The ten countries acceding to the European Union in May 2004 will at the same time become members of the Economic and Monetary Union (EMU). Nevertheless, they will not adopt the euro from the very beginning, as they will be member states with derogation. Since the new member countries do not have an opt-out clause, they are committed to participating in the euro area in due course. However, the wish to opt out is not an issue. On the contrary, the accession countries want to adopt the euro as soon as possible. Parallel to preparing their EU membership, the ten accession countries (referred to hereafter as “AC-10”) have aimed at achieving nominal convergence, which is the precondition for joining the euro area, although with varying success. The Bank of Slovenia for instance states explicitly that “preparing the conditions for adoption of the euro at the earliest opportunity remains the Bank’s ... basic policy orientation”.1

In contrast, the EU has called for a slower timetable and sees the adoption of the euro as the final stage of a long convergence process. The different approaches also become evident in the discussion on the appropriate interpretation of the convergence criteria on exchange-rate and price stability and on the sense of participation in the new Exchange Rate Mechanism (ERM2) prior to joining the euro area. Nonetheless, it can be expected that the first accession countries will enter the euro area in 2007 or 2008.

**Current Exchange-rate Regimes**

The current exchange-rate regimes of the AC-10 range from currency boards to free floating. Estonia has had a currency board with a fixed rate to the DM/EUR since 1992. Lithuania introduced a currency board in 1994; the anchor currency was changed from the US dollar to the euro at the beginning of 2002. Latvia and Malta have pegs to currency baskets with small fluctuation bands of ±1% and ±0.25% respectively. Cyprus closely pegs its pound to the euro (notwithstanding the formal fluctuation band of ±15%). Officially, Slovenia pursues a managed float, although the Bank of Slovenia conducts an active exchange-rate policy. The result looks rather like a crawling peg with a steady devaluation at a falling rate (3% in 2003).

The remaining four accession countries have replaced the (crawling) pegs that they pursued during most of the 1990s by more flexible regimes. The Czech Republic and Slovakia switched to managed float systems in 1997 and 1998 respectively. Since 2000, Poland has let its currency float freely, after widening the fluctuation band of its crawling peg in prior years. In 2001, Hungary widened its fluctuation band from ±2.25% to ±15% and abolished the gradual devaluation of the central parity, thereby mimicking the rules of ERM2. Hungary devalued its central parity from 276 to 282 HUF/EUR in June 2003, but this was not due to a weak forint. On the contrary, the purpose was to shift the margins to avoid a renewed appreciation.2

**Steps to Adopting the Euro**

Upon accession to the EU, the AC-10 can maintain their different exchange-rate regimes. The responsibility for monetary policy will remain in the hands of the respective central banks. Although the new member states will not join the euro area upon accession, the obligation of adopting the acquis communautaire also applies to its EMU related part including central bank independence, the prohibition of direct financing of budget deficits, and the liberalisation of capital movements.

As a next step towards adopting the euro, a new member state can request to join ERM2 at any time after accession. Participation in ERM2 is voluntary, but member states with a derogation can be expected to join the mechanism. Moreover, according to the convergence criterion on exchange-rate stability, participation in ERM2 for at least two years is a precondition for adopting the euro. Finally, the new member states will fully participate in the euro area once they meet the convergence criteria set out in the Maastricht Treaty.

---

1 Bank of Slovenia: Monetary Policy Implementation Report, October 2003, p. 4.
2 Hungarian National Bank: On the Bank’s Exchange Rate Decision of 4 June 2003, Press Release. The forint appreciated immediately after widening the fluctuation band, and since then it has always nominated more strongly than the central parity. In late 2002, the forint appreciated in response to a loose fiscal policy combined with a tight monetary policy, and in January 2003, the central bank had to intervene at the margin of the fluctuation band. A subsequent cut in interest rates caused a depreciation by a few per cent. In June 2003, the government requested a shift in the central parity to signal to the markets that a renewed appreciation of the forint would not be allowed.
The New Exchange Rate Mechanism ERM2

When the third stage of EMU began in 1999, the European Monetary System (EMS) was replaced by ERM2. According to the respective Resolution of the European Council, the exchange-rate mechanism is based on central rates against the euro with a standard fluctuation band of ±15%. Decisions on central rates are taken by mutual agreement of the ministers of the euro area member states, the ECB and the ministers and central bank governors of the countries participating in ERM2.

Interventions at the margins are in principle automatic and unlimited, unless they conflict with the primary objective of price stability of the ECB or of the central bank concerned. All parties to the mutual agreement, including the ECB, have the right to initiate a confidential procedure aimed at reconsidering central rates.

Finally, fluctuation bands narrower than ±15% may be agreed at the request of a member state, which will be backed by automatic intervention of the country’s central bank and the ECB. This is the case for Denmark, the only country currently participating in ERM2, with a fluctuation band of ±2.25%.

Although the basic decision of the Eastern enlargement had already been made, the characteristics of the accession countries were not taken into account when the rules of ERM2 were laid down in 1997. Soon afterwards, a discussion emerged as to whether a currency board arrangement (CBA) would be consistent with ERM2, as Estonia wanted to keep its currency board until it adopts the euro.

A CBA may be considered as a peg to the euro with a fluctuation band of zero. In contrast, there was also the opinion that a CBA should be regarded as a completely different regime, as the rules of ERM2 presuppose the possibility of realignments by mutual agreement and some fluctuation around the central parity. However, there do not appear to be any good economic reasons for abolishing a well working CBA to allow for an interim period of exchange-rate flexibility prior to joining the euro zone.

In April 2000, the ECB reached the conclusion that a euro-based currency board will not a priori be considered incompatible with ERM2, if certain conditions are met. To be consistent with ERM2, the CBA must be deemed sustainable, implying that it may not be introduced during participation in ERM2. Moreover, the CBA of a participating country would be understood as a unilateral commitment, meaning that a CBA is not exactly equivalent to ERM2 with a zero fluctuation band. Finally, a mutual agreement must be reached not only on the maintenance of the currency board itself, but also on the central parity. If this is understood literally, it includes the possibility that a country could keep its currency board but would be required to adjust its parity. The substance of this last qualification is not clear, as the requirement that the CBA is deemed sustainable already implies that the central parity does not represent a real misalignment. A rationale for this qualification could be that it prevents a country from unilaterally changing its central parity shortly before or during participation in ERM2. In summary, countries that have had a CBA for a long time may keep it during ERM2. However, a CBA may serve neither as a short-cut to adopting the euro nor to circumvent the principle that in ERM2 decisions must be reached by common accord.

In November 2000, the Council of the EU stated that only the following exchange-rate regimes are clearly incompatible with ERM2: free floating (or managed float without a mutually agreed central rate), crawling pegs and pegs against anchors other than the euro. Compatibility of CBAs with ERM2 will be assessed case-by-case.

Interpretation of the Exchange-rate Criterion

As a precondition for joining the euro area, the accession countries have to fulfil the convergence criteria. According to the Treaty of Maastricht, each country has to achieve a high degree of price stability, convergence in long-term interest rates, sustainability of its fiscal position, and – last but not least – the exchange-rate criterion requires the observance of the normal fluctuation margins of ERM2 for at least two years, without devaluing.

It is not clear exactly what this requirement means. In its resolution on ERM2, the European Council avoided the expression “normal fluctuation band” to refrain from prejudicing the interpretation of the exchange-rate criterion. It was generally assumed that the ±15% margins would be relevant. However, in the Convergence Reports of 1998 and 2000, the

---

7 ECOFIN Council Conclusions on Exchange Rate Strategies for Accession Countries, Brussels, 7 November 2000.