INSTITUTIONAL ASPECTS OF DYNAMICS OF INCLUSION OF ACCESSION COUNTRIES INTO THE EMU

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The Eastward Enlargement of the Eurozone

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Abstract

The main topic of the paper is optimal dynamics, i.e., timing of entry of the accession countries in the ERM 2 and EMU. Some of the crucial questions addressed in the paper are as follows: a) Should accession countries aim at an early or a delayed entry into the EMU? b) What are economic and other arguments for an early or late inclusion? c) What are the institutional external constraints which may prevent an early inclusion of accession countries?

Institutional rules of the phased process of monetary integration for the accession countries are not quite transparent and leave much room for discretion to the EU side. In such circumstances it is difficult for the accession countries to devise clear and consistent strategies with respect to the timing of entry in the ERM 2 as an interim institutional mechanism in the run-up to the EMU.

JEL–Classification: E6

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Dynamics of Inclusion of Accession Countries into the European Monetary Union: Some Institutional Aspects

Vladimir Lavrač

INTRODUCTION

This paper focuses on some institutional aspects of monetary integration process for the accession countries in their run-up to the euro adoption, with the final aim to contribute to the debate on the optimal dynamics of inclusion of these countries in the euro area. Institutional aspects are here understood as mechanisms, rules and procedures which the accession countries have to follow on the road to the euro area.[1]

The rules and procedures for the monetary integration of accession countries are defined by the EU side (this term is used here as a shortcut expression for relevant EU institutions, such as the EU Commission and the ECB - European Central Bank). Accession countries simply have to follow these rules and procedures which from their point of view are externally determined. In other words, they can not influence them, so they see them as an external institutional constraint. In the process of negotiations with the EU these rules and procedures were presented as a part of the aquis communautaire and as a part of the whole EU accession package, which resulted in an asymmetric position of "take it or leave it" when "joining the club".

Within this context the paper concentrates particularly on the ERM 2 (Exchange rate mechanism 2) as a specific institutional arrangement for the accession countries in the interim period from their EU accession to their adoption of the euro. At this very moment it is the right time for the accession countries to define their strategies towards joining the ERM 2 - should they aim at an early entry in the ERM 2, as soon as possible after their EU accession, or should they rather wait and postpone the membership in the ERM 2 into the future? The paper aims at shedding some light on the underlying open issues and at contributing to some arguments which may help to define an ERM 2 strategy for an accession country such as Slovenia.

[1] An institutional approach to monetary integration process of accession countries is emphasized in Lavrač (2002b).

The paper starts from the three phases of monetary integration designed from the EU side for the accession countries. The focus of the paper is on the ERM 2 as a central institutional framework of the second phase. Main technical characteristics of this mechanism are analysed and some open issues identified. The question whether the ERM 2 as a waiting room before the adoption of the euro is a stable or a dangerous institutional arrangement is addressed next. After discussing the optimal dynamics of inclusion of the accession countries in the euro area, some suggestions for defining an ERM 2 entry strategy for these countries are given. Finally, before concluding, the paper touches upon the issue of real convergence and its impact on the dynamics of inclusion of the accession countries in the euro area.

1. Phases of monetary integration for the accession countries

1.1 Three phases of monetary integration

The EU side sees the process of euro adoption of accession countries as the final phase of their process of economic and monetary integration with the EU.[2] The process of their monetary integration is divided in the three distinct phases:

The first phase, the pre-accession phase, from now on until their EU accession in May 2004, still leaves much room for independent monetary and exchange rate policy to the accession countries. In particular, they can choose their own exchange rate arrangements which they prefer.[3] However, they have to fulfil the Acquis Communautaire in the area of EMU (economic and monetary union), such as making their central banks independent and completely liberalising their capital flows. Also, they have to share the aims of EMU, which means they have to join the euro area when they are ready. In other words, they can not opt out of the euro as some current EU member countries did.

The second phase, the accession phase, starts with their EU accession in May 2004 and lasts until they finally adopt the euro. The duration of this phase is at this moment hard to predict, it could be at minimum two years or considerably more. In this phase exchange rate policies of accession countries become the matter of common concern.

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2 Position of the EU side is defined in European Commission (2000) and European Central bank (2000).

3 Their current exchange rate arrangements and policies are discussed in more detail in Bolle (2002) and Lavrač (2002).

This relatively vague phrase means that the independence of their exchange rate policies will be somewhat constrained. Their exchange rate policies should not be harmful to other member countries (such as competitive devaluations) or to the smooth functioning of the single market (such as excessive volatility of their exchange rates). Also, their overall economic policies will be the matter of common concern, which means subject to surveillance and co-ordination procedures. Accession countries are expected to join the ERM 2, although not necessarily immediately after their EU accession. Finally, in this phase accession countries should devote their efforts to meeting the Maastricht convergence criteria, which should qualify them for joining the euro area. Their central banks will in this phase be included in the ESCB (European system of central banks) and their governors will join the General council of the ECB.

The third, final phase is the euro phase when accession countries, after meeting the Maastricht convergence criteria, join the euro area and adopt the euro as their own currency. From then on, they will participate in the euro area with equal rights and obligations as any other euro area members. Their central banks will be included in the Eurosystem and their governors will join the Governing council of the ECB.

As discussed above, for the accession countries the rules and procedures are prescribed by the EU side. They do not have much room for manoeuvre and more or less have to follow them step by step. It seems that the only substantial choice they have at this moment is their decision on the timing of joining the ERM 2 and perhaps on the intensity of their efforts to meet the Maastricht convergence criteria and thus to have on their part some influence on the timing of their inclusion in the euro area. However, it should be reminded that there is another option for the accession countries to by-pass these rules and procedures and to speed up their joining the euro area: an unilateral adoption of the euro i.e. euroisation. For various reasons this option is not acceptable to the EU side.[4] It is true that the EU side could not really prevent a unilateral euroisation, but would most likely retaliate somewhere along the way. For this and other reasons an unilateral euroisation is at the moment not very seriously considered among the accession countries, they rather concentrate on their preparations for the participation in the ERM 2 some time after their EU accession.

[4] Why unilateral euroisation is not acceptable to the EU side is analysed in Begg et al. (2002).

1.2 ERM 2 as a waiting room for the adoption of the euro

In the process of monetary integration of accession countries particular attention should be devoted to the ERM 2. This part of the text is focused on the ERM 2 and discusses its aims, rules, characteristics, open issues and its relation to the dynamics of inclusion of accession countries in the euro area.

ERM 2 is an interim exchange rate mechanism, devised for the so-called pre-in countries, EU member countries which are not yet ready for joining the euro area. By participating in this interim exchange rate arrangement for at least two years, the member countries should demonstrate the stability of their exchange rates and thereby fulfil the criterion on exchange rate stability as one of the five Maastricht convergence criteria.

Participation in the ERM 2 is in principle voluntary. But if we take into account that joining the euro area is sooner or later mandatory for accession countries, and that participation in the ERM 2 for at least two years in order to fulfil the Maastricht exchange rate stability criterion is a necessary precondition for joining the euro area, it turns out that participation in the ERM 2 is actually mandatory. The part which is in fact voluntary is only the decision when to join the ERM 2, or to be more precise, when to apply for an ERM 2 membership.

ERM 2 came into being in the beginning of 1999 when EU countries entered the third stage of the EMU and introduced the single currency, the euro. Although it was not devised specially for accession countries, they will obviously be its main "clients". In a way, ERM 2 is partly modelled on its forerunner, ERM, which ceased to exist in the beginning of 1999, and in fact substituted it, although it has to be said that their characteristics are rather different. Although this goes beyond the scope of this paper, it should be noted that the experience of the EU member countries in participating in the ERM prior to their euro area membership and particularly the experience of some EU member countries in participating in the ERM 2 after 1999 could be helpful in assessing some open issues and problems of this exchange rate mechanism which may have a crucial impact on the dynamics of inclusion of the accession countries in the euro area. Among four EU countries which did not join the euro area in the beginning of 1999, the UK and Denmark negotiated an opt-out from adopting the euro, while Sweden and Greece did not fulfil the Maastricht convergence criteria, Sweden formally, by not wishing to participate in the ERM beforehand, and Greece actually, by failing to fulfil any of the five convergence criteria. In terms of their membership in the ERM 2, the UK and Sweden decided not to participate, while Denmark and Greece participated in it from the beginning. Greece succeeded in fulfilling the Maastricht convergence criteria in two years and joined the euro area as the twelfth country in the beginning of 2002. It seems that the experience of Greece from participating in the ERM 2 may be particularly relevant for the case of accession countries in their run-up to the euro adoption.

It should be mentioned that when the EU countries were assessed for their readiness to adopt the euro, some of these countries were assessed in the Convergence reports by the EU side as meeting the Maastricht convergence criterion on exchange rate stability, although at the time they had not been actually participating in the ERM for two years, but somewhat less (the case of Italy and Finland). The question remains whether such a discount would be given also to an accession country claiming an equal treatment, which seems most unlikely.

ERM 2 is basically a system of a fixed exchange rate. It is meant to be a training ground for pre-in countries in which they should learn to live with a fixed exchange rate system before finally completely and irrevocably fixing the exchange rate or, in fact, giving up the national currency and the exchange rate altogether when adopting the euro. However, the exchange rate in the ERM 2 is not completely fixed, there is relatively much room for the flexibility of the exchange rate in line with the rules and characteristics of this specific exchange rate arrangement. From a broader perspective, ERM 2 as a waiting room for the euro adoption is meant to be an exchange rate arrangement which should lead to exchange rate stability, while allowing for necessary flexibility of the exchange rate in the interim period. Later on, an opposing view will be presented, which sees the ERM 2 as a potentially dangerous exchange rate arrangement, which may not be as flexible as claimed and which may lead to exchange rate instability and even to currency crises.

Until recently, the ERM 2 was defined as a consistent mechanism, whose rules and procedures should apply to all member countries uniformly. Lately the concept of the ERM 2 was somewhat broadened. ERM 2 is now understood as a broader framework, which can include several exchange rate regimes from the spectrum of alternative exchange rate arrangements actually in use in individual accession countries. Most of the current exchange rate regimes of these countries are now seen as consistent with the ERM 2 requirements. The only exceptions are floating exchange rate regimes, crawling pegs and exchange rates pegged to a non-euro currency. In other words, hard peg regimes such as currency boards are acceptable as a unilateral stronger commitment to exchange rate stability. The idea is for those countries which already now rely on hard pegs as an exchange rate arrangement to avoid double switch from their hard pegs to somewhat more flexible ERM 2 arrangement and then back to complete fixing of the exchange rate at the time of the adoption of the euro.

Contrary to the ERM, which was a multilateral exchange rate arrangement among each pair of the participating EU currencies, the ERM 2 is a bilateral exchange rate arrangement between a currency in question and the euro. The central role in the ERM 2 is therefore given to the ECB.

1.3 Characteristics of the ERM 2 and some open issues

Let us now review some technical characteristics of the ERM 2. Broadly speaking, ERM 2 is a specific system of a fixed exchange rate. In the broader public this is often approximated and in fact wrongly understood as if a country entering the ERM 2 was actually fixing its exchange rate, which is not the case.

The central exchange rate which is the official exchange rate of the currency in terms of the euro is determined. The level of the entering central rate is agreed upon in the process of negotiations between the EU side and the country in question. In general, the central rate should be sustainable and it should reflect the underlying equilibrium exchange rate which means the currency should neither be overvalued nor undervalued. The question remains how to determine the equilibrium exchange rate. There are various approaches to this (purchasing power parity rate, fundamental equilibrium exchange rate, behavioural equilibrium exchange rate, etc.),[5] but none of them can be indisputably be accepted as the right one. Ideally, the entering central rate should also be the final conversion rate to the euro at the time of the euro adoption.

The standard band around the central rate of +/- 15% is available, but a narrower band of +/- 2.25% can also be negotiated with the EU side. Within this margins, the market exchange rate can freely move around the central rate. On the margins, however, mandatory unlimited intervention from both sides, the ECB and the central bank of the country in question, is

[5] These and other technical issues are analysed in more detail in Borowski et al. (2002).

required in order to keep the market exchange rate within these prescribed limits. The ECB, however, can refrain from such interventions if it was considered to be against its primary goal of price stability in the euro area. In the case of lasting one-sided pressures on the exchange rate which would manifest themselves in the persistence of the exchange rate on either the upper or the lower margin of the band, the central exchange rate could be realigned, i.e. corrected, by a devaluation or a revaluation of the currency. Later in the text some open issues related to the characteristics of the ERM 2 are discussed.

Membership in the ERM 2 is open only to the EU countries. This means that the accession countries can not join the ERM 2 before they are formally admitted to the EU. Does it mean that they can join the ERM 2 at the time of their EU accession or immediately after? This is not clear at the moment. ERM 2 is an intergovernmental agreement and is not founded in the EU Treaty. There are no clearly defined criteria for the participation in the ERM 2 such as the Maastricht convergence criteria for the adoption of the euro. Actually, new entrants first have to apply and finally have to be assessed as ready to join the ERM 2 by the EU member countries, the ECB and the EU Commission. In the period of preparations the candidate country must start with informal discussions in which it announces its goals in terms of the entry date, the central rate and the width of the intervention band. These issues have to be negotiated with the EU side before the actual application for the ERM 2 membership is presented and the country is accepted in the ERM 2. How long all this may take is hard to predict, but a guess would be around half a year and up to one year. The earlier preparations start, the sooner after the EU accession the ERM 2 membership can be expected. However, since formal application can be presented only after the EU accession, and some of the formal procedures can start only then, it can realistically be expected that a candidate country can not join the ERM 2 immediately after the EU accession. It is true that in the case of the Austrian entry in the ERM 2 it took them only a couple of days after their EU accession to join the ERM 2, but this can be considered a special case, as its currency was effectively tied up to the German mark in an informal unilateral monetary union with the Germany. In the case of the accession countries their acceptance in the ERM 2 will probably take longer. Slovenian monetary authorities for instance expressed their intention to enter the ERM 2 early, as soon as possible, but for technical and logistic reasons assume this should happen in the beginning of 2005, i.e. good half a year after the Slovenian EU accession.

Although essential formal rules of the ERM 2 are rather precisely defined, some ambiguities and uncertainties concerning its actual operation in practice still remain. These uncertainties originate not so much from the ERM 2 per se, but mostly from the fact that the ERM 2 is the basis for the assessment of fulfilment of the Maastricht convergence criterion on the exchange rate stability. This criterion states that in order to demonstrate the exchange rate stability, the currency of the country in question must participate for at least two years in the ERM 2, while keeping the exchange rate within normal bands of fluctuations around the central rate and without devaluations of the currency taken at the initiative of the country in question. In the official assessment of fulfilment of this criterion, which will be given in the Convergence reports by the ECB and the EU Commission, only formal compliance with the ERM 2 rules may not be enough. Actually, some qualitative aspects of the exchange rate policy will most likely also be taken into consideration in order to assess factual stability of the exchange rate. This gives room for discretion to the EU side in the assessment of the compliance with the Maastricht exchange rate stability criterion and causes ambiguities and uncertainties with respect to how the exchange rate policy actually should be conducted in practice within the framework of the ERM 2. Some of the problems and open issues with respect to the interpretation of the rules and procedures of the ERM 2 are the following:

a) How unconditional and unlimited is the intervention on the margins of the band around the central rate? In principle, both sides, the country in question and the ECB, should intervene at the upper or the lower margin of the band in order to keep the market exchange rate within the prescribed band. For the country in question the potential for the intervention on the bottom of the band is limited by the extent of its foreign exchange reserves, while the limits for the intervention on the upper margin of the band may be determined by potential inflationary consequences of the accumulation of foreign exchange reserves. For the ECB the limits for the intervention are set by the fact that it can withdraw from this intervention if it was considered to be against its main objective, the price stability in the euro area. Obviously this gives much room for discretion to the ECB to decide when this should be the case. Additionally, available funds which are allocated for such interventions to defend the currencies of the individual accession countries are according to available information very limited and thus not sufficient to protect the exchange rate in the case of a serious speculative attack on the currency.

b) How actively can intramarginal intervention be used? In principle, the exchange rate should be market determined, which would exclude intramarginal intervention. Would a country be allowed to manipulate its exchange rate with the intramarginal intervention, in which circumstances and to what extent, these issues remain open for the moment. In the extreme case of no intramarginal interventions, within the band we would practically have the situation of free floating. In the other extreme case of a strong intramarginal intervention, the situation within the band would be close to managed floating.

c) How intensively realignments of the central rates in the ERM 2 will be used? In the one extreme, central rates should be corrected often, always in the case if the exchange rate would hit the top or the bottom of the intervention band and stayed there for a while. In the other extreme, there would be no corrections of the exchange rates at all and interventions at the margins of the band would take care of bridging the temporary problem. The issue of course is who and how should determine whether a one-sided large deviation of the market exchange rate from the central exchange rate is a temporary or a more lasting phenomenon?

d) Are devaluations and revaluations of the central band to be treated symmetrically or not? According to the rules and procedures of the ERM 2 both devaluations and revaluations are allowed and at least in principle in fact encouraged in the case of serious one-sided deviations of the market exchange rate from the central rate of a more or less persistent character. But according to the Maastricht convergence criterion on the exchange rate stability a country should not devalue the currency at its own initiative. Does this mean that a country can revalue but not devalue its currency? Although at first sight it may seem so, actually a country can also devalue. First, it can devalue if this was mutually agreed with the ECB. In this case this would not be a devaluation at its own initiative and would therefore probably not be considered as a violation of the Maastricht exchange rate stability criterion. Second, a country can devalue its currency on its own initiative, but in this case counting the two years period participation in the ERM 2 according to the Maastricht exchange rate stability criterion starts probably from that date anew. With revaluations there are no similar problems. Obviously there is an asymmetry between devaluations and revaluations in the practical operation of the ERM 2, but at this point it is hard to say how strong this asymmetry will actually be.

From the above it can be seen that there is a grey area of ambiguity and uncertainty around the interpretation of the rules and procedures of the ERM 2 and its practical operation as well as around the practical interpretation of the Maastricht criterion on the exchange rate stability. This nontransparency gives the EU side additional discretion, while for the accession countries it complicates their decision making when trying to define their ERM 2 strategies.

2. ERM 2 – a stable or dangerous mechanism?

According to the EU side, the ERM 2 is a stable but flexible exchange rate arrangement, which should be beneficial for the accession countries as a waiting room in the interim period before they become ready for adopting the euro. There is also an opposing view, which sees the ERM 2 as a potentially dangerous exchange rate mechanism which instead of preparing the accession countries for the soft lending in the euro area may actually lead to financial crises, divert these countries from their path towards the euro and postpone their joining the euro area into indefinite future.[6]

It should be remembered that the ERM 2 is basically an adjustable peg type of the exchange rate system. As such, it belongs to the so-called intermediate or soft peg exchange rate regimes, which proved to be at least potentially most unstable, vulnerable and dangerous. Any soft peg exchange rate regime can be exposed to speculation, if markets decide to test the willingness and ability of the central bank to protect the official exchange rate which speculators find not to be sustainable. In the case of the ERM 2 in particular it is not clear how far the ECB and the central bank of an accession country would go in defending the central rate so the markets may be tempted to test it. Pessimistic scenario could be the following: Net foreign capital inflows characteristic for the accession countries already now and expected to grow further substantially when convergence play sets in before their expected EU and euro area accession will push the market exchange rate to the top of the intervention band.[7] While the intervention on the upper margin of the band can prevent a revaluation of the currency for a while, continued speculative pressures may finally result in the correction of the exchange rate. In the meantime, additional capital inflows may overheat the economy and make the fulfilment of the Maastricht convergence criteria even harder.

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6 Stability of the ERM 2 arrangement and its vulnerability are analysed in Begg et al. (2002) and Folsz (2003).

7 A detailed analysis of the capital inflows and their relations to exchange rate policy is given for the case of Slovenia in Caprirolo and Lavrač (2001).

On the other hand, if the market sentiment suddenly changes, for good reasons (economic fundamentals in the country) or bad reasons (contagion effect from other countries), situation may get completely reversed. The exchange rate may hit the lower margin of the band and finally result in a devaluation of the currency. Under such a scenario, for which the ERM 2 arrangement does not offer a credible protection, it is clear to see why the ERM 2 can turn out to be a dangerous waiting room for the accession countries. It is obvious that under such circumstances the stability of the exchange rate would not be demonstrated, the fulfilment of the Maastricht convergence criteria would be endangered, and the accession countries would deviate from their path to the euro adoption and postpone their joining the euro area into indefinite future. Therefore, from the point of view of the accession countries, their first best strategy would in fact be not to join the ERM 2 at all. However, as this strategy is not an available option if they want to adopt the euro at some point, the second best strategy for them would be to stay in the ERM 2 for as short as possible, i.e. for two years only.

The accession countries if asked would probably rather avoid the ERM 2 arrangement altogether. They did not ask for it, did not help design it and see it as an externally given constraint, which unfortunately they can not avoid. They tried in some ways to by-pass it anyway. Slovenia for instance in the negotiations with the EU on the acquis communautaire in the EMU chapter at first in fact asked for an exemption from the ERM 2 participation, arguing that the factual exchange rate stability should do for demonstrating compliance with the Maastricht exchange rate stability criterion. Of course, as the ERM 2 was already a part of the acquis at that time, such an exemption could not be granted, particularly to just one country. Also there were some claims, particularly in the academic literature, that the accession countries could be admitted to the ERM 2 earlier, even before formally becoming the member countries of the EU. However, again this was considered to be against the formal rules of the EU. Perhaps the only way to avoid the participation in the ERM 2 is to wait and see what happens if the UK (and Sweden) finally decide to join the euro area. Would the UK, after its obviously painful decision to finally adopt the euro, be willing to participate for at least two years in the ERM 2 and to let its currency be tested in this potentially dangerous mechanism? This would most likely be the result of negotiations and balance of political powers. However, if the UK had been exempted from the ERM 2 participation, on the ground of the "same rules" principle it would be hard to make a case for forcing the accession countries to go through this mechanism.

3. Dynamics of inclusion of accession countries in the euro area

Although there are some differences among individual accession countries' positions, in their pre-accession programmes they as a group expressed the intention to join the euro area as soon as possible.[8] That on the one hand reflects their preference for an early adoption of the euro, but on the other hand also reflects the fact that they recognise the institutional constraints set by the EU side which prevent them from joining the euro area earlier, perhaps even at the time of their EU accession or somewhat later, as some of the accession countries planned still just a couple of years ago. The EU side is less optimistic about an early adoption of the euro for the accession countries. Although the rules for the new entrants are the same as for the current members of the eurozone, for the accession countries as the transition economies the concept of real convergence was introduced a couple of years ago, which may have an effect on the dynamics of inclusion of accession countries in the euro area. Some open issues concerning the concept of real convergence are discussed later in the text.

The attitude of the EU side in fact somewhat changed over time. At first the EU side did not clearly define its position, so the accession countries more or less had to guess how they would join the euro area and when they should expect to adopt the euro.[9] Later on, around 2000 the EU side defined its position and presented the three-phased approach to the euro adoption for the accession countries. At the same time the EU side signalled to the accession countries some pessimistic assumptions concerning their readiness for joining the euro area, from which it could be understood that their monetary integration could be a rather lengthy process. It was implicitly suggested that the adoption of the euro could not realistically be expected after just the minimum period of two years in the ERM 2 waiting room, but most likely after an additional period of maturation. Furthermore, it was explicitly mentioned that perhaps even the ERM 2 membership should not be expected immediately or relatively shortly after the EU accession. In the last year or two, the signals coming from the EU side are somewhat less clear.[10] Now it somehow seems as if both options, an early or a delayed

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8 This can be seen in their pre-accession programmes. For the evaluation of the monetary and exchange rate parts of their pre-accession programmes, see European Commission (2003).

9 For an early discussion on the dynamics of inclusion of the accession countries in the European monetary union, see De Grauwe and Lavrač (1999). A more recent analysis of the topic is presented in Gros et al. (2002) and Backé and Wojcik (2002).

10 The attitudes of the EU side can be discerned from the speeches by its high officials, such as Padoa-Schiopa (2002) or Solbes (2003) and from the European Central Bank (2003).

entry in the euro area were in fact open and as if it was mostly in the hands of the accession countries themselves to decide the outcome, depending of their efforts to successfully meet the required entry preconditions. The rules and procedures for joining the euro area for the accession countries are formally defined, but their interpretation and application remains somewhat non-transparent, which gives some discretion to the EU side. Perhaps the EU side now waits for the right moment to see how things evolve before defining its position more precisely.

As mentioned, the accession countries in general expressed their intention to join the euro area as soon as possible. Slovenia for instance in its official documents expressed its ambition for an early adoption of the euro. There are several reasons behind the ambition of the accession countries for an early adoption of the euro. Without going into much detail the following should be mentioned:

a) If a country expects net benefits (more benefits than costs) from the adoption of the euro, and accession countries obviously expect net benefits, it should start collecting these net benefits as soon as possible.

b) With the adoption of the euro, a country gets out of the potentially dangerous intermediate exchange rate regime of a soft peg in the ERM 2, so it should aim at an early entry in the euro area. In the ERM 2 a country can be exposed to speculative attacks on its exchange rate, while not having sufficient lines of defence against it. In the euro area it is protected from these risks (although, of course, other risks emerge).

c) On the first sight it may appear that delaying the euro adoption is beneficial for an accession country, since it gives it more time for preparations, structural reforms and other required adjustments in the economy. However, buying additional time may not always be productive, it may just delay the necessary reforms and adjustments, the momentum for positive efforts may be lost, etc. In the accession countries very low inflation rates have been reached recently. Can this be sustained for a longer period or the trend may start to diverge? The fiscal situation has worsened (not only) in the accession countries. Extending the period before the adoption of the euro may therefore lead to more and not necessarily only to less problems with meeting the Maastricht convergence criteria.

d) There are also political and prestigious reasons from an early participation in the euro area, particularly from the viewpoint of an individual accession country. Obviously they are not co-ordinating their euro area and ERM 2 entry strategies, nor are encouraged by the EU side to do so. It is also not very clear at this moment whether the accession countries will be admitted to the ERM 2 and to the euro area really individually according to their individual merits, or in some kind of packages or in a convoy approach as it turned out to be the case with the EU accession. It is politically important and prestigious to be the first or in the group of the first countries to join the ERM 2 and/or to adopt the euro. This can also have an economic effect. Suppose that in the extreme case all accession countries except one decided to enter the ERM 2 and the euro area as soon as possible, while the last one would decide for a more careful wait and see approach. The credit rating agencies would probably be suspicious about such a country, markets would see it as a strange case and could start avoiding it.

4. Defining an ERM 2 entry strategy for the accession countries

Even if we take an ambition of the accession countries to join the euro area as soon as possible for granted, at this moment it is difficult for them to formulate a rational and riskless ERM 2 entry strategy. Unfortunately there is no more time for delaying the decision. Taking into account the fact that the informal preparations for the ERM 2 entry take some time, they should start right now if they have an ambition to join the ERM 2 as soon as possible, i.e. immediately or shortly after the EU accession. The accession countries should therefore already by now have defined their basic ERM 2 strategy, i.e. decide on an early or a delayed entry in the ERM 2. This is obviously not a simple decision, since there are at least two kinds of important uncertainties involved in this decision-making. First, as argued earlier in the text, the rules and procedures of the ERM 2 are somewhat undefined. This non-transparency gives quite some room to the EU side for the interpretation and application of the ERM 2 rules and procedures. Second, it is not clear when the EU side will actually want to admit the accession countries to the euro area. Will on the basis of equal rules treatment for the accession countries the fulfilment of the Maastricht convergence criteria be enough, or some additional preconditions such as real convergence requirements or other administrative obstacles will be introduced just to delay the process? From today's perspective it is hard to give a definite answer.

The accession countries should probably define their ERM 2 strategy from the starting point that the ERM 2 is a potentially dangerous mechanism, which does not necessarily lead them to a smooth fulfilment of the Maastricht convergence criteria and to the swift and soft lending in the euro area. Since it seems they can not avoid the ERM 2, their best interest is to try to stay in the ERM 2 as short as possible, which means for the minimum period of two years only. But this starting point still does not answer the question whether it is better to join the ERM 2 early or later. There are risks involved in both cases, and the accession countries must weigh between both kinds of risks.

The risks of an early entry in the ERM 2 are related to the fact that the accession countries now can not in advance know with certainty whether they will be able to get out of the ERM 2 and join the euro area in just two years. This has to do with their ability to fulfil the Maastricht convergence criteria in time (which means practically immediately after joining the ERM 2, because of the fact that the assessment of the compliance with the convergence criteria has to be done at least half a year before joining the euro area, and is based on the previous year's data) and with the actual willingness of the EU side to admit the accession countries to the euro area without additional preconditions. In the worst case scenario the accession countries would join the ERM 2 but could not get out of it for a number of years. They would get stuck in the ERM 2, remain exposed to dangers of speculative attacks, experience exchange rate volatility and perhaps even financial crises, lose momentum and diverge from meeting the Maastricht convergence criteria, thus postponing their entry in the euro area into indefinite future.

The risks of a delayed entry in the ERM 2 are related to the fact that in this case a country also at least proportionally delays its adoption of the euro. This more cautious wait and see approach gives more time for necessary preparations and adjustments, but as argued above additional time is not always a guarantee for successfully meeting the Maastricht convergence criteria later. It seems that this strategy would make sense only if accession countries were pretty sure that realistically they could not expect their joining the euro area before a longer period, say before 2010. It this case it would perhaps make sense to postpone the ERM 2 membership to just two years before this date, in order to stay in the ERM 2 for as short as possible period. A somewhat cynical remark would be that an advantage of a delayed entry in

the ERM 2 could also be that in this case by that time the ERM 2 may already have disappeared, although this does not seem very realistic.
Although the accession countries obviously can not avoid the risks, weighing both risks it seems that their preference should be for an early entry in the ERM 2. This way they leave the door open for an early inclusion in the euro area. They should try to stay in the ERM 2 for as short a period as possible to avoid unnecessary additional vulnerability. At the same time they should take care of complying with the Maastricht convergence criteria, and pressure the EU side to apply the equal rules treatment for joining the euro area to the accession countries in such a way as to effectively enable their early entrance in the euro area just after two years of their participation in the ERM 2.

Accession countries also have to watch each others' strategies. Not knowing the EU side reactions and other accession countries' strategies, formulation of an optimal ERM 2 entry strategy for an accession country becomes a kind of complicated game theory problem.

5. Real convergence issue

Finally, a few words about the real convergence should be added. The EU Treaty defines only the Maastricht convergence criteria as the precondition for joining the euro area. This so-called nominal convergence was applied to the EU countries when they adopted the euro and on the assumption of equal rules treatment it should also suffice for the accession countries. Real convergence was introduced as a concept somewhat later, probably to give the EU side additional discretion to delay the process of inclusion of the accession countries in the euro area if they fulfilled the Maastricht convergence criteria relatively soon. In this case the EU side would have no arguments and instruments to keep the accession countries outside the euro area for a while, if their early adoption of the euro was considered to be too risky from the point of view of the EU side.

Real convergence is not precisely defined, which gives additional room for interpretation and discretion. No specific quantified indicators for the real convergence which could be applied for the assessment of readiness of the accession countries for joining the euro area have been presented so far. However, it can also not be completely excluded that they could emerge in time. The idea is that apart from the nominal convergence real convergence should also be a precondition for the adoption of the euro and that it should be pursued in parallel or in fact even before the nominal convergence. The concept of real convergence is rather vague. Usually it is meant as the catching up in the economic development (GDP per capita level) with the EU average, or finishing the process of transition and related structural reforms which would make the transition economies more similar to the EU member countries.[11]

Although there is nothing wrong with accession countries' efforts to speed up their real convergence process, the real convergence should not be used as a precondition for joining the euro area for the accession countries. The catching up process can take many years or decades, structural reforms are never really finished, and transition countries will still remain somewhat different from the present EU member countries at least for a while. The real convergence should not be used as an excuse and as an instrument for keeping the accession countries outside the euro area into indefinite future. At the bottom of the issue is the question: Is a monetary union possible among countries at a different level of economic development? Obviously yes, although it might be easier to run a monetary union with member countries at the same level of economic development, which in practice never happens. The history of different monetary unions, the euro area itself and some EU member countries which conditionally speaking can be looked upon as "monetary unions" between their more and less developed regions, demonstrate that the functioning monetary unions have to and can live with differences in the economic development among their member countries.

[11] More about the nominal and real convergence can be found in Lavrač and Zumer (2003).

CONCLUSION

The accession countries expressed their ambition to join the euro area early, as soon as possible. In the process of their monetary integration they face some external institutional constraints. In the first place, after their EU accession and before their adoption of the euro, they have to participate in the ERM 2 for at least two years. The paper finds the ERM 2 a potentially dangerous institutional mechanism. Instead of being a stable and flexible arrangement leading to their soft lending in the euro area, it may lead to financial crises, difficulties in meeting the Maastricht convergence criteria and to postponing their adoption of the euro into indefinite future. As the accession countries have to go through the ERM 2 for at least the minimum period of two years anyway, they should try to make their participation in the ERM 2 as short as possible, i.e. limited to two years only. When formulating their ERM 2 entry strategies, the accession countries should be advised to decide for an early participation in the ERM 2, more or less immediately after their EU accession, although this is also not a riskless strategy. The overall message of the paper is that there should be more transparency, equal rules treatment and less discretion in the hands of the EU side in the process of monetary integration of accession countries, which could make the formulation of their optimal ERM 2 and euro area entry strategies much easier.

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