out", step towards the status of an "in" country is expected only if those already "ins"⁽¹⁾ also have interest in it. This interest depends on to what extent they are satisfied with the functioning of the exchange rate mechanism. If it is convenient for them, one might ask why they would change this situation, so why they would bear the risk and the complications of accepting a new member. Among others, there is a fundamental problem: since the new members from Central and Eastern Europe will most probably have significantly higher growth rates than the existing member-states, their membership will definitely make it rather complicated to pursue a common and unified monetary policy.

However, it is not only the satisfaction with the functioning of ERM2 and the fear from the problems of policy co-ordination in a wider Eurozone that might cause delays in the entry of new members.

Another reason to postpone their accession may be that the Eurozone is not suitable for enlargement, since its institutional building is too straight to incorporate more than about a dozen members. Therefore the entry of several new members presuppose institutional reforms in the EMU as well, and the history of EU institutional reforms shows how difficult and long this process can be(2).

Thus, "ins", while voting on the entry of new members have several reasons to refer to the lack of "culture of stability" in the case of new members despite the fulfilment of the numeric criteria, and thus keep them out of the Eurozone.

As a result, a paradoxical situation can come out of the double functions of the ERM2: the better and more it carries out its first function, the less it performs its second function, that is the less it is expected to promote the inclusion of "outs" into the euro area.

In the followings I will view ERM2 from both aspects.

First, [Section 1](#) gives an overview of the new exchange rate mechanism and the preconditions for taking on the euro.

Then [Section 2.1](#) considers ERM2 as a framework of monetary cohabitation. First, I review to what extent it shelters "outs" from currency crises. In this respect I discuss some relevant lessons from recent currency crises and also compare the new ERM with the old one. Some recommendations for further developments of the system are also made.

[Section 2.2](#) discusses ERM2 from the point of view of "ins", and concludes that what really protects them from the devaluating policies of "outs" is that the lack of devaluation is a precondition of the promotion of "outs" into the Eurosystem.

[Section 3](#) therefore concerns ERM2 from this point of view: to what extent it is capable of leading the "outs" into the Eurozone.

[Section 3.1](#) briefly discusses the entry criteria. It refers to the basic inconsistencies first among the convergence criteria, and then particularly the contradictions between the criteria of nominal convergence and the requirements of catching up, that is of real convergence.

[Section 3.2](#) gives a negative answer to the question, whether the "ins" and the Eurosystem in general have interest in its early eastern enlargement. Then it tries to reveal – in the light of the fact that that the fulfilment of the convergence criteria is not without sacrifices –, what behaviour might be expected from the "outs" if they do not see sufficient commitment from the part of the "ins" for the enlargement of the Eurozone.

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The [concluding](#) section reveals the main paradox of ERM2: even if initially it guarantees the peaceful cohabitation of "ins" and "outs" (which is not necessarily the case), it does not fulfil its second function of leading "outs" into the Eurosystem. Thus, ultimately it will not fulfil its first function, either.

1 The institutional framework for "outs" [↑]

1.1 The ERM2

The new exchange rate mechanism started to exist in the beginning of 1999, when Stage Three of EMU was launched and the former ERM ceased to exist. The members of the new exchange mechanism are those EMU member states that have not joined the euro area yet. The major difference of ERM2 vis-à-vis the former exchange rate mechanism is that while the former had the structure of a grid and therefore was at least formally symmetric, the new one has a radial structure and is openly asymmetric. In the former mechanism neither of its currencies declared to have a special position, despite of the fact that in reality it worked as a *de facto* DM-zone. Contrary to that the new system is a *de jure* "euro-zone", in the sense that the currencies of its member states are expressed in terms of euro, and the bilateral exchange rates among member states are not fixed.

From the point of view of its members ERM2 is practically nothing else than fixing of the central parity of the currencies to the euro, within the framework of a bilateral exchange rate agreement. This means two things: First, members of ERM2 do not determine their central parity on their own. Second, they do not unilaterally guarantee to keep that parity, but within certain constraints the European Central Bank also promises to defend it, too. With respect to a unilateral peg these two aspects of this institutionalised exchange rate agreement by all means improve the credibility of the exchange rate and monetary policies of the member states.

The central parities of the member-currencies vis-à-vis the euro are determined by the finance ministers of the EU member states, the ECB and the governors of central banks of the "outs", taking into consideration the proposal of the Commission. Unilateral realignment is not allowed within ERM2, such a move means an automatic exit from the exchange rate mechanism.

Exchange rate protection in the new ERM is similar to that of the previous one. Intervention on the margins is binding, while intramarginal intervention is just a possibility, decided by mutual agreement between the ECB and the respective member states (Article 7, European Central Bank, 1998). However, similarly to the Emminger-clause of the former exchange rate arrangement, there is a pretext. The European Central Bank is obliged to intervene in order to defend an exchange rate only to the extent that it does not threaten price stability. This is consistent with the statute of the ECB, which says that the main target of its monetary policy is price stability. This pretext therefore strengthens the consistency and anti-inflationary commitment of the common monetary policy. However, at the same time it reduces the credibility of the exchange rates of ERM2 currencies and increases their exposure to speculative attacks.

In the new exchange rate mechanism margins are fixed in a bilateral exchange rate agreement. By default the margin of fluctuation is identical with that of applied in the former ERM after its 1992-93 crisis: +/- 15 % around the central rate. However, "narrower than the standard margin of fluctuation may also be set on a case-by-case basis"⁽³⁾. (Article 2.4, European Council, 1997) An additional feature of the flexibility of ERM2 is that upon common agreement it allows for the realignment of the central parities "in a timely fashion so as to avoid significant misalignments". (European Central Bank, 1998, p. 1)

Obviously a wider band is easier to defend than a narrower. Moreover, it makes it possible for the "outs" to undertake a somewhat different monetary policy than that of the European Central Bank, and to deviate to a certain extent from the uncovered interest parity without necessarily endangering the central rate. Apparently there will be a need for that, since the new exchange rate mechanism has been brought to existence directly for the sake of those EU member countries whose convergence is not appropriate yet. At the same time, the wider the band is, the less it serves as nominal anchor for convergence.

1.2 The exchange rate criterion [↑]

Exchange rate stability is one of the main indicators of sustainable convergence. Originally the exchange rate criterion was set on the basis of the following consideration: a member country that within the framework of the ERM is capable of pursuing a monetary policy that is in accordance with that of the other member states is expected to adapt smoothly to the single monetary and exchange rate policy in the future as well. This remains valid after the birth of the euro, too. A member state that is able to adapt externally to the monetary policy of the ECB within the framework of ERM2 presumably will have no problem with taking on this monetary policy as an "in" country, either. Therefore the exchange rate criterion remains to be in vigour, and is applied identically in the case of founding and future members: member states can not devalue the central rate of their currencies for two years.⁽⁴⁾

The widening of the band of the ERM after the crisis of 1992/93 from +/-2.25 % to +/- 15 % questioned the very sense of the criterion of exchange rate stability. Therefore prior to the birth of the euro, the European Monetary Institute in its convergence reports always emphasised – without revealing the exact measure – the importance of the extent the market rate of the currencies remained close to the central parity. Besides Article 121 of the TEU prescribes to take into account other factors as well, affecting the sustainability of the exchange rates as well, among others the development of the real exchange rate and the situation of the balance of payments.

These considerations obviously remain valid in the new situation as well. Surely it is not possible to enter the Eurozone with an unstable exchange rate. The "normal margin of fluctuation" of +/- 15 % might be too wide to be a sufficient condition of the fulfilment of the exchange rate criterion for those currencies that are able to stay inside but are volatile enough to occasionally exhaust its width. Although EMU has no track record yet concerning the interpretation of this criterion, one can presume that only those countries will be judged to fulfil the exchange rate criterion that are able to keep their currencies within a significantly narrower band without serious tensions for a prolonged period of time. It is questionable whether this should also mean that the applicant must openly take on the narrow band or it is sufficient that independently of its open commitment it will be able to keep its currency in a narrow margin of fluctuation somewhere within the official wide band. Apart from that it is expected that in the case of accession countries the ECB will refrain from making any commitments to keep the exchange rates of these countries within a narrower band, at least in the time of the entry of these countries to ERM2. Later on, however, a gradual tightening of the band is not ruled out.

2 ERM2, as a framework for monetary cohabitation [↑]

The new exchange rate mechanism must provide for exchange rate stability and for the monetary cohabitation between "ins" and "outs", until the "outs" become able to join the euro area. Among others it primarily must mean two things. First, "outs" are protected from currency crises, and second, "ins" are protected from competitive devaluation of the "outs". In this section both aspects will be discussed.

2.1 Exposure of "outs" to currency crises [↑]

2.1.1 Lessons of the EMS crisis

In the new exchange rate mechanism a recent turn of mainstream economic thinking is reflected.

While in the eighties the advantages of fixed exchange rates were emphasised, in the nineties analysts became rather sceptical about the sustainability of fixed exchange rate systems. Earlier, any kind of fixed exchange rates were suggested, mainly because of the losses attributed to excessive exchange rate fluctuations experienced particularly after the collapse of the Bretton-Woods system. The inflationary bias that seemed to be too excessive without external constraints also called for exchange rate peg. Nowadays, however, in the context of free capital movements the vulnerability of fixed exchange rate arrangements and the questionable credibility of the unconditional commitment to a fixed exchange rate serve as main arguments in favour of flexible exchange rates.

The EMS (European Monetary System) crisis in 1992/93 and the recent financial crises in some emerging markets have directed the attention to the risks of fixed exchange rates. The major lesson is that "... a fixed exchange rate is very costly for a government to maintain when its promises not to devalue lack credibility. At the same time, developing and maintaining credibility has become increasingly difficult. A careful analysis of the genesis of speculative attacks suggests that even broad-band systems á la EMS pose difficulties, and there is little, if any, comfortable middle ground between floating rates and the adoption of a common currency." (Obstfeld – Rogoff, 1995, p. 74.)

The EMS crisis provides some lessons for the new exchange rate mechanism as well.

Generally, one may give four complementary explanations to the crisis. First, the hard core of the EMS, that applied narrow band without realignments in a seemingly successful manner for years, accumulated serious problems of foreign competitiveness, and sustaining the exchange rates became more and more doubtful.

Second, the sufficient symmetry of the business cycles was missing, so the similar monetary policy stance, demanded by the fixed exchange rate did not correspond to the needs of the member-countries with different macroeconomic situations. The Bundesbank, aiming at domestic price stability, tried to neutralise the inflationary pressure of German reunification by raising interest rates. However, the fellow members, suffering from recession did not want to follow the policy of high interest rates, and it led to the weakening of their currencies and to increasing pressures to devalue them.

Third, some problems occurring with the Maastricht program of monetary unification were also conducive to the currency crisis⁽⁵⁾. The need to fulfil the convergence criteria so as to be qualified for EMU membership exacerbated the already existing inconsistency between the macroeconomic equilibrium targets on the one hand and the growth and employment targets on the other. Moreover, the exchange rate and inflation targets reduced the propensity to make the necessary exchange rate realignments. As the economic policies concentrated on domestic problems, it was impossible to undertake a general, co-ordinated EMS wide exchange rate adjustment.⁽⁶⁾ When the post-Maastricht ratification crisis made the future of the plans of monetary integration doubtful, the commitment for sustaining the fixed exchange rates became also questionable, and after all it led to speculative pressure.

Fourth, the integrated financial markets and the full liberalisation of capital movements, consistent with the international trends and the single market program, raised the probability of unpredictable and self-fulfilling currency crises. As a result, even a seemingly stable currency might prove to be unprotected against such self-fulfilling speculative attacks.

The most astonishing in the collapse of EMS is that it justified exactly those views that were used as arguments by EU politicians in favour of monetary unification. Ultimately the currency crisis was an

empirical justification of the classical proposition of Mundell: of the three of free capital movements, fixed exchange rate and autonomous monetary policy only two must be assumed simultaneously⁽⁷⁾. Although it is not appropriate for predicting the concrete timing and measure of the speculative attack, it could (have been) suitable for making the decision-makers aware of the tensions and ready to make the necessary measures. Unfortunately the necessary co-ordination for harmonised actions was missing for several reasons, among others for the pressures for convergence due to the monetary unification project.

2.1.2 On the nature of speculative attacks

If the crisis itself was not, its size and strength was certainly a novelty, and it prompted economists to seek new explanations. As a result, second generation explanations were born (see Obstfeld (1986, 1994, and 1996).

According to first-generation models (see Krugman, 1993) there are always some domestic economic tensions behind the crises, that are incompatible with the peg. These crises are relatively easy to predict on the basis of such economic fundamentals as inflation, increasing budget or current account deficit. These factors lead to large sales and the weakening of the exchange rate. In order to protect the currency, the Central Bank is constrained to intervene at the expense of its foreign reserves and/or to drastically raise interest rates. If these defensive measures do not convince the markets, the attack continues and sooner or later the exchange rate must be given up.

While in the above-described model economic trends quasi determine the crisis, in the more recent second-generation or stochastic models the worsening economic indicators are not necessary preconditions of the speculative attacks that consequently are rather unpredictable. While in the first-generation models it is the worsening of macroeconomic indicators that cause the crisis, in the second generation models it is quite the contrary: here the consequences of the currency crisis lead to the deterioration of the indicators. Hence breaking out of the crisis is not inevitable. The crisis might explode just because of a sudden worsening in the expectation of the markets. Then speculation against the currency starts, and the market actors know well, that after a certain point the authorities could not bear the costs of defence of the exchange rate. Therefore they bet for devaluation, and try to get rid of the currency, since this is what seems to be the safe response. If the devaluation ensues, and they still have a lot of the currency, they will bear enormous losses. However, if they sell their holdings, but there will be no devaluation, their only loss will be the transaction costs.

These crises, triggered by negative expectations are called self-fulfilling crises⁽⁸⁾. The precondition of these self-fulfilling crises is a multiple equilibrium situation. If the strength of the economy and the stability of the currency are unquestionable, there is no sense in speculating against the currency, and there will be no crisis. If it is obvious that there is no sense in sustaining the exchange rate, it is worth of speculating against the currency, and the attack will succeed. There may be, however, a situation when it is not known for sure in advance that the given exchange rate will continue to exist or not. In this grey zone – in most of the cases – some economic variables are promising, others are not. Therefore if the expectations are pessimist, the attack will be launched, and it will be successful. Sooner or later the authorities will be constrained to give up the exchange rate. However, if the market actors think that the currency is not in danger, it will not be attacked, and the given fixed exchange rate will be sustained. In this grey zone ultimately not the macroeconomic fundamentals, but the market's self-fulfilling expectations decide upon the fate of the exchange rate.⁽⁹⁾

As far as the crisis of the European Monetary System is concerned, it can be described with this latter model. Due to the ratification crisis financial market actors suddenly changed their expectations. They judged that – as the Maastricht plan was threatened – sustaining the existing exchange rates became less important for the governments, and their resistance against the growing pressure for expansionary monetary policy would weaken under the circumstances of high and increasing unemployment. Then the devaluatory expectations triggered the process.

2.1.3 ERM2 and ERM1 compared

The above described model of speculative attacks is independent of the concrete form of fixed exchange rate regime, and draws attention to the risks of any type of fixed exchange rate regimes. However, it seems reasonable to analyse that to what extent some characteristics of the European exchange rate mechanism influenced the concrete unfolding of the crisis of 1992-93 and to what extent ERM2 looks different in these respects.

First, in ERM1 the currencies were fixed in the framework of a multilateral international agreement. Moreover, at least in principle, both parties had the obligation to intervene in order to defend the given bilateral exchange rate, and there existed centralised funds for this purpose as well. In principle this system must assure a much safer protection against attacks than a unilateral peg. However, facts prove, that even such a sophisticated system is not immune against currency crises, particularly if just because of the difficulties of international co-operation the necessary intervention suffers delays.

Another important feature of the exchange rate mechanism of the European Monetary System was that it functioned quite successfully for several years: it was able to stabilise the exchange rates, and the national inflation rates started to converge. It is a commonplace that the credibility of economic policies can be established mostly by a good track record. If the authorities – violating their promises – once resort to devaluation, later with this experience the market will be more sceptical about the strength of the commitment to the new exchange rate. If it does not happen, commitment to sustaining the regime strengthens policy credibility. In this sense the positive experiences with the hard EMS should have exactly strengthened the credibility of the exchange rate system and the monetary policies based on fixed exchange rates. Contrary to that, an exactly opposite relationship can be observed: due to the postponed adjustments the market judged some currencies to be overvalued, and sustaining the existing fixed exchange rates became more and more costly. It is not true therefore, that past experience necessarily provides sufficient basis for presuming a successful continuation. Quite the contrary: it raises the probability that sooner or later the peg will be given up.

The third feature of the ERM1 that deserves attention is the band within the market rate of the currencies could deviate from the central parity: a narrow, +/- 2.25 % band for the more disciplined countries, while a wider, +/- 6 % band for others. Theoretically applying such a target zone instead of a fixed exchange rate decreases the chances for a one-way bet against the currency. Apart from this the assumption of interventions on the margins in itself should alleviate exchange rate fluctuations. It is true, but when the market rate achieves the margin, this alleviating effect no longer prevails. Moreover, there are several difficulties in defining the appropriate width of the zone. On the one hand, in principle, the wider is the band, the more the currency is allowed to fluctuate and the less the disciplinary, anti-inflationary effect of the exchange rate works. On the other hand the narrower the band is, the more difficult it is to keep the currency within this band. Additionally it is more probable in this case that expectations are attached to devaluation beyond the margin, and it increases the propensity of speculative attack. From this point of view a wider band is less risky for it has a calming impact on great jumps of the exchange rate. However, the experience of the European currency crisis shows that if the necessary exchange rate realignments are postponed, the width of the band in itself does not matter much. There are examples that both wide- and narrow-band currencies equally collapsed or resisted the enormous pressure.

Presumably decision-makers took all these factors into consideration while designing ERM2. The new exchange rate mechanism is more flexible than the previous was.

The first feature of this higher degree of flexibility concerns the width of fluctuation band. Although the default band with a 30 % width does not entirely rule out the attack, it obviously limits its possibility. Besides, it provides some time for the decision-makers to react on the first signs of devaluation pressures and to make the necessary measures. In case of wide band realignments of the central rate do not lead to such sudden jumps in the exchange rate that most stimulate speculations. Of course, there is also the possibility of having narrower band instead. As it requires the approval of the ECB (European Central Bank), the chance for applying excessively narrow bands that are inconsistent with the state of the economies of the "outs" is negligible. It is so because obviously the primary objective of the ECB with these arrangements is to minimise the risk of currency crises and thus the probability of the necessity to intervene in defence of the member currencies. Of course, member states are free to follow such monetary policy that keeps their currencies in a narrower band, either in an open, declared mode, or in a hidden way, applying a "soft", inner band, that was the practice in the post-1993 ERM.

An additional feature of flexibility is the possibility of adjustment of the central rates. Realignment was possible in ERM1 as well, but it was more complicated. The previous exchange rate system, similarly to the new one, was based on the undertaking of international obligations. This in principle provides more credibility than unilateral pegging. However, this credibility has a price: such a system is more rigid, and exchange rate adjustments are more complicated. The institutional features of ERM2 seem to be more advantageous than the previous one. While ERM1 was a multilateral exchange rate system, ERM2 is practically a set of bilateral exchange rate agreements between the euro-zone and the "out" members. The "outs" fix the central rates of their currencies vis-à-vis the euro, and not against each others' currencies. Thus the operation of the new system will cause far less co-ordination problems, so it must adjust to the changing circumstances far more flexibly. It is expected that in case of necessity realignments could take place in time, in order to prevent such overvaluation problems that the Spanish and Italian currencies suffered from preceding the currency crisis.

2.1.4 The asymmetry of ERM2 and its protective system against currency crises

In contrast to the former ERM, the new exchange rate system is overtly asymmetric: member-states do not determine their currencies in terms of the fellow members' currencies, but only in terms of the central one, the euro. Among others, it has the advantage that the member states' monetary policies face a much simpler task of accommodation. While one of the functions of ERM1 was to promote the convergence among the member states' economies, ERM2 is to promote the convergence of the periphery (the "outs") to the core (the euro area).

However, one of the unfavourable aspects of the overtly asymmetric character of the system concerns the obligation to intervene. *De jure* the system is symmetric: in this respect, since intervention at the edges is an obligation of both the ECB and the member countries, and one is allowed to wriggle out of it only by referring to the threat to price stability. Nevertheless, it is quite problematic how it can work *de facto*. The Eurosystem or the ECB will definitely not be shaken if a speculative attack is unravelling against an "out" currency. Contrary to that, the ERM member country risks a lot: for instance, due to an eventual forced devaluation the chances of entry to the Eurozone are postponed by at least two years. Thus, there is a legitimate fear: even if an intervention at the defence of the currency of a small member can not seriously threaten price stability in the big Eurozone (and the accidental small inflationary effects can easily be sterilised), the ECB would be reluctant to intervene, particularly if the inappropriate economic policy of the "out" country can be blamed for the attack.

It is a well-known experience with exchange rate bands that in most case intervention over the edges can not protect the exchange rate, and there is a need for intramarginal intervention as well. In ERM2 by default no mechanism is laid down for that. According to the legal provisions this is only a possibility: "The ECB and participating non-euro area NCBs (*national central banks – A.F.*) may agree to a co-ordinated intramarginal intervention." (II. Art 4., European Central Bank, 1998) Thus, it is up to the ECB whether it helps the currency in trouble or not. It is true for this case as well, that the intervention is far more important for the member country than for the ECB, despite that its costs are relatively much higher for the former.

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Based on these considerations we can conclude that there is a risk that in practice the new exchange rate system might work as a unilateral fixed exchange rate mechanism, and as such it might leave the member states' currencies highly vulnerable to speculative attacks.⁽¹⁰⁾

Now let us see, what kind of attacks might threaten the currencies of accession countries. The first kind (hereafter type A) of attacks are those experienced in many cases, among others in the ERM in 1992-93: financial markets bet on the collapse of the exchange rate. This is the typical consequence of accumulated real exchange rate overvaluation, but such crises might also break out as a result of contagious effects. In ERM2 wide margins and timely realignments might reduce the likelihood of occurrence of this kind of crises. However, there is a danger of an other kind of attack in the opposite direction (hereafter type B).⁽¹¹⁾ Speculators bet on the revaluation of the currencies and try to force out a realignment. Holding open the realignment option make the participating currencies vulnerable to this kind of attacks. For the markets this might serve as invitation to test, whether by massive capital inflow this realignment can be forced out or not.

If this argumentation is correct not only has the new exchange rate system no advantage for the out members, but it is directly disadvantageous for them. They are forced to maintain a fixed exchange rate that is exposed to speculative attacks. Moreover, considerations to defend the exchange rate might easily contradict with other macroeconomic objectives, and the resulting inconsistencies might make the fulfilment of convergence criteria extremely difficult. Furthermore, even if the country successfully performs, entry to the Eurozone is not warranted, because the member states may regard the convergence performance unsatisfactory from the point of view of its future sustainability and refer to the non-convincing state of the non-quantified indicators of the Maastricht criteria.

Therefore the decisive question is whether the ECB can afford not to bother with the currencies of the ERM2 member countries. In my opinion it can hardly afford it, just because of the contagious characteristics of currency crises. Contagion usually spreads among individuals with similar fundamentals or circumstances. Thus, if one of the member currencies is attacked, the probability, that the currencies of countries in similar position will also be attacked, rises, as the ERM crisis or the East-Asian currency crises justified. Therefore if one member currency happens to be in danger (among others because the ECB did not show readiness to prevent the crisis), the other member currencies might also become vulnerable, and because of the self-fulfilling nature of the crisis they might also be attacked. Eventually the entire system might collapse. Even if the breakdown of one member country did not shock the system, the defeat of the entire exchange rate system would definitely shake the whole integration process in Europe, for it would endanger the smooth functioning of the single market and would undermine the political commitment for further integration objectives. The ECB would definitely not take that risk.⁽¹²⁾ As a consequence, EMU has a big stake in assuring the smooth and safe functioning of ERM2, and most probably it would be ready to act in favour of it as well.

However, there is an additional problem. Currency crises have also demonstrated that when the

attack has already been launched, it can hardly be stopped by intervention in the currency markets. Thus even the slightest possibility must be ruled out that there occurs an unforeseeable, self-fulfilling currency crisis. This requires that it is evident for all market actors that it is no worth of speculating against the currency. As we have already seen, the flexibility of the exchange rate system provides some, but far from sufficient security. What is more, the credibility of the fixed exchange rates within the framework of ERM2 is increased by the facts that after all the economic policies of the "outs" are under community supervision. However, it does not predestine speculation to failure. Although perfect protection does not exist, the defensive system would be stronger if the commitment of the ECB to intervene was free of all uncertainties. So as to achieve it two things are needed: first, an institutional *obligation* (and not just a possibility) for intramarginal interventions, and second, the elimination of unconditional exemption of the ECB from its obligation to intervene. An advantageous institutional solution would be a stability agreement, urged by Wyplosz (1996). If a member country's economic policy complied with its stipulations, the ECB would make a really unrestricted commitment to intervene at the defence of its currency.

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One might argue against this reasoning that the unrestricted commitment of the ECB in favour of a certain exchange rate really contradicts with the primary objective of price stability and consequently undermine the credibility of the common monetary policy suffer damage. (Persson – Tabellini, 1996) But this view can be rejected. As we have just seen, eventually the ECB can not afford to wriggle out of its obligation to intervene, even if it is not so apparent at first glance. Therefore the only task is making the markets aware of it, since this is what really minimises the chances that interventions at the defence of a currency becomes necessary. After all this is exactly what eliminates all danger that the bank's anti-inflationary commitment suffers because of its duties of exchange rate protection. Thus, the public announcement of the terms and conditions of an unrestricted commitment to intervene would be a better solution than the existing one, for at least three reasons. First, such an agreement would really mean a strong incentive for "outs" to apply convergence-oriented policies. If the member country fulfilled its obligations of the stability agreement, her currency would less likely be attacked and this would reduce the necessity of interventions to defend the currency. Second, if the country in question did not perform sufficiently, the ECB would dispose of an unambiguous and unquestionable pretext that exempts it from the obligation to intervene on the currency markets. Third, if the attack were launched in case of non-fulfilment, it would presumably not spread to further, otherwise fulfilling members, like a contagion.

Of course, there is no perfect exchange rate mechanism that assures the stability of the exchange rates without any cost and risk. Learning from the bitter experiences with the EMS, by permitting some degree of exchange rate flexibility the architects of ERM2 could only attempt at reducing the risks to a tolerable level. They more or less succeeded in doing so; although based on what has been discussed so far it is obvious that the system could be further improved. It is dubious whether it is worth of experimenting with fixed, but adjustable exchange rates at all in the era of free international capital movements and the global integration of financial markets. However, if for whatever reason – for instance because of the level of real integration – fixed exchange rates are judged to be necessary, ERM2 obviously provides a more favourable framework for that than any other kinds of fixed exchange rate arrangements.

The case for the necessity of any kind of exchange rate mechanism at all between the "ins" and "outs" of EMU might be challenged on pure economic grounds, but it is unquestionable from a political economic point of view. The relationship between "ins" and "outs" must be regulated in one way or another, so that there exists an appropriate common interest in both parties that the "outs" really proceed towards Eurozone membership. Exchange rate mechanism is a relatively easy way to assure that. Apart from that, an unproblematic membership in the ERM provides sufficient guarantee

for the "ins" about the EMU-maturity of the new members.

2.2 The relationship of "ins" and "outs" and the temptations to devaluate

It is clear from what has been said so far that for Eurosystem members the enlargement of the area of single currency is not pressing. The less "outs" are able or allowed to follow economic policies that are harmful for the "ins", the less interest "ins" have in voting in favour of the promotion of the "outs" into the Eurosystem.

Not being members of the currency union, in principle the "outs" preserve their autonomy in economic policy making. They are able to follow sovereign monetary and exchange rate policies, and – since the sanctions of the Stability Pact do not apply to them – they have wider scope for fiscal policy making as well. Thus, in principle they have the chance to follow "beggar-thy-neighbour" policies, and to improve their own situation at the expense of their partners. Its typical way is devaluation. In the short run devaluation can undoubtedly improve the country's external competitiveness in the presence of market rigidities. The devaluing country is able to increase its exports and output, improve its trade balances and reduce unemployment until inflation absorbs the positive effects of devaluation, whereas trade partners are constrained to bear the fall of demand to their products with all of its consequences. Since both "ins" and "outs" are members of the single market, in principle the "ins" are unprotected against the consequences of competitive devaluation of the "outs".(13)

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The size of the danger it really means for the whole Eurozone or for its individual members depends on the intensity of trade relations. If one or two small countries follow the policy of competitive devaluation, it does not cause serious problems for the Eurosystem as a whole. However, individual "ins" might be differently affected. Those "ins" must bear the negative consequences of an "out" member's devaluation that have more or less parallel production line with the devaluing country. As full members of the monetary union, they can neutralise it neither by fiscal nor by monetary means.

In principle the entire Eurozone could follow beggar-thy-neighbour policy. However this is not a really attractive option for a big and relatively closed region, at least not with respect to the "outs", for their insignificant weight in the trade of the Eurosystem as a whole. The more "ins" are able to prevent through other means that "outs" follow such policies, the more it is true.

As a matter of fact Eurozone does possess such other means. The institution that serves for preventing or keeping a hold on the competitive devaluation of the "outs" or exchange rate fluctuations in general is the exchange rate mechanism itself. In ERM2 there is no possibility for unilateral devaluation, or it is possible only by a simultaneous exit from the exchange rate mechanism. Of course, it is possible to follow inflationary policies that obtain devaluation by force. But this devaluation – if takes place within framework of the ERM2 – can rather be considered as maintenance of the real exchange rate, eliminating or preventing overvaluation, than an attempt to get unjustified advantage in the international competition, since this latter would not be approved by the partners. Real – although necessarily temporary – advantage can be acquired only outside the exchange rate mechanism. Thus, until an out is kept inside the ERM, the protection of "ins" against the devaluing policies of the "outs" can be guaranteed.

Therefore it is easy to see why "ins" have eminent interest in the membership of their fellow EU members in the ERM. Then the next question is how they can assure it. Well, it can be achieved by two means: either as an obligation or by maintaining the interest of the "outs". ERM membership is not an obligation it is voluntary, although accession countries are "expected" to enter. Thus, staying

out can not be sanctioned. Of course, the absent country might expect retaliation, but it is accidental, and most probably occurs in the intergovernmental bargaining process, and can by no means be regarded as direct legal consequence.

As far as the incentives for ERM membership are concerned, by staying out of the exchange rate mechanism one risks only the fulfilment of the exchange rate criterion and consequently the entry to the Eurosystem.⁽¹⁴⁾ Obviously it means sufficient deterrence against competitive devaluation only if the “out” country does want to join the currency union and sees real chances to get membership there as well. If she is unwilling to enter or for any reason considers that she has no chance to do so, it is not by all means beneficial for her to comply with the regulations of the TEU and to take her exchange rate policy “as a matter of common interest”.

Therefore the “ins” must count with the – otherwise highly exaggerated – danger of the competitive devaluating policies of the “outs” only if for them Eurozone membership is not an attractive or realistic alternative. Let us see now this question.

3 The ERM2, as the anteroom of the Eurosystem [↑]

As Article 121 of the TEU prescribes, no country can take on the euro without having spent at least two years without devaluing its currency in the exchange rate mechanism of the EMU.

The obligations of new members include “adherence to the aims of economic and monetary union”. (p. 10, European Commission, 1998). Therefore, in principle all new members must aspire to Eurozone membership and prove it by making “progress towards the fulfilment of the Maastricht convergence criteria”. (p. 11, European Commission, 1998) Despite of these provisions, it is possible to stay out of the euro area: no country becomes member against her own will, as one can stay out without legal basis as well. However, accession countries have already revealed their intention to get full membership in the currency union. Therefore voluntary abstention will no longer be discussed here.

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Thus, in the followings it is assumed that accession countries want to become members of the Eurosystem. So as to achieve this goal, it is essential that they fulfil the convergence criteria, or – to put it correctly – that both the ECB and the member countries unanimously find their convergence record satisfactory and vote for their promotion to the third stage of monetary unification and introduce the euro.

3.1 ERM membership and convergence [↑]

First let us consider in a short macroeconomic analysis, whether the exchange rate mechanism of the EMU provides appropriate environment framework for convergence (and for fulfilling the preconditions for promotion into the Eurozone). The question is the following: is it feasible for advanced transition economies to follow a convergence-oriented economic policy and at the same time keep a fixed exchange rate? In other words: is ERM2 suitable for the specific features of Central and East European economies or not?

In order to acquire full-scale membership in the EMU, accession countries must assure exchange rate stability and fulfil the monetary and fiscal convergence criteria in an environment of fully liberalised capital movements. In addition, so as to reduce the extent of lagging behind the union average in terms of the level of development they must grow significantly faster than the union average for a

long period of time.

Let us see therefore, whether the consistence of these objectives can be assured.

It is a well-known fact, that if all the criteria must be simultaneously fulfilled, achieving one of them does not necessarily make it easier, but rather makes it more difficult to achieve an other one. We have just discussed that the anti-inflationary policy that uses fixed exchange rate as nominal anchor is exposed to speculative attacks. Thus, stable exchange rate must be regarded rather as the result than the means of successful stabilisation.

Let us see in details what forces work against exchange rate stability in the case of transition countries.

One of these forces concerns the real exchange rate, and derives from the Balassa-Samuelson effect: the currency of fast-growing country appreciates vis-à-vis the slower growing country. This can take place either through appreciation of the nominal exchange rate in case of flexible exchange rate or through inflation in case of fixed exchange rate.

Taking Hungary as an example, due to the Balassa-Samuelson effect the real appreciation of the HUF can be as high as 3 % per annum(15). As a consequence, the inflation criterion can hardly be met under fixed exchange rate. Therefore occasional realignments of the central parity are indispensable. If these realignments result in appreciation, they are not regarded as infringements of the exchange rate criterion. However, these realignments can take place only by the accord of the member states and the ECB, so they can suffer delays or can fail to come about.

Accession to the EU, accompanied with high growth rate and real appreciation attracts foreign capital inflow. This exercises a further pressure on the currency to appreciate. Its inflationary effect can be counterbalanced only by sterilised interventions, but it pushes interest rates up, that is a further invitation to capital inflow, while at the same time impedes investments and real convergence. At the same time capital inflow reacts to changing circumstances very flexibly, so its direction can easily turn round. Thus the intensity of short-term exchange rate fluctuations can be too big to keep the currency in an eventual narrow band. Of course, it is easier to keep the currency in the standard, wider, +/- 15% band. However, in both cases it is probable, that the currency sticks to the stronger edge of the band, particularly if the macroeconomic policy is (nominal) convergence-oriented. In this case markets might bet for the realignment option and launch an attack of type B.

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A further problem is that due to capital inflow the real exchange rate might exceed its equilibrium level, and it might further worsen the current account – that for high growth rate and other reasons already shows deficit –, leading to further indebtedness. It might be aggravated by the fact that because of the insufficient level of domestic savings and because of the financing needs of economic growth and of high domestic interest rates, the private economy is more and more relying on foreign credits.

As a consequence a bubble effect, typical preceding type A currency crises, can evolve. Due to financial market pressures the real exchange rate can strengthen excessively and because of the worsening external equilibrium it becomes obvious that the currency is overvalued. As a consequence, speculations are launched against it. The bubble bursts and the exchange rate starts to slump. As we have seen, no exchange rate mechanism provides full protection against this mechanism. A wide band á la ERM2 is not a safeguard against the disruptive consequences of a sudden capital reversal, either (see Begg et al, 2002).

Thus two dangers threaten the currencies of accession countries in the ERM2. The first danger is a usual speculative attack (of type A) in the form of capital reversal. In this case the market speculates in the opposite direction, and forces out the devaluation of the currency.

The second is that the Balassa-Samuelson-type real appreciation translates into excessive nominal appreciation because of the convergence efforts and huge capital inflows. It is becoming less and less easy to keep the currency in the band, whatever its width is. The realignment option invites further capital inflow. This strange attack (of type B) either leads to realignment and an excessive real exchange appreciation that incompatible with the needs of the real economy, or to a softening of the monetary policy stance, abandoning disinflation objectives. In this latter case a loose fiscal policy further exacerbates the inflationary pressures.

The probability of crises of both directions makes staying in ERM2 highly risky for new EU members.

How to cope with these dangers? Mundell's inconsistency theory shows that in such a situation monetary policy is practically ineffective. A monetary restriction to prevent the excessive current account deficit causes interest rates to rise, and its results in further capital inflow and pressure for appreciation, that further worsens the current account.⁽¹⁶⁾

Therefore what remains as a tool is fiscal policy. From the textbook example of the Mundell-Fleming model it is obvious that under fixed exchange rate contrary to monetary policy fiscal policy can affect the current account. A restrictive fiscal stance reduces aggregate demand on the short run and by that it can improve the current account.⁽¹⁷⁾ At the same time financial reforms that seem convincing for the markets just anticipate a future strengthening of the exchange rate, and it has impact on the current exchange rate, too. In this case fiscal prudence can exactly contribute to the upward pressures on the exchange rate, and as a consequence it can aggravate current account problems instead of mitigating them. For this and other reasons the link between fiscal and current account deficit can not be determined unequivocally. What seems sure is that strict fiscal policy can release domestic resources for the private sector and by that it can ease the need for external financing. So – at least for this reason – if the accession countries want to keep their exchange rates fixed within the ERM2, they must follow an even more restrictive fiscal policy than what is prescribed by the Maastricht convergence criteria.

As we have seen, the Balassa-Samuelson effect causes in the accession countries either nominal appreciation or further inflation. The latter is incompatible with the Maastricht inflation criterion, while the former would cause too low interest rates because of interest rate parity, if growth of productivity is high in the accession countries while interest rates are low in the EMU.⁽¹⁸⁾ It would of course ease the fulfilment of the interest rate criterion, but its impact on domestic savings would be unforeseeable. Thus it is obvious that the inflation criterion in the case of fast-growing Central and Eastern European countries is incompatible with exchange rate stability.

Moreover, the central parity of the ERM, applied when the eventual decision on the entry to the euro area is made will most probably be the final conversion rate applied preceding the entry to the Eurozone, as it was the practice in case of the founding members. The exchange rate therefore has a long-term effect on the competitiveness of the country within the EMU. If due to the constraint to fulfil the inflation criterion an "out" country enters the Eurozone with an overvalued exchange rate, in the future it will cause competitiveness problems and losses in growth.

Based on the above considerations we can answer the question of the introduction: The new

exchange rate mechanism does not provide an appropriate framework for the Central and Eastern European accession countries' convergence to the monetary union. The major reason for that is the contradiction between the exchange rate and the inflation criteria that for many reasons come up more sharply in their case than in the case of more developed EU members. The required level of inflation can be reached only by nominal appreciation and excess current account deficit, which is rather risky since might easily lead to currency crisis.

However, the new exchange rate system is more flexible than the previous one was. It must be questioned therefore whether this fact can cure these problems or not. Well, it seems that just to a certain extent. It is true that the wide band makes more nominal appreciation possible without changing the central rate. But it does not exclude the occurrence of the bubble effect. Moreover, in order to achieve the membership in the Eurozone most probably it will not be enough to keep the currency within the standard wide band for the determined period of time: the necessary convergence will be sufficiently demonstrated only by applying a much narrower band. Of course, the central rate can always be appreciated, but it just induces bubble-effect and has unfavourable long-term consequences. Thus, a wide band is unable to solve the basic problem.

Therefore there exists a fundamental inconsistency among the convergence targets in the case of advanced transition (and accession) economies. This inconsistency does not preclude in advance that in beneficial circumstances these countries comply with the criteria. But their fulfilment under the existing conditions is excessively risky and/or disadvantageous in the long run.

Thus, the conclusion of the macroeconomic reasoning is the following: the exchange rate mechanism together with the convergence criteria is not suitable for a relatively fast and unproblematic entry of accession countries to the Eurozone. Simultaneous fulfilment of all the criteria is problematic, and requires enormous sacrifices, particularly as far as its burden on the real economy is concerned. Moreover – together with the features of ERM2 – it increases the exposure to speculative attacks. Now the question is, whether it is worthwhile for the incumbent governments to take these sacrifices. The speculative answer is that only if fulfilment of the criteria is certainly honoured with a fast accession to the Eurosystem.

In the followings I discuss to what extent entry to the Eurozone is warranted in case of full and unambiguous fulfilment of the criteria.

3.2 Chances for enlargement of the Eurozone

After EU accession new members are expected to enter the new exchange rate mechanism. This is also their best interest, since it is among the preconditions of Eurozone membership. However one may raise the question that what is going to happen if these countries experience a lack of commitment in favour of their accession to the Eurosystem from the part of the EMU.

For the Eurosystem its eastern enlargement is not pressing. It has several reasons for keeping "outs" out of the single currency area.

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First, enlargement of the single currency area would raise similar kind of institutional problems that the whole European Union suffers from. Its institutional structure is simply too tight for several new members, while its reform to be able to incorporate new members would be extremely complicated, would require a lot of time and would necessarily hurt the interests of some present member states.

Second, a single monetary policy would be rather difficult to apply for the old and new members,

taking into consideration their different macroeconomic situation and the fact, that presumably the growth rate of new members will be significantly higher than that of the old members. Therefore in order to avoid such complications that already occurred in the case of Ireland, it might be in the interest of the present members to postpone the accession of new members into the Eurosystem as long as possible.

Third, the status of the new members as "outs" of the EMU is absolutely satisfactory for the "ins". Until the "outs" have the intention to be promoted to the Eurosystem, their economic policies remain under the control of EU and EMU, and "ins" are not threatened by competitive devaluation of the "outs". Therefore these former do not feel to hurry with the accession of "outs" into the single currency area and to take its burdens and complications.⁽¹⁹⁾

Since the entry criteria are formulated in such a way that they leave room for different interpretations, "ins" always have the possibility to regard the convergence record of the "outs" as non-convincing, and to reject their application.

Thus, it seems evident that the membership of accession countries in the Eurozone is not warranted despite of their convergence record. Let us see, what might be the consequences of this situation.

In this case the most attractive feature of ERM2 – that is it serves as anteroom of the Eurozone – loses its value. Consequently the commitment of "outs" in favour of convergence suffers. The main reason to pursue anti-inflationary policy, that is politically risky and implies short-term sacrifices, disappears. The sense in maintaining the fixed exchange rate is being questioned, and temptations to improve competitiveness through devaluation instead of structural reforms are growing⁽²⁰⁾. In this case it is not sure that they will show further interest in ERM membership.

Moreover, ERM membership might have negative consequences as well. As the obligation to intervene of the ECB is ambiguous, in worst case the system could work in practice as a unilateral peg. At the same time it is not excluded that the currencies of the future "outs" will be exposed to greater speculative attacks than now, just because of the fact that in the Europe of EMU the number of currencies, and the possibilities for speculation have fallen. In such a situation for the sake of the policy of hard currency interest rates must be kept higher than what is considered optimal, and this has negative effects on the real economy. Moreover, the financial markets might also feel, that joining the common currency is not expected in the near future, and consequently the commitment of the "out" country to keep the peg might become weaker, and – what is more – that the ECB itself might leave the currency on its own. The longer the accession countries are constrained to wait for Eurozone membership in ERM2, the more they are exposed to speculative attacks, and the more burdensome the fulfilment of the convergence criteria seems. Thus, the commitment for convergence weakens.

In such a situation not only in order to improve competitiveness, but also for pure self-defensive motivations leaving the ERM might be of interest for the "outs". To sum up: if the "outs" do not feel that the "ins" are ready to include them into the Eurosystem, they could lose their interest in forming an exchange rate mechanism with the euro. Thus, instead of monetary integration Europe could progress towards monetary disintegration.

This is of course the most pessimistic scenario of all that could derive from the present terms. Fortunately it is not the most probable one. EMU is not expected to postpone forever its eastern enlargement. It is not always in its interest to wriggle out of intervention, either. Moreover, delays of the "out" members' full EMU membership will not necessarily lead automatically to inflationary

policies in these countries. And last, but not least, EMU has other means, that are independent of the monetary union, to prevent that these countries – that otherwise have low bargaining power – follow exchange rate policies that are against the common interest. However, the above scenario serves for highlighting the conflicts that are inherent in the present regulatory framework of monetary cohabitation between "ins" and "outs".

There is a chance therefore that a paradoxical situation occurs. The ERM is able to fulfil its major function to appropriately regulate the relationship of "ins" and "outs". In this case the "ins" are able to keep the exchange rate policies of the "outs" under control and are exempt of the dangers of competitive devaluation. The "outs" adjust to the monetary policy of the ECB, and their membership in the ERM2 increases the credibility of their economic policies, contributes to the fall of inflation rate and to the macroeconomic convergence in general. In this situation right because of the success of ERM it is not pressing for "ins" to let "outs" enter the single currency area. Since the extension of the Eurosystem must necessarily cause some problems to them it is probable that the full-scale EMU integration of the accession countries delays just because the exchange rate mechanism is working well. However, one might ask the question, how long a transitory arrangement, like ERM2 is able to maintain this equilibrium.

Let us see therefore, how the judgement of the markets differs if the "outs" get stuck in the anteroom of the Eurozone for a longer time. Entry to ERM2 must necessarily be regarded positively as an important step on the road to the euro, and membership in the exchange rate system in itself increases the trust in the currencies in question. However, the more entry to the Eurozone delays, the less ERM2 membership is regarded as a virtue. The market might consider the delay of full EMU membership as a sign of insufficient convergence. The belief gains ground that the frustrated "outs" feel the constraints of the ERM more and more as a shackle, and – acknowledging that the hopes for Eurozone membership are vanishing – sooner or later they will devalue their currencies. Whatever the reason for that might be, it is probable that with the time passing the market evaluation of ERM membership will worsen, the credibility of the exchange rate agreement will fall and devaluatory expectations will grow. This in itself could lead to rising interest rates that further reduce the interest of the "outs" in sustaining the exchange rate. Moreover, all these increase the chance for a speculative attack against their currencies.

After all just because it successfully fulfils its duty to regulate the cohabitation of "ins" and "outs" ERM2 can outlive itself. Its consequences are identical to those of the former scenario that started from the assumption that the ERM does not work in a satisfactory way.

The principal lesson of all this is that uncertainties over Eurozone membership make it improbable that accession countries from Central and Eastern Europe soon become full members of EMU.⁽²¹⁾ Its consequences on the entire European integration process are yet to be seen. Therefore it is essential that entry criteria are defined more concretely and the EU guarantees in the most unambiguous way that is ready to enlarge the Eurozone if the applicants meet the requirements.

Conclusions

The paper discusses whether ERM2 in its present regulatory framework is optimal from the point of view of providing a system of peaceful monetary cohabitation between "ins" and "outs" and from the point of view of being conducive to the enlargement of the Eurosystem.

The major findings are the following:

1. Without an institutional *obligation* for intramarginal intervention ERM2 does not fully protect the currencies of "outs" from currency crises.
2. The ECB can wriggle out of its obligation to intervene at the defence of the "out" currencies as well, so there is some uncertainty over the full protection of their currencies that might invite markets for testing.
3. In order to eliminate this uncertainty and to provide full protection for the "outs", obligatory intramarginal interventions must be institutionalised. The ECB must commit to undertake interventions in favour of the out currencies if the "out" country in question complies with the terms of a stability agreement made between the EMU (ECB) and the respective out country.
4. ERM provides full protection for the "ins" against the devaluation of the "outs" only if the "outs" really want and feel to have good chance to be promoted to the Eurosystem.
5. Simultaneous compliance with all the convergence criteria is problematic and presupposes great sacrifices. Thus, "outs" hardly do so unless they see real chance for being honoured for that by accession to the Eurosystem.
6. If "outs" do not experience that "ins" are ready to admit them to the Eurosystem, sooner or later their commitment to the convergence targets will diminish.
7. As a consequence, the unfolding of a worst case scenario is not ruled out: being frustrated by the negative attitude of EMU towards the accession of new members, "outs" sooner or later give up their convergence efforts and might feel the temptation to improve their competitiveness by devaluation. As a consequence, "ins" have really legitimate reason for not admitting them to the Eurosystem. Therefore, the reserves of "ins" over EMU enlargement undermine the convergence efforts of the "out" countries, and this ultimately ex post justifies why EMU was not ready to admit them into the Eurosystem.

Thus, just because ERM does not fulfil its second function of providing a good framework for transition of the new members into the Eurosystem, it will not fulfil its first function of providing a framework of monetary cohabitation between "ins" and "outs", either. Moreover, although the present institutional set-up can be responsible for the failure, the blame for that might be on the "out" countries, since they will really not perform well in terms of convergence. The far-reaching consequences of such a development are left to the imagination of the reader.

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Endnotes

- (1) The decision on membership in the Eurosystem requires qualified majority vote in the Council. (Article 122, Treaty on European Union, 2002.)
- (2) The ECB have just recently presented a recommendation on the voting modalities for an enlarged euro area, that already received several criticism (European Central Bank, 2003)
- (3) Since the entry of Greece to the Eurosystem the only ERM2-country is Denmark which entered with a narrow, +/- 2.25 % band.
- (4) Appreciation is allowed, as it happened in the case of the Irish pound.
- (5) It is a widespread view that the currency crisis served as an unambiguous proof of the fact that EU members were not mature for monetary integration, since they were not able to sustain even a less binding system. Contrary to that, the author is convinced that one can not draw any conclusion from the EMS crisis to the functioning of the EMU. The EMS crisis proves only the inherent vulnerability of whatever kind of fixed exchange rate systems. As a matter of fact, developments after the EMS crisis showed that despite of the relaxation of the exchange rate arrangement the convergence of the member states continued. Moreover one can venture to say that after the crisis some countries – although the growth effects of devaluation were more or less counterbalanced by fiscal restriction – were ultimately able to bear the costs of convergence efforts directly because of these effects. Of the macroeconomic effects of the collapse of EMS see Gordon (1999).
- (6) In September 1992 there was a German and Italian proposal for a general exchange rate adjustment aiming at the appreciation of the DM, but it was not listened to.
- (7) This proposition was evoked by Padoa-Schioppa, when he extended the three – reasonably from a political economic, but unnecessarily from a macroeconomic point of view – with a fourth element, the single internal market. He then argued in favour of the monetary union on the basis of the "inconsistent quartet" (Padoa-Schioppa, 1995).
- (8) Of course, for the full explanation of these crises it is insufficient. Therefore a large bulk of researches considers financial market imperfections, not excluding the possibility of deliberate manipulation of the markets and the herding behavior of investors. The horizontal spreading or contagion of these crises is also a major research topic.
- (9) For a simple game theoretic model of this situation see Obstfeld, 1996, 1997.
- (10) Critics usually reject ERM2 particularly for this. Look for instance Wyplosz (1996).
- (11) After the Irish referendum and the Copenhagen decision about the enlargement in 2004 accession countries like Poland, Hungary and the Czech Republic are facing the challenge that short-term capital inflow exercises an upward pressure on the exchange rate that contradicts with the fundamentals of these economies. In early 2003 Hungarian Forint survived a strange speculative attack of this kind: the financial investors made an unsuccessful attempt to force out that the Hungarian National Bank revalues the Forint – and realigns of the exchange rate band.
- (12) We should not forget, that the new ERM – although so far only two, and now only one country take part in it – might later consist of all the ten new members, and together these countries will represent a significant weight in the future European Union.
- (13) See the model of Martin (1995). Accordingly if two low-inflation countries make a monetary union, making use of its exchange rate sovereignty a third high-inflation country is able to benefit

from this as a free rider.

(14) Here there is some ambiguity since according to the minority understanding of Sweden the exchange rate criterion can be fulfilled despite of formal ERM membership as well.

(15) See the calculations of Simon and Kovács (1998). Accordingly in Hungary if the improvement of productivity of tradeables continues to exceed that of the non-tradeable goods by the extent that was experienced in the previous years, than the pace of annual appreciation must be 3.4 % , if we take agriculture as a non-tradable sector, and 1.2 % if we take it as tradeable. However, for many reasons one might expect somewhat slower improvement.

(16) Kopits (1999) proposes to cure this problem by temporary restrictions of capital movements, similarly to what was applied in the recent years by Chile or Portugal. However, markets would see such a move as stepping back, and – moreover – it is incompatible with OECD and EU membership.

(17) Thus the impact of fiscal adjustment on the external competitiveness is identical with that of devaluation. As a result, "outs" can improve their competitiveness against the "ins" through fiscal adjustment as well. See Wyplosz (1996)

(18) Rostowsky (1999) exposes this anomaly. In the preceding years if real appreciation had been taken place through nominal appreciation, its consequence would have been negative interest rates in the accession countries. "Fortunately" after the transition period such big difference in the growth of productivity exceeding 6 % can not be expected.

(19) Brussels officials nowadays tend to keep accession countries warning against early adoption of the euro. They usually argue with the hardships due to premature fulfillment of the convergence criteria. (See for example Pedro Sobres (2003) However, one can not rule out that apart from benevolence there are other considerations behind these advises, as well.

(20) Buitert and Sibert (1997) also come to the conclusion that if the "outs" are deprived of the Eurozone membership, their inflation bias will increase and reform commitment will decrease.

(21) Thus for accession countries it is not reasonable to set early entry to the Euro-zone as an objective, and not only for the economic burdens of fast and forced convergence. So far Hungary for example expressed its intention to adopt the euro as early as year 2007 or 2008, while Poland and the Czech Republic have a more cautious position.