THE EXCHANGE RATE AND ITS ROLE IN THE EMU ACCESSION PROCESS

INSTITUTIONAL ASPECTS OF CONVERGENCE CRITERIA OF THE EXCHANGE RATE IN THE FRAMEWORK OF EMU[1]

Rastislav Čársky, Martina Klačanská, Andrea Tvarošková

Introduction

Slovakia is to become a member of the European Union in May 2004. On the basis of the EC Treaty, membership of the European Union means for Slovakia a commitment to conduct its economic policy in coordination with other Member States, with the aim of achieving common goals. A component of the economic policy, as well as of other activities of an EU Member State is adherence to the Stability and Growth Pact with subsequent adoption of the single currency (the euro) and a common monetary policy. The accession process thus creates certain limitations for individual components of economic policy, which in the case of budgetary policy are set in terms of budget deficit and public debt criteria. Monetary policy will be determined by the need to fulfil inflation criteria and the convergence of interest rates. Last but not least, the EMU accession process also creates a framework for exchange rate policy. This is given by the definition of the exchange rate criterion as well as the need to create macroeconomic stability and ensure the vitality of the economy after country's accession to the euro area. In this connection, the country's membership in the exchange rate mechanism (ERM II) and the setting of central parity become an important question.

With upcoming Slovakia's accession to the EU, exactly the ERM II membership and the function of the exchange rate in the economy is currently under discussion. Consequently, what is the role of the exchange rate in the process of ensuring macroeconomic stability? What is the ERM II and how is the exchange rate criterion defined? How has the evaluation of this criterion progressed over the past years and what is the view of the European Commission and the ECB on fulfilment of the criterion as presented in the convergence reports? This article attempts to provide answers to these and other questions, and to give the reader some idea of the experience of Greece in the ERM II membership on the road to the common European currency.

Membership in the ERM II and the role of the exchange rate in the context of macroeconomic stability

Membership in the ERM II and the level of central parity in the framework of the mechanism need to be seen on two levels – as a precondition for the fulfilment of the nominal criteria of membership in the euro area and in the context of the role of the real exchange rate as an instrument for maintaining/recovering macroeconomic stability.

The ERM II membership creates certain determinations for the exchange rate development set by the definition of the exchange rate criterion, or respectively its application in practice. At the same time, the exchange rate should not be understood merely as an instrument for accession to the euro area, but the level should also reflect the development of economic fundamentals. In other words, the exchange rate should be perceived as a means for maintaining the economy close to its equilibrium.

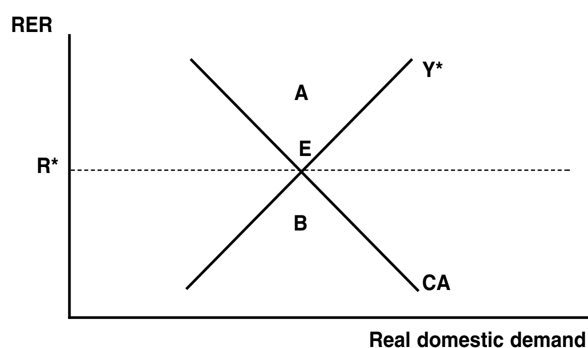
In this respect, a future central parity should thus reflect (generally it should be understood by the markets as a conversion exchange rate as well) the medium-term level of the equilibrium real exchange rate.

The importance of the real exchange rate has been especially underlined in connection with entry to the monetary union and the factual loss of the nominal exchange rate as an instrument for solution of economic imbalances. In the case of a country's entry to the euro area in a situation where the actual level of the real exchange rate differs significantly from the equilibrium level, a return to equilibrium could be realized only via price development, or through adjustment of real economic variables (output, employment, wages). Economic equilibrium of a country is depicted in Graph 1.

Economic equilibrium is shown in relation to the level of the real exchange rate and domestic demand. The curve of CA (current account) indicates the long-term

[1] Opinions stated in this article are those of the authors and do not necessarily reflect the opinion of the NBS.

Graph 1 Macroeconomic equilibrium



Note: Growth in the real exchange rate indicates appreciation

sustainable level of current account, or the stance of external equilibrium. A country having a current account surplus is located below the CA curve, while conversely a country with a current account deficit will be located above the curve. Internal equilibrium is represented by the potential output curve (Y*). In the case that economy is located above the curve Y*, it is below the level of its potential output and, conversely, below the level of this curve the actual output is higher than the potential output. The position of an individual economy in the framework of this diagram is determined by the level of real domestic demand and the real exchange rate in relation to equilibrium figures.

If the real exchange rate in comparison with its equilibrium level is overvalued, the country is located below point A, from the view of domestic economic subjects tradable goods are relatively cheaper in comparison with non-tradable goods and also the export price is relatively higher in comparison with the price level of trading partners. On the one hand, the economy suffers an increasing deficit on the current account of the balance of payments due to relatively more expensive exports and the growth of imports (in comparison with non-tradable goods, these are relatively cheaper). At the same time, relatively low demand for non-tradable goods dampens inflation, or reduces their production. The economy thus occurs below the level of the potential output. A recovery of the macroeconomic equilibrium in this situation may be effected via depreciation (devaluation) of the nominal exchange rate, through a reduction in the inflation differential in comparison with the price growth of trading partners or via a combination of these factors. In the case of depreciation (devaluation) of the exchange rate the return to economic equilibrium may be faster. Export competitiveness will be restored, prices of tradable goods will increase in relation to the prices of non-tradable goods, resulting in a growth of demand for non-tradable goods. The economy thus moves back to the level of potential output and to external equilibrium. If a country enters the euro area with an overvalued real exchange rate, then with regard to the non-existence of the nominal exchange rate, macroeconomic equilibrium could be established via price development only (a fall in the level of inflation differential below the level of trading partners) with an impact on the real economy. In this case the process of restoring equilibrium in the economy would be significantly more painful and slower (especially with regard to the high rigidity of prices, wages and labour markets in transforming economies).

Conversely, the point B represents a situation where the real exchange rate in comparison with its equilibrium level is undervalued. Thus, the export price is lower (in comparison with trading partners) and concurrently, prices of tradable goods are relatively more expensive for domestic economic subjects in comparison with those of non-tradable goods. This results in excessive demand for non-tradable goods, real economic growth above the level of the potential output and inflationary pressures stemming from this. Similarly, as in the previous case, the most rapid way of return to macroeconomic equilibrium is via appreciation (revaluation) of the nominal exchange rate, what will occur also via price development (higher inflation in comparison with trading partners). If a country enters the euro area with an undervalued real exchange rate, then, given the non-existence of a nominal exchange rate, the return to macroeconomic equilibrium is carried out via price development with a corresponding impact on the real economy. Thus the economy moves over the level of its potential output, where prices rise faster in comparison with trading partners. So the exchange rate not corresponding to economic fundamentals can be a source of macroeconomic imbalance.

By entry to the euro area, a country practically gives up control over the nominal exchange rate as an instrument for resolving macroeconomic imbalances. The setting of a central parity and subsequently the conversion exchange rate at a level not imposing a threat to sound, balanced economic development of a country thus becomes an important question facing the current candidate countries on the road to accession to the EU and subsequently to the EMU.

Nominal limitations on exchange rate development on the road to a single currency

This nominal determination is set by Maastricht criterion on exchange rate and its application or interpretation by the European Commission and the ECB within the convergence reports. These limitations are quite closely connected with political will or the lack of it to enlarge the euro area. To minimize the risk of non-fulfilment of the exchange rate criterion requires relatively strict adherence to the interpretation of criterion evaluation by both institutions.

The EC Treaty defines the exchange rate criterion as observance of the normal fluctuation band provided by the exchange rate mechanism of the European Monetary System for at least two years without devaluation against the currency of any other Member State.

The Protocol on convergence criteria also specifies that participation in the exchange rate mechanism means a movement of the exchange rate in the framework of the normal fluctuation band without severe tensions for at least two years before examination. On the basis of the European Council Resolution on the establishment of an exchange-rate mechanism in the final stage of the economic and monetary union a normal fluctuation band means ± 15% around approved central parity.

According to the application of EC Treaty provisions regarding the evaluation of the exchange rate criterion as expressed by the European Commission and the ECB/EMI in the convergence reports, however, the fulfilment of this criterion responds to exchange-rate development close to the central parity, where the country under examination should not record a long-term, and in particular, systemic breach exceeding 2.25% into the depreciation band. However, evaluations of individual countries in the framework of convergence reports indicate that the fulfilment of the exchange rate criterion in the past was not strictly fixed to maintaining exchange rate development in a band not exceeding ± 2.25 % around the central parity during the whole time horizon, nor to the condition of two-year participation in the ERM (ERM II) before the examination of the country (in the case of Italy and Finland).

In following part of this article we shall examine in greater detail the evaluation of the fulfilment of the exchange rate criterion by individual countries, current members of the euro area, as well as the strategy of Greece (as the only country with a derogation, which joined monetary union at a later date and from the ERM II) prior to entry to the ERM and EMU.

The exchange rate mechanism (ERM II) and approach of the European Commission and ECB to evaluating the exchange rate criterion

In the run-up to the final stage of monetary union it has been necessary to formally establish an institution which would oversee the functioning of the exchange rate mechanism (ERM) under the new conditions – the introduction and existence of a single currency. Therefore, on 16 June 1997, European Council approved the Resolution on the exchange-rate mechanism in the third stage of economic and monetary union. In contrast to the previous multilateral system, in the framework of the ERM II the central parities of the participating currencies were fixed against the single currency.

A comparison between the ERM and ERM II

In comparing both systems it can be said that there are certain similarities, as well as differences. Similarities include especially the common procedure of setting a central parity and fluctuation band. The finance ministers, the ECB, the governors of national central banks as well as the European Commission take part in this common procedure. A further similarity is the standard fluctuation band of ± 15%, which does not exclude the possibility to narrow it, even though within the ERM until 1993, a fluctuation band of ± 2.25% had been set with a permitted exception of 6%. Within both mechanisms, interventions at the margin with appropriate financing are undertaken automatically. Similarly, within the ERM as well as within ERM II there is a possibility to change the parity and the fluctuation band by common procedure.

The difference between both mechanisms could be seen mainly in the fact that ERM II is built on bilateral relations between the euro and the currency of a non-euro area Member State. So an intervention obligation arises between the ECB and the NCB of a non-euro area Member State (in the framework of the ERM, interventions were made on a multilateral basis). The euro has become the formal anchor of the ERM II, whereas in the ERM no formal anchor was set (the DEM was merely an informal anchor of the system). In a framework of the ERM II, there is a clause stating that the ECB and a NCB have the right to suspend interventions if the objective of price stability would be jeopardised (in the ERM this article did not formally exist). In the framework of the ERM II, adjustments to the central parity can be initiated in a timely manner and by all participating parties (in the ERM the process of adjustment could be initiated only by the Member State concerned).

The role and objective of the ERM II and its institutional definition

Pursuant to the Resolution of the European Council of 16 June 1997, one of the main objectives of the ERM II is exchange rate stability, a precondition of which is economic convergence of the participating Member States, and is reflected in a sound fiscal policy and structural reforms. The exchange rate mechanism of the ERM II should help non-euro area Member States participating in it in their efforts towards adopting the single currency at a future date. Equally, the ERM II provides to States not yet adopting the single currency the same treatment in the evaluation of the convergence criterion fulfilment as to States which became members of the euro area on 1st January 1999. The ERM II functions without prejudice to the primary objective of the ECB or NCB to maintain price stability. Participation in

the mechanism is voluntary, nevertheless, the participation of EU Member States with derogation is expected (Article 1.6 of the Resolution). The ERM II exchange-rate mechanism ensures sufficient flexibility in implementing the exchange rate policy of the participating states and concurrently enables the creation of closer links to the euro, for example through narrower fluctuation band (Article 1.8 of the Resolution).

Based on the Resolution's text, a central parity is set for the currency of each EU Member State outside the euro area participating in the ERM II in relation to the euro, with a standard fluctuation band of ± 15%. Interventions at the margins are automatic and unlimited, nevertheless, the ECB or NCB can suspend these interventions in case of conflict with the primary objective to maintain price stability. The mechanism allows co-ordinated interventions in case of exchange-rate movement within the band. The flexible use of official interest rates by central banks is one of the important characteristics of the ERM II.

The decision on central parity is taken by mutual agreement between the finance ministers of the euro area Member States, the ECB and the finance ministers and governors of the national banks of the EU Member States outside the euro area participating in the exchange rate mechanism. This mutual agreement follows after a common procedure involving the European Commission, and after consultation of the Economic and Financial Committee (EFC). The ministers of finance and governors of national central banks of the EU Member States not participating in the ERM II may take part in the decision-making process, but without voting rights. All participating parties have the right to initiate the process of reconsidering the central parity.

On the basis of an individual judgment it is possible, at the request of a Member State that is a participant in the ERM II, to set a narrower fluctuation band. In this case the decision is taken by the ministers of finance of the euro area Member States, the ECB and the minister of finance and governor of the national central bank of the State concerned. Their decision is made following a common procedure, in which the European Commission participates and subsequent to consultation with the EFC. Ministers and governors of central banks of other States participating in the ERM II may participate in the decision-making process, but without voting rights.

The operational framework for the ERM II exchange-rate mechanism was set by the Agreement of 1st September 1998 between the ECB and the national central banks of the Member States outside the euro area. According to this agreement the participating parties agreed on the joint notification of central parities and changes to them, as well as the lower and upper limits for automatic intervention of the market participants. Interventions are effected in euro or in the currencies of countries outside the euro area participating in the ERM II. The ECB and participating NCBs must mutually inform one another of their intended interventions.

The exchange rate criterion – a definition and its application, or interpretation in convergence reports of the European Commission and the ECB

The present candidate countries must in the Monetary Union accession process unconditionally fulfil the convergence criteria for adopting the euro as they are stated in the EC Treaty and will be evaluated by the respective institutions (European Commission and ECB) in convergence reports. The interpretation of the convergence criteria in an evaluation is based above all on the principle of equal treatment. This means that pursuant to the Treaty, Member States acceding to Monetary Union at a later date may neither be advantaged nor disadvantaged in comparison to those Member States which originally created the Monetary Union. The second principle is strict adherence to the provisions of the EC Treaty so as to avoid any watering down of the convergence criteria and to eliminate any legal risks ensuing from a breach of the Treaty. According to the third principle, where literal application of a criterion is not possible, technical adaptation should be made in accordance with the original intention at the time the criterion was defined[2].

In evaluating the exchange rate criterion it is necessary to work primarily from the relevant articles of the EC Treaty and the Protocol on convergence criteria. Article 121 of the EC Treaty specifies the Maastricht exchange rate criterion as observance of a normal fluctuation band within the exchange rate mechanism in the framework of the European Monetary System for at least two years without devaluation against the currency of another Member State.

The Protocol on convergence criteria also specifies that participation in the exchange rate mechanism means a movement of the exchange rate in the framework of the normal fluctuation band without severe tensions for at least two years prior to examination. Pursuant to the approved Resolution of the European Council the establishment of the exchange-rate mechanism in the third stage of the economic and monetary union, a normal fluctuation band corresponds to ± 15% around the approved central parity. A Member State, during this period, may not devalue the central parity of its currency against that of another Member State.

[2] Position Paper of the ECB in relation to the accession process to the euro area, December 2002.

The evaluation of fulfilment of the exchange rate criterion has undergone certain developments due to changes in the exchange-rate mechanism in the framework of the European Monetary System, as well as in connection with the ongoing process of building up the monetary union.

In the case of the convergence examination in 1998, the European Commission, in the framework of the second stage of building up monetary union with the single currency, applied in its evaluation of the exchange rate criterion the so-called median currency approach[3]. In applying this method a movement of the exchange rate within the ± 2.25% fluctuation band vis-à-vis the median currency of the mechanism is tolerated. This in fact allowed a 4.5% appreciation, or depreciation of one currency against another (currencies at the upper and lower end of the range of currencies on a given day).

The decision of August 1993 on expanding the fluctuation band of the ERM II to ± 15% required clearer specification in evaluating exchange-rate stability. At the time of the examination in 1998 it was still not precisely defined, whether a "normal fluctuation band" corresponds to this expanded band or to the original ± 2.25%. On the one hand, in connection with assessing exchange-rate stability the expanded band was thought to be inappropriate, since at the inception of the EC Treaty the ± 2.25% band was deemed normal, and so a 30% appreciation or depreciation of a currency (in the case of using the median currency approach between currencies at the lower and upper end of the range of currencies) could hardly be considered as a stable development. In addition, the expanded band was originally introduced as a temporary measure meant to serve as an instrument to ward off speculative attacks on individual currencies in the ERM. On the other hand, however, the fluctuation band of ± 2.25% was nowhere formally encoded.

In evaluating the exchange rate criterion in its convergence report the European Commission did not consider the exceeding of the defined fluctuation band automatically a sign of severe tensions. In assessing the severity of swings in the movement of the exchange rate it was necessary, according to the European Commission, to take into consideration the duration and amplitude when the limit of the band was exceeded, the nature and scope of corrective measures, primarily foreign currency interventions and changes in short-term interest rates, and this as to whether there was actually pressure for an appreciation or depreciation of the currency.

Assessing the fulfilment of the exchange rate convergence criterion, the European Commission stated that by the end of the evaluation period (February 1998) the Belgian, Luxembourg, Danish, German, Spanish, French, Irish, Dutch, Austrian and Portuguese currencies participated in the ERM for more than two years. Among these currencies only the Irish currency was traded outside the fluctuation band of ± 2.25% against the median currency during the evaluation period, nevertheless its deviation was primarily in the appre-

[3] The median currency approach defined the currency closest to its central parity against the ECU as the reference currency, against which the other currencies in the mechanism are compared. The reference currency is determined according to exchange rate fixing on a daily basis.

Tab. 1 Spread of ERM currencies against the median currency (for the period March 1996 to February 1998)

	Average (%)	Average of absolute values (%)	Maximum (%)	Minimum (%)	Standard deviation	Days below the limit -2.25%	
						Number	Percentage of trading days
BEF/LUF	–0.08	0.22	0.44	–0.44	0.23	0	0
DKK	–0.46	0.47	0.04	–1.41	0.52	0	0
DEM	–0.13	0.14	0.34	–0.46	0.12	0	0
ESP	0.71	0.71	2.61	0.00	0.47	0	0
FRF	–0.81	0.81	0.05	–2.35	0.56	2	0
IEP	4.56	5.21	10.91	–4.24	4.17	32	6
ITL*	–0.77	1.57	1.84	–7.82	2.13	96	19
NLG	0.15	0.25	0.93	0.30	0.32	0	0
ATS	–0.15	0.16	0.31	–0.47	0.13	0	0
PTE	0.67	0.86	2.76	–1.36	0.88	0	0
FIM*	0.54	1.26	3.74	–4.21	1.44	39	8

*Data for the Italian lira and Finnish marka are calculated as if both currencies participated in the ERM throughout the whole evaluation period. All days when currencies fell below the – 2.25 % limit, were for the period before joining the ERM.
Source: European Commission

ciation part of the band. During the evaluated two-year period, the exchange rate of these 10 currencies did not experience severe tensions.

At the time the European Council passed its decision in May 1998, the Italian and Finnish currencies participated in the ERM for 17, and 18 1/2 months respectively. The period when the exchange rates of both currencies were below the – 2.25% limit, was also before entry into the ERM. Prior to their entry into the ERM, however, both countries showed a trend of appreciation, and following entry into the ERM had experienced relatively stable development. For the purposes of the examination both currencies were evaluated as if they participated in the mechanism throughout the two-year period. Neither of these currencies had needed direct monetary policy instruments for defence (an increase of official interest rates, or pronounced interventions).

From this examination it is clear that the European Commission in assessing fulfilment, did not follow strictly the definition of the convergence criteria, but took instead into consideration the overall trend of development in the exchange rates of the individual currencies. In the case of Italy and Finland, it had therefore not been necessary to keep to the two-year period of participation in the ERM. At the same time, it needs to be said, that all the currencies concerned had showed deviations from the stipulated conditions only at the beginning of the evaluation period, while in the later phases no swings occurred in the case of any of the currencies and the exchange rate gradually converged to central parity, vis-à-vis the median currency.

The European Monetary Institute (EMI) based its evaluation in 1998 on the opinion that the convergence report need not be founded on a detailed interpretation of participation in the ERM, but rather on a thorough evaluation of the sustainability of exchange-rate stability in the context of the economic fundamentals of the individual Member States. In evaluating fulfilment of the criterion the EMI did not use the median currency approach (as did the European Commission), but assessed the development of individual currency's exchange rates mutually against one another. The EMI in its examination also paid attention to the development of the real effective exchange rate, balance of payments current account development, foreign trade development, and the direction of exports.

From the above, it is clear that the EMI in its report, in the same way as the European Commission, did not adhere strictly to an application of the convergence criterion and the development of the exchange rate of the countries concerned in the period under review was described without particular reference to adherence or non-adherence to the conditions for fulfilling the criterion. In the case of the EMI, the evaluation, in comparison with the European Commission, may be described as less specific. The EMI in its evaluation does not state whether a country fulfils or does not fulfil a criterion – it leaves this a matter for the Council (ECOFIN) to decide.

In 2000 and 2002 the European Commission in its convergence reports on the fulfilment of the exchange rate criterion considered the following conditions as the most important:

1) participation in the ERM II at the time of the examination is mandatory,

2) participation in the ERM II for at least two years prior to the examination is required, and the stability of the exchange rate prior to entry into the exchange rate system is taken into consideration,

3) no devaluation from the central parity during the evaluation period,

4) in the context of the ERM II, the exchange rate must be maintained within the fluctuation band of ± 2.25% from the central parity stipulated in relation to the euro, and breech of the given margins does not unconditionally mean a severe tension in exchange-rate development. In the case of an exchange rate movement there is a difference in the evaluation between exceeding the limit of the fluctuation band of 2.25% in appreciation, or depreciation direction.

The European Central Bank, in the same way as the European Monetary Institute in 1998, in its convergence reports for the years 2000 and 2002, in connection with the relevant provisions of the EC Treaty, defined the basis for evaluating individual currencies as follows:

1) In the evaluation it is necessary to take into consideration whether the country participated in the ERM II "for at least two years prior to the examination", or not.

2) In the assessment of the "normal fluctuation band" it is necessary to take into account the fact that despite the ERM II fluctuation band was set at ± 15%, in the conceived Treaty a fluctuation band of ± 2,25% was "normal" with a permitted exception of ± 6%, and, therefore, in the examination it is necessary to put emphasis on the development of the exchange rate close to the central parity.

3) With regard to "severe tensions", it is necessary in the examination, to take into consideration the degree of deviation of the exchange rate from the central parity together with the assessment of the foreign currency intervention, or the use of indicators as short-term interest rates differentials in relation to the euro area.

In the case of Greece, as the only country with a derogation, and which entered monetary union at a later date (Greece became a member of the euro area on 1 January 2001), the European Commission in its convergence report in 2000, stated that the drachma participated in the ERM and, subsequently the ERM II, longer than the required two-year period. During its par-

ticipation in the ERM the exchange rate occurred above the central parity level set against the median currency and during its participation in the ERM II, the exchange rate moved similarly above the central parity vis-à-vis the euro. Furthermore, the European Commission stated that during the period under review no devaluation of the central parity of the drachma against any currency in the ERM or against the euro in the ERM II had taken place. Although the drachma exchange rate had come under some pressure due to turbulence on the international financial markets in the summer of 1998, this was only temporary and no serious swings were recorded in the exchange rate development. On this basis, the European Commission found that Greece had fulfilled the exchange rate criterion.

The ECB in its convergence report in 2000, discussed the exchange rate development of the drachma in relation to the ECU, (later the euro). This development was split into two different phases. The first phase, from the beginning of the evaluated period up to February 1999, was characterised by a trend of an appreciation vis-à-vis the ECU/euro. During the second phase, the drachma showed a moderate depreciation trend towards the central parity. As in its previous convergence report, the ECB in its description of the development of the nominal exchange rate, paid attention also to the development of the real effective exchange rate, the development of the balance of payments current account and the foreign trade of Greece. There was no statement on fulfilment of the convergence criterion. The ECB left this decision to be taken by the ECOFIN Council, which decides through a qualified majority on the fulfilment of the criterion by a country in the status of a Member State with a derogation.

After the accession to the EU, the position of the current candidate countries will not be the same as it was the case with Greece. These countries on entry to the ERM II mechanism (Greece originally entered the ERM) will have their central parities set against the euro. For this reason, the evaluation of the exchange rate criterion, for example, by the European Commission, may be somewhat different, since the development of the exchange rate will not be judged by means of the median currency approach, applied in the examination in the year 2000. The candidate countries may, on accession to the euro area, create a precedent in the process of evaluating the fulfilment of convergence criteria, also with reference to the interpretation of individual criteria for accession to the euro area.

To be continued by Greece's participation in the ERM and ERM II exchange-rate mechanisms in the period prior to entering the EMU in the next issue.