Exchange rate policy and ERM II

Acquis Screening Seminar

Brussels, 16 February 2006

Overview

- Exchange rate policy of Member States outside the euro area (Article 124) – part of the *acquis*
- Exchange Rate Mechanism II – established by intergovernmental agreement

Article 124

"Each Member State shall treat its exchange-rate policy as a matter of common interest."

In practice:

- **Avoid <u>real exchange rate misalignments</u> and <u>excessive nominal exchange rate fluctuations</u> that disrupt the functioning of the Single Market**

  (European Council Resolution, Amsterdam, 16 June 1997)

From EMS to ERM II

ERM II set up by Amsterdam Resolution on 16 June 1997

“With the start of the 3rd 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. ”

Main Principles of ERM II - 1

Legislative references

- ***The Amsterdam Resolution (AR), 16 June 1997***
- ***Central Bank Agreement of 1 September 1998 lays down the operating procedures of ERM II.***
- ***Amended in 2000 (euro entry of Greece) and 2004 (EU enlargement)***

Main Principles of ERM II - 2

- *Participation voluntary but "expected"*
- *A central rate against the euro*
- *Central rates, fluctuation bands and realignments are set by common procedure (involving Finance Ministers, ECB and NCB Governors and the Commission)*

Main Principles of ERM II - 3

- ***Standard fluctuation band** of 15% but exchange rate policy co-operation may be further strengthened*
- ***Interventions at the margins** will in principle be automatic and unlimited, but without prejudice to the primary objective of the ECB and the non-euro area NCBs to maintain price stability*
- ***Possibility of co-ordinated** intramarginal intervention*

Council Statements of 2000/2003 on Exchange Rate Policy and ERM II

- No unilateral euroisation
- Clear incompatibilities with ERM II are: free floating, crawling pegs and pegs against an anchor other than the euro
- Currency board pegged to the euro: OK but still need an agreement on the central rate. Unilateral commitment; no additional obligation on the ECB

ERM II strategies of New Member States

Estonia	**Currency board with the euro**
Lithuania	**Currency board with the euro**
Malta	**Hard peg to the euro**
Latvia	**Peg to the euro with a ± 1 % fluctuation band**
Slovenia	**Peg to the euro with a ± 15 % fluctuation band**
Cyprus	**Peg to the euro with a ±15 percent fluctuation band**
Slovakia	**Peg to the euro with a ±15 percent fluctuation band**
Hungary	***Peg to the euro with a ±15 percent fluctuation band***
Czech Republic	***Managed float with euro as a reference***
Poland	***Free float***

- Estonia, Lithuania and Slovenia joined ERM II on 28 June 2004, with standard fluctuation bands. Estonia and Lithuania kept their currency boards as unilateral commitments.
- Cyprus, Latvia and Malta joined ERM II on 2 May 2005, with standard fluctuation bands. Latvia and Malta adopted unilateral commitments to pursue high exchange rate stability.
- Slovakia joined ERM II on 28 November 2005, with a standard fluctuation band.

Considerations for ERM II strategies

- Integral part of overall policy framework
- ERM II participation not necessarily immediately after accession
- Could be useful for longer than 2 years
- ERM II framework offers flexibility, but not designed for a free float
- Not a “waiting room” but a “training room” to foster convergence – need for credible policies