ERM II and the Exchange-rate Convergence Criterion

Information material for the Czech Government

1. Introduction

In May 2004 the Czech Republic is likely to become a member of the European Union (EU). On joining the EU, the Czech Republic (just like all the new Member States) will be granted the status of "Member State with a derogation" i.e. it will not immediately adopt the euro. Upon accession, the Czech National Bank (CNB) will become a member of the European System of Central Banks (ESCB). However, it will not participate in monetary-policy decision-making on the European scale until it introduces the euro.

At the end of 2002, the CNB submitted to the Czech Government a document entitled "The Czech Republic and the Euro – Draft Accession Strategy". In this document the CNB proposes implementation of the necessary economic and political measures in such a way "*as not to rule out the possibility of joining the eurozone sometime around 2007*". In its Resolution No. 189 of 24 February 2003, the Government of the Czech Republic noted this document as a basis for further discussion and tasked the Minister of Finance with elaborating a supplement to the Draft Strategy by 30 September 2003, in co-operation with the Minister of Industry and Trade and by agreement with the CNB Governor. This Strategy – along with the Pre-accession Economic Programme (PEP) for 2003 – will include the Czech Republic's position on the Czech koruna's participation in ERM II and hence also its target for fulfilling the exchange-rate convergence criterion (one of the Maastricht convergence criteria).

The aim of this document is to describe the ERM II and the provisions relating to the exchange-rate convergence criterion as the basis for the Czech Republic's official position. The text is structured as follows. Part 2 describes the basic features of the ERM II and explains the exchange-rate convergence criterion. Part 3 discusses the benefits and risks of the Czech koruna's participation in the ERM II. Part 4 deals with institutional aspects of adopting the single currency, and Part 5 sums up the CNB's recommendations in the ERM II area. The document contains two annexes. Annex 1 – "A glossary of terms associated with European monetary integration" – summarises key terms relating to the single currency. Annex 2 provides a historical guide to exchange rate and interest rate developments in selected current eurozone member states prior to introducing the single currency.

In line with the aforementioned Draft Accession Strategy, the Czech National Bank views participation in ERM II merely as the gateway to joining the eurozone and does not recommend staying in the mechanism for any longer than the minimum required period of two years. In the CNB's view, the Czech Republic should enter the ERM II only after conditions have been created that will enable it to introduce the euro at the time of the assessment of the exchange-rate criterion (two years after joining the ERM II). Given the outlook as regards fulfilment of the other convergence criteria, the CNB recommends that the Czech Republic should remain outside the ERM II after its expected accession to the EU in May 2004.

2. ERM II and the Exchange-rate Convergence Criterion

The ERM II (Exchange Rate Mechanisms II) is a mechanism for fixing the participating currencies against the euro within a fluctuation band. Each currency participating in ERM II has a defined central rate (parity) against the euro and a fluctuation band for movements around the central rate. In the event of exchange rate pressures, both the national central bank and the European Central Bank (ECB) will intervene to keep the exchange rate within the fluctuation band. By contrast, *the exchange-rate convergence criterion* is one of the criteria for adopting the euro. Fulfilling the criterion requires *participation in ERM II* and *maintenance of exchange-rate stability*. In other words, to fulfil the exchange-rate convergence criterion, the currency must be part of ERM II yet stay within a range that is narrower than the standard ±15% fluctuation band. So, the maintenance of exchange-rate stability is closely linked to the ERM II, but the two terms are not interchangeable, as it is possible for a country to participate in ERM II yet not fulfil – or not even be heading towards fulfilling – the exchange-rate convergence criterion.

A. ERM II

The original ERM – established in connection with the introduction of the euro's predecessor (the non-cash ECU – European Currency Unit) – has undergone dynamic development over the past two decades. Two events in particular shaped the design of the mechanism. The first was the currency upheaval in 1992–1993, when the ERM fluctuation band was widened from ±2.25% to ±15% (August 1993). And the second was the introduction of the single currency (on 1 January 1999), which entailed switching from the multilateral ERM exchange rate system (the principle of a "grid" connecting the individual currencies) to the bilateral ERM II system, where the currencies of the participating countries are linked to the euro. At present, only one country – Denmark – is a member of the system.

The basic features of the ERM II are as follows:

(a) central rates and fluctuation bands of participating countries' currencies against the euro are set by common procedure (involving Finance Ministers, ECB and national central bank governors and the European Commission);

(b) the standard fluctuation band is ±15%, while not excluding the possibility of setting a narrower band;

(c) intervention support of the ECB to the national central banks (NCB) is automatic at the margins of the band (marginal interventions); any interventions within the band (intra-marginal interventions) need not be – but may be – supported by the ECB;

(d) the ECB and NCBs have a formal right to suspend intervention should the price stability objective be jeopardised;

(e) realignments of central parity are made by the common procedure, which both the ECB and the member states have the right to initiate.

As mentioned above, with regard to the width of the ERM II band it is crucial to differentiate between the *functioning* of the mechanism and the *assessment* of exchange rate stability. The setting of the fluctuation band in ERM II is significant for the *functioning* of the interventions of the national central banks and the ECB. The mechanism for *assessing* the fulfilment of exchange rate stability, which is closely linked to the ERM II, is described below.

B. The assessment of exchange rate stability

The exchange-rate convergence criterion is one of the Maastricht convergence criteria that have to be fulfilled before the single currency can be adopted. The assessment of fulfilment of the exchange-rate convergence criterion is based on the relevant provisions of the Treaty on European Union (the "Treaty"), as elaborated by the relevant protocol, and by the Council Resolution establishing the ERM II with effect from 1 January 1999. The relevant passages of these official documents are cited in Box 1 below. The present position of the European authorities as regards assessing the exchange-rate stability criterion can be summed up as follows (the CNB's interpretation in parentheses):

(a) Participation in ERM II for at least two years at the time of the assessment is mandatory.
(b) No downward realignment of the central parity within the two-year examination period (upward realignment of the central parity is implicitly possible).
(c) By the CNB's current understanding, and following consultations with the competent EU and ECB authorities, fulfilment of the criterion requires the exchange rate to have been maintained within a fluctuation margin of ±2.25% (i.e. narrower than the standard band) around the central parity in ERM II "without severe tensions" (in other words, maintaining the exchange rate within the narrow margin of ±2.25% "at any cost" by means of excessive interventions or non-market measures will not necessarily be assessed as successful fulfilment of the exchange-rate stability criterion). If the exchange rate moves outside this band, a distinction is to be made between a breach of the upper margin and a breach of the lower margin (a breach of the upper margin being implicitly more admissible). In such a case it is necessary to examine the duration of the deviation, the reasons for it, and interest rates and intervention policy at the time of the deviation.

To conclude the definition of exchange rate stability it should be mentioned that as European economic integration is a political process, the vagueness of the economic criteria may also reflect an intentional decision to leave some leeway for political decision-making.

BOX 1: Provisions of official EU documents on the fulfilment of the exchange-rate convergence criterion

The relevant Treaty provisions are:

- ***The third indent of Article 121(1)***, which refers to the exchange rate criterion as:

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

- ***Article 3 of Protocol No. 6***, which states that:

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

- ***The Council Resolution on the establishment of the ERM II (97/C 236/03 of 16 June 1997)***, which states that:

"With the start of the third stage of economic and monetary union, the European Monetary System will be replaced by the exchange-rate mechanism as defined in this Resolution…. The exchange-rate mechanism will link currencies of Member States outside the euro area to the euro".

The EU expressed its standpoint on the fulfilment of the exchange-rate criterion in ERM II in its ***2000 Convergence Report*** (Directorate-General for Economic and Financial Affairs, No. 70), Annex D, Article D.4. as follows:

- *Participation in the ERM II at the time of the assessment is mandatory.*
- *Participation in the ERM/ERM II for at least two years is expected, although exchange rate stability during a period of non-participation before entering ERM/ERM II can be taken into account.*
- *No downward realignment of the central parity either in the ERM or in the ERM II within the two-year examination period.*
- *Exchange rate to have been maintained within a fluctuation band of ±2.25% around the currency's central parity against the euro. An assessment of any deviation from the ±2.25% fluctuation band would have to take account the reasons for that deviation. A distinction is to be made between exchange rate movements above the 2.25% upper margin and movements below the 2.25% lower margin.*

3. Benefits and Risks of ERM II Participation

The exchange rate is not an isolated economic variable, but acts in the context of, and in line with, the other key economic variables that shape a country's internal and external economic balance. Moreover, the exchange rate regime is just one element in a set of economic policies and does not have an exclusive or unique position. Whether the exchange rate regime is sustainable and plays a stabilising role depends primarily on whether other variables and macroeconomic policies evolve in a balanced, sustainable and mutually consistent fashion.

Exchange rate regimes can be divided according to their basic features into two broad types: fixed and flexible. A fixed exchange rate is predominantly "leading", i.e. internal developments and economic policy must adapt to the requirements of maintaining the fixed rate. Successful operation of a fixed exchange rate regime is therefore not compatible, for example, with a long-term fiscal deficit policy or with wage growth that is not in line with productivity growth. By contrast, a flexible exchange rate "follows" other variables and can mitigate the consequences of sub-optimal economic policies. However, even a flexible exchange rate can, in the event of inconsistent economic policies, react sharply to emerging economic imbalances and hence multiply the negative effects of such policies.

The ERM II, which under the EU legislation is a necessary stepping stone along the path towards adopting the euro, is a fixed exchange rate regime. It differs from other fixed exchange rate regimes mainly in that there is an anchor point for exiting the regime (in the form of an irrevocable fixing of the currency against the euro) and in that the country can obtain help from the European Central Bank to maintain its currency within the fluctuation band. However, in common with other fixed rate regimes the ERM II puts high demands on economic policy consistency and macroeconomic stability. With sufficiently prudent policies, a flexible economy and macroeconomic stability, the two-year participation in ERM II with a fluctuation band of ±15% may proceed smoothly. However, fulfilment of the exchange-rate convergence criteria with the narrower margin of ±2.25% does not have to be problem-free.

One of the much-emphasised benefits of participation in ERM II is its role in stabilising the exchange rate (by anchoring exchange rate expectations) and the economy. Also emphasised is its positive effect on macroeconomic policy consistency. These benefits are clearly visible when examining monetary developments in most European economies over the past ten years. The question arises whether the transition economies, which are subject to large inflows of foreign capital and are undergoing economic transformation processes, stand to benefit from participating in ERM II (as compared to the alternative monetary-policy regimes they could operate until introducing the euro) to the same extent as the advanced countries.

(a) the exchange-rate stabilising role of ERM II

The exchange-rate stabilising role of ERM II should derive from the announcement of the central parity, which should provide the markets with a lead and thereby reduce exchange rate fluctuations . This should in turn contribute positively to the country's process of economic convergence to the level of the more advanced EU Member States. Nevertheless, this stabilising role may in practice be limited by two factors. Firstly, the central parity is subject to possible realignments, a fact that reduces both its credibility and its signalling role. In economies with a stable exchange rate (such as Denmark, the only ERM II participant at present) realignment of the central rate is not very likely, hence the possibility of revaluation does not necessarily undermine the stabilising role of the mechanism. However, in the case of transition economies, whose currencies are subject to an appreciation trend associated with real convergence processes, the credibility of the central rate may be eroded over time. Secondly, the standard fluctuation band of ±15% permits substantial exchange rate volatility, so it is questionable whether it will play a stabilising role.

The stabilising effect of ERM II should be further enhanced by the ECB's intervention assistance. However, as stated in section 2.A., such support is automatic only at the margins of the fluctuation band. The ECB's support is not guaranteed for countries wishing to operate a managed float around the central rate, which is meanwhile necessary for fulfilling the condition of exchange rate stability in the likely event that the fluctuation band is wider than ±2.25% (required for fulfilment of the exchange-rate stability condition). In this situation, intra-marginal interventions, i.e. interventions within the band, would be more important. The ECB may conversely restrict such interventions by the national central banks.

(b) ERM II and macroeconomic policy consistency

As mentioned above, participation in ERM II, just as in any other fixed exchange rate regime, requires consistent macroeconomic policies. This assertion is confirmed both by economic theory and by the experience of many economies, including the Czech one (cf. the currency turmoil in 1997). There is also an argument that participation in ERM II will exert effective pressure for faster consolidation of public finances and responsible policies. However, the CNB believes that sustainable fiscal and structural policies should precede the introduction of a fixed exchange rate regime and that restrictions on the movement of the exchange rate should thus be the consequence of implementing consistent policies, and not the trigger for them.

If a country applies consistent policies, it should be possible – from the purely theoretical perspective – to consider immediate adoption of the euro without the need for the intermediate stage embodied by the ERM II. In a world of massive capital flows, viewing the ERM II as a time test of consistent and sustainable economic policies may be associated with potential costs as the financial markets "test" the willingness of the authorities to maintain the exchange rate within the fluctuation band (cf. the attack on the Hungarian forint in January 2003). So instead of the expected stabilising effect, a fixed exchange rate with a fluctuation band may, on the contrary, lead, in certain situations, to destabilising capital flows.

(c) ERM II as an inflation-stabilising mechanism

Participation in ERM II is also being recommended because of the beneficial effect that a stable exchange rate has in fostering lower and less volatile inflation. A fixed rate fosters price stabilisation both directly – by stabilising import prices – and indirectly by stabilising inflation expectations. However, in the case of the standard ±15% fluctuation band, which permits sizeable exchange rate fluctuations (and where there is also the possibility of revaluation of the central rate), this stabilising role is limited.

A strategy of inflation targeting is being pursued in the Czech economy. In this context the question arises whether inflation targeting is consistent with ERM II. In a small open economy, a relatively stable exchange rate is vital for price stabilisation. Accordingly, close attention is paid to exchange rate movements within the inflation targeting regime. However, the ERM II goes further by explicitly setting a quantitative exchange rate target. In an environment of inflation targeting and simultaneous participation in ERM II, two monetary policy objectives exist alongside each other: a target for inflation and a target for the exchange rate. This may undermine the comprehensibility of monetary policy and affect the central bank's credibility and the effectiveness with which it performs its stabilising activities. This problem is reduced if participation in ERM II is limited to the short period of two years. In the case of a longer stay in the ERM II, or insufficiently compatible economic policies, the combination of inflation targeting and the fixed exchange rate with a fluctuation band could generate macroeconomic pressures.

To conclude this section, it can be said that the ERM II has certain stabilising potential. This potential, however, is dependent on the level of transformation of the economy, the degree of alignment of the economic cycle, and on economic policy consistency. For transition economies – subject to huge inflows of foreign investment exerting appreciation pressures on their domestic currencies – or for countries with insufficiently consolidated structural or fiscal policies, the balance of the costs and benefits of joining the ERM II is not necessarily clear-cut. Such an approach corresponds to the position of the European Commission, which states that "in certain cases, staying outside the ERM II for some time [after accession] may be useful in light of large and volatile capital flows, large fiscal imbalances, and/or risks of large economic shocks" (cf. "Acceding countries and ERM II", a document prepared by the European Commission for the High Level Meeting in Athens on 28 May 2003).

4. Institutional Issues of ERM II Participation and the Setting of the Central Parity

The procedures for ERM II entry and the subsequent irrevocable fixing of the koruna against the euro have been specified in detail. The procedural steps leading to ERM II participation have been laid down in the *Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union (97/C 236/03, 16 June 1997)* and in the *Agreement between the European Central Bank and the national central banks of the Member States outside the euro area* of 1 September 1998.

A. The process of joining ERM II

The key procedural feature of ERM II is the multilateral approach of the Member States to making decisions on issues linked to the functioning of the mechanism. Such decisions are taken by the ministers of the euro area Member States, the ECB and the ministers and central bank governors of the non-euro area Member States participating in ERM II. The ministers and governors of the central banks of the non-euro area Member States not participating in ERM II have only an advisory vote. Such decisions are preceded by a procedure involving the European Commission and the Economic and Financial Committee (EFC).

For new EU Member States, the first step (which is not, however, a direct part of the procedure for participation in ERM II) is accession to the aforementioned Agreement between the European Central Bank and the national central banks of the non-euro area Member States. It is possible to sign the agreement and request entry into ERM II at a later date.

The procedure itself consists of the following steps (cf. "Procedural steps to allow participation in ERM II", a document prepared by the European Commission for the High Level Meeting in Athens on 28 May 2003):

<u>i. The Exchange-rate Procedure</u>

- may be initiated by a confidential joint request from a minister and a central bank governor from a country requesting entry into ERM II (as well as from the decision-making bodies – see above), addressed to the Ecofin minister of the country holding the EU Presidency;
- at the same time, the EFC member(s) from the initiating country inform the President and the Secretary of the EFC;
- takes place at a closed confidential meeting of the ERM II Committee (see below);
- when consensus can be reached on the central rate and fluctuation band, allows for confirmation of agreement from the authorities of the home countries.

<u>ii. The ERM II Committee</u>

- is called by the EFC President; its members are the EFC members from national administrations, the EFC members from the non-euro area central banks , two representatives of the ECB, two representatives of the Commission, the President of the alternates, the EFC President and Secretary, and two members of the EFC Secretariat;
- the meeting is a kind of "pre-screening" of the countries applying to introduce the euro (the results of the meeting serving as the basis for the "Exchange-rate Procedure"): the

Committee discusses and determines whether the macroeconomic framework of the ERM II applicant country is consistent with ERM II entry, notably in connection with the Broad Economic Policy Guidelines and the Stability and Growth Pact;
- the Committee will also discuss the appropriate central rate and fluctuation band;
- the decision-making bodies of the ECB will have meetings prior to the Committee meeting on the central rate and fluctuation band.

<u>iii. The ERM II Exchange-rate Meeting</u>
- is called by the Ecofin minister of the Member State holding the EU Presidency; composition: the ministers of the euro area Member States, the ministers and the central bank governors of the non-euro area Member States, the President of the ECB, representatives of the Commission, and the President and Secretary of the EFC;
- final adoption of the central rate and fluctuation band;
- also confidential; held in the same room as the "Exchange-rate Procedure"

<u>iv. The final communiqué, in the name of the EU, includes the following elements:</u>
- the party initiating the procedure and the parties making the decision
- the decision
- the central rate
- the fluctuation band
- the announcement on the economic policy of the Member State
- a statement on the discussion of intervention points between the ECB and the national central bank

The time schedule for the whole process is not fixed but depends on the degree of agreement reached between the authorities of the Member State and the bodies of the EU. The entire process can be very quick and take just a few days (as in the case of Austria) or it can last for several months (Denmark).

B. The CNB's role in the ERM II participation process

The timing of the adoption of the euro and the initiation of the country's accession to the euro area is a political decision that falls to the Czech Government, acting in co-operation with the CNB. Before the single currency can be adopted, the provisions of the Act on the CNB concerning the currency and the CNB's powers will have to be amended. Other legislation will also have to be revised. The integration of the Czech koruna into the ERM II can be viewed on the one hand as a change in exchange rate regime, for which the CNB bears responsibility (see Box 2), but on the other hand as the start of the euro-adoption process.

BOX 2: The CNB Act and the CNB's role in the euro-area participation process

Article 35(a) of the Act on the CNB: *The Czech National Bank shall, after discussion with the Government, stipulate the exchange rate regime of the Czech currency vis-à-vis foreign currencies, with the proviso that the primary objective of the Czech National Bank must not be jeopardised.*

Article 10(2) of the Act on the CNB: *The Czech National Bank shall act in an advisory capacity vis-à-vis the Government in matters of monetary policy and banking.*

The CNB understands its role in the euro-adoption process within the meaning of Article 10(2). The CNB presumes that it will act as an expert guarantor and initiate discussions in the monetary area, including of any proposals for a change in the exchange rate regime, as it has done hitherto. It should regularly assess the preparedness of the Czech Republic and make suggestions (in co-operation with the Ministry of Finance) to the Government regarding the timing of the individual steps and the macroeconomic and monetary parameters associated with steering the Czech economy towards the euro (the central parity, the conversion rate, the fluctuation band, interventions). A major role in this process will be played by the convergence reports, which are directly aimed at assessing the economy's preparedness for participation in the single currency of the euro area.

5. Conclusions and Recommendations of the CNB

The aforementioned discussions and consultations with EU and ECB representatives have led the Czech National Bank to make the following recommendations:

(a) *The Czech Republic should enter the ERM II only after conditions have been created that will enable it to introduce the euro at the time of the assessment of the exchange-rate criterion (two years after joining the ERM II).* The CNB thus still holds the opinion it expressed in the document: "The Czech Republic and the Euro – Draft Accession Strategy", namely that staying in the ERM II for longer than the minimum required period is not deemed desirable or beneficial to macroeconomic stability. This is because participation in the ERM II alone – unlike the irrevocable fixing of the exchange rate within the monetary union – does not in itself eliminate the risk of currency turbulence.

(b) *CNB recommends that the Czech Republic should remain outside the ERM II for some time after its accession to the EU.* Under the EU legislation, the Czech Republic's potential participation in ERM II as from May 2004 (simultaneously with its expected accession to the EU) would imply the assessment of the exchange-rate convergence criterion taking place sometime around June 2006. Under the fiscal reform proposal of June 2003, however, the public budget deficit is to reach 4.8% of GDP in 2005 and decrease to 4% in 2006. This means it will exceed the Maastricht criterion of 3%. Even the looser interpretation of the criterion, i.e. that "the ratio has declined substantially and continuously and has reached a level that comes close to the reference value", would not, we expect, given the trajectory under consideration, result in fulfilment of this criterion by the time of the assessment in 2006. As the outlook for the public finance deficit is currently a critical factor affecting the timing of the adoption of the single currency, and given the significance of flexible markets in this process, the CNB recommends continuing with the efforts to consolidate public finances and with the structural reforms, in order to improve the efficiency and competitiveness of the Czech economy.

(c) The CNB further recommends that a *mechanism of regular assessment of the fulfilment (and prospects of fulfilment) of the Maastricht convergence criteria and assessment of the Czech economy's alignment with the euro area* be incorporated into the strategy for euro area accession to be submitted to the Government by 30 September 2003. Such regular assessments, which would facilitate the selection of the right time to participate in ERM II, would be implemented on the basis of a joint document of the CNB and the Ministry of Finance for discussion by the Czech Government and would coincide with the preparation and discussion of the convergence programmes every autumn.

Annex 1: A glossary of terms associated with European monetary integration

The euro area *(also known as the **EU-12** – the figure indicating the number of participating countries – and the eurozone)* consists of those EU Member States that have introduced the single currency and in which the single monetary policy of the European Central Bank is conducted. The euro area currently comprises 12 countries: Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. *The United Kingdom, Denmark and Sweden currently remain outside the euro area.*

Economic and Monetary Union *(EMU)*
Economic and monetary union (EMU and "HMU" in the Czech language) is the name given to the process of harmonising the economic and monetary policies of the Member States of the Union with a view to the introduction of a single currency, the euro. It was the subject of one of the two Intergovernmental Conferences (IGCs) in December 1990.

The Treaty provides that EMU is to be achieved in three stages:

- First stage (1 July 1990 to 31 December 1993): free movement of capital between Member States, closer co-ordination of economic policies and closer co-operation between central banks;
- Second stage (1 January 1994 to 31 December 1998): convergence of the economic and monetary policies of the Member States (to ensure stability of prices and sound public finances);
- Third stage (from 1 January 1999): the establishment of the European Central Bank, irrevocable fixing of exchange rates and introduction of the single currency.

  The third stage of EMU was launched in eleven Member States. Four Member States did not adopt the single currency: the United Kingdom and Denmark, both of which possess an opt-out clause under protocols attached to the Treaty establishing the European Community, and Sweden and Greece, which did not meet all of the Maastricht convergence criteria. Greece became the twelfth euro-area Member State on 1 January 2001. The Czech Republic will automatically become an EMU member (with a derogation as regards introducing the euro) upon accession to the EU (see the extract below the title).

European Monetary Union (EMU)
This expression is often confused with the aforementioned terms "euro area" and "economic and monetary union". In the vast majority of cases, though, it is identified (particularly in the British literature) as the area in which the single currency has been introduced (European Monetary Union). This term is rather confusing, however, since in the EU legislation "EMU" refers to Economic and Monetary Union. Under Community law, the Economic and Monetary Union is a broader term also encompassing the system of co-ordination of the economic policies of *all* the EU Member States. The term "EMU" (i.e. Economic and Monetary Union) is therefore not justified in the Czech language to express monetary co-operation in Europe (the expressions "eurozóna" or "EU-12" being more appropriate).

Opt-out clause
Opting out is an exemption granted to a country that does not wish to join the other Member States in a particular area of Community co-operation. The United Kingdom, for instance, asked to be allowed not to take part in the third stage of economic and monetary union (EMU)

and similar clauses were agreed with Denmark as regards EMU (it participates in the third stage, but the termination of its status as a “Member State with a derogation” is conditional on a domestic political decision), defence and European citizenship. The Czech Republic, just like the other acceding countries, will not be granted an opt-out clause.

European Central Bank *(ECB)*

The European Central Bank was inaugurated on 30 June 1998 and is located in Frankfurt am Main. On 1 January 1999 it took over responsibility for implementing European monetary policy. The ECB ensures that the tasks conferred upon the Eurosystem and the European System of Central Banks (ESCB) are implemented either by its own activities (pursuant to the ESCB Statute) or through the national central banks. The ECB is governed by the Executive Board, a six-member management team headed by the President.

Eurosystem

The Eurosystem consists of the European Central Bank (ECB) and the national central banks of the EU Member States which introduced the euro in the third stage of economic and monetary union (EMU). Twelve national central banks are therefore participating in the Eurosystem at present. Its decision-making and managing body is the Governing Council (comprising the governors of the euro-area national central banks and the ECB Executive Board). It is tasked with implementing the single monetary policy of the euro area as from 1 January 1999. Its primary objective is to maintain price stability.

The European System of Central Banks *(ESCB)*

The European System of Central Banks is composed of the ECB and the national central banks of all 15 EU Member States. Unlike the Eurosystem, it includes the national central banks of the EU Member States that have not adopted the euro. Its supreme body is the General Council, comprising the governors of the national central banks of all 15 Member States and the members of the Executive Board. The General Council has limited decision-making powers and will be a decision-making body only as long as there exist Member States with a derogation.

Stability and Growth Pact *(SGP)*

The Stability and Growth Pact has to be seen against the background of the third stage of economic and monetary union. Its aim is to ensure that the Member States continue their budgetary discipline efforts once the single currency has been introduced. The Pact comprises a European Council resolution (adopted at Amsterdam on 17 June 1997) and two Council Regulations of 7 July 1997 laying down detailed technical arrangements (one on the surveillance of budgetary positions and co-ordination of economic policies and the other on implementing the excessive deficit procedure). In the medium term the Member States have undertaken to pursue the objective of a balanced or surplus budget and to present the Council and the Commission with a stability programme each year. Member States with a derogation and those not taking part in the third stage of EMU are required to submit a convergence programme. The Stability and Growth Pact opens the way for the Council to penalise any participating Member State which fails to take appropriate measures to end an excessive deficit. Initially, the penalty would take the form of a non-interest-bearing deposit with the Community, but it could be converted into a fine if the excessive deficit is not corrected within two years. In the case of high budget deficits a similar procedure will also be applied to Member States with a derogation, although without the threat of financial penalties (a formal procedure).

Annex 2: Exchange rate and interest rate differentials in some EU countries prior to introducing the euro

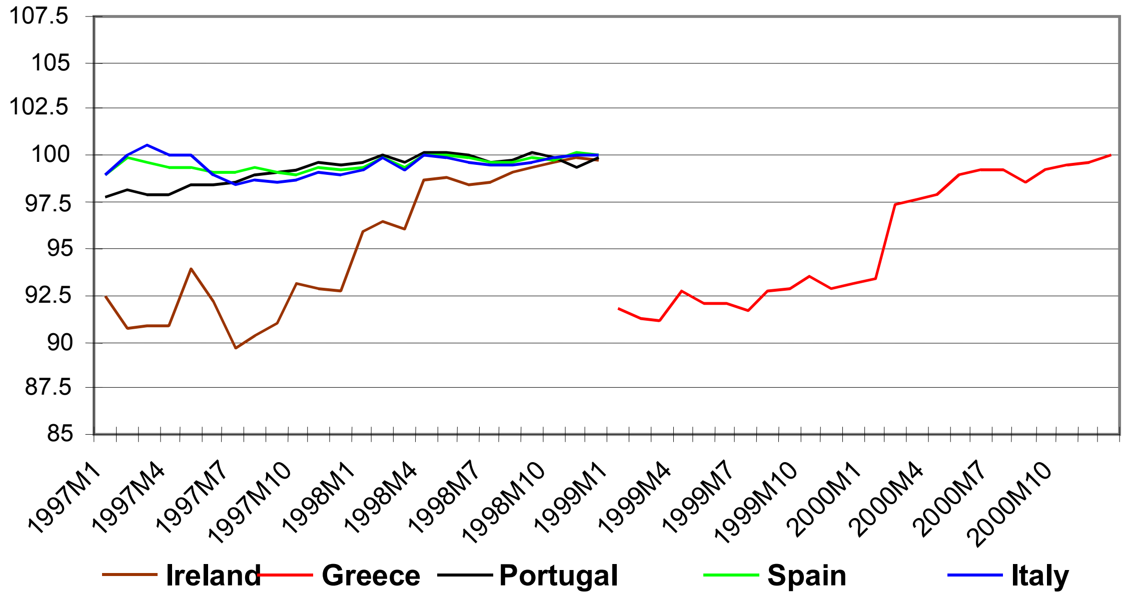
As the two charts below illustrate, the experience of the EU Member States points to the existence of two scenarios:

- *exchange rate stabilisation* – in the two years before they joined the euro area, Spain and Portugal stabilised their exchange rates against the German mark within a relatively narrow fluctuation band. Although they had the wide band at their disposal, the volatility of their exchange rates did not exceed the "narrow" ERM band (±2.25%) in this period. These countries also saw a continuously falling and almost identical interest rate differential vis-à-vis Germany, as well as a moderately rising inflation differential (but nevertheless fulfilled the inflation criterion).

- *exchange rate appreciation* – Ireland and Greece initially recorded relatively strong appreciation of their nominal exchange rates inside the standard ERM fluctuation band of ±15%. This appreciation was later partially "accommodated" by revaluations of central parity within the ERM/ERM II (in the case of the punt by 3% in 1995 and in the case of the drachma by 3.6% in 2000). The full cancelling out of the "exchange rate overshooting" (the maximum deviations against the mark were 11.1% for Ireland and 9.2% for Greece) took place through a gradual depreciation of the punt and drachma in line with expectations of the irrevocable fixing of their rates and with a narrowing of the interest differential. This period is shown in the chart.

A. Exchange rates against DEM/EUR

(central parity/conversion rate against EUR = 100; depreciation = growth of the exchange rate)



B. Interest rate differentials against DEM/EUR - (O/N rates in per cent)