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EXCHANGE RATE ARRANGEMENTS PRIOR TO EURO ADOPTION

Abstract

This paper discusses the exchange rate policies in the three stages of the euro adoption process. In the first stage, i.e., after EU accession but before ERM II entry, the exchange rate becomes a matter of “common concern” according to the Treaty. The paper argues that in the modern conditions, this has no real meaning besides mutual consultations on macroeconomic policy issues. In the second stage, common concern becomes institutionalized under the ERM II mechanism. Its main advantages and risks are discussed, and the arguments for minimizing the length of this stage are presented. In the third step, the exchange rate stability criterion is assessed before the country is allowed to adopt the euro. The paper discusses the open issues in the interpretation of this criterion. Finally, the current state of the Czech euro adoption strategy is described.

Keywords: monetary integration, euro adoption, convergence criteria, ERM II

JEL classification: E42; E58; F02; F33

1. Introduction

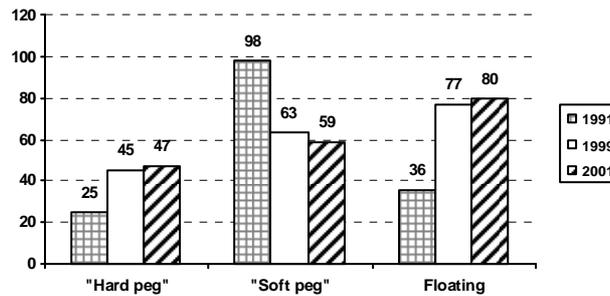
The new EU Member States are expected to join the euro area some time in the future. This must, however, be seen only as a final step in a continuous process rather than a single discrete decision. There are basically three distinct periods along the way. First, EU entry made exchange rate policy a matter of common concern. Second, in order to join the euro area the Member States are required to stay within the ERM II for at least two years before assessment of the convergence criteria and maintain their exchange rates close to the central parity. The third stage is the adoption of the euro after meeting the convergence criteria.

The objective of this paper is to show that these distinct stages in the euro adoption process all have their historical backgrounds. Based on these, we argue that it would be a mistake not to take these backgrounds into consideration when interpreting the milestones that need to be met on the way to the euro.

The structure of the paper is as follows. We start with a brief description of the development of the exchange rate arrangements in the past several decades. In the se-

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FIGURE 1 Exchange Rate Regime Distribution (number of countries)



Source: (Fisher, 2001) and IMF

cond part, the period before ERM II entry, in which the exchange rate is a matter of common concern, is studied. In the third part a discussion of the ERM II period, with some pros and cons of the mechanism, is provided. Assessments of the exchange rate convergence criterion are investigated in the fourth part. The paper concludes with the key points of the Czech euro adoption strategy.

2. The Development of the Exchange Rate Arrangements

The exchange rate systems and the corresponding monetary policy regimes adopted worldwide have shown diversity across countries and changing popularity over time. The monetary authorities have been constantly forced to evaluate what the optimal policy regime for their economies is, and respond to the changing environment. The Bretton Woods system, the international monetary framework after World War II, attempted to preserve autonomous monetary policy on the one hand and to preserve some of the benefits of fixed exchange rates on the other hand. However, the system exhibited internal conflicts; it was not flexible enough to buffer periodic shocks and not strong enough to prevail. Parities were difficult to negotiate, resulting in delays and too late adjustment. Eventually, the system collapsed in 1971.

Since Bretton Woods, an increasing number of countries worldwide have been gradually moving away from intermediate exchange rate regimes such as crawling pegs and soft pegs toward the ends of the spectrum, adopting either floating or hard pegs. This is a consequence of rising capital mobility and integration into world assets and goods markets.

Countries that maintain floating exchange rates against the major currencies have become the largest group during the 1990s. Fisher (2001) reports that the number of soft pegs dropped from 98 in 1991 to 63 in 1999, while flexible exchange rate arrangements increased from 36 to 80 over the same period (*Figure 1*). This trend has continued, even though at a slower pace, in the early years of this decade. At the same time, there have been efforts toward regional monetary integration, and so-called hard peg exchange rate regimes (currency boards, dollarization, etc.) have also become more popular worldwide.

These polar regimes are tending to prevail and there appears to be no viable middle ground.¹ Both the de jure classification of exchange rate regimes, which focuses on the stated policy intentions of monetary authorities, and the de facto classification of exchange rate regimes based on actual movements of the exchange rate, support this trend.

2.1 Exchange Rate Trends in Europe

In Europe, the European Monetary System (EMS) was established after Bretton Woods in 1979. EMS was similar to Bretton Woods in declaring a central parity and a fluctuation band. The currencies were tied together mutually (the so-called parity grid) and vis-à-vis the artificially created ECU.

Some problems resulting from the rigidity of the system remained. Moreover, increasing capital mobility made the system more vulnerable to asymmetric shocks and speculative attacks. These aspects contributed to the EMS crisis of 1992–1993.

On the one hand, France, Belgium, the Netherlands, Luxembourg, Austria, and Denmark, countries that had established and maintained tight pegs to the German mark for a long time in the ERM, were able to defend the parity. On the other hand, speculative pressures led to the withdrawal of Italy and the United Kingdom from the ERM and to exchange rate devaluations in Spain, Ireland, and Portugal. Finland and Sweden, which were not formally in the ERM, were forced to abandon their pegs. The EMS as such remained in place, but its practical functioning was substantially modified by a widening of the fluctuation band to $\pm 15\%$. Ultimately, it was only the formation of the euro area in 1999 that removed the risk of exchange rate crises and excessive exchange rate volatility among the participating countries.

The exchange rate arrangements of the new EU Member States are summarized in the *Table 1*. Among the twelve new Member States, five pursued hard pegs or narrow bands before their EU entry (the Baltic states, Malta and Bulgaria), another five operated under flexible exchange rates, and only two countries (Hungary and Cyprus) had intermediate regimes.² Thus, the polar regimes also dominated among the new Member States before the EU enlargement. Since then, the major changes have consisted in ERM II entry by seven countries, one of which (Slovenia) had already adopted the euro. The first wave comprised Estonia, Lithuania, and Slovenia at the end of June 2004. However, Estonia and Lithuania have unilaterally retained their currency board arrangement. The second wave was Latvia, Cyprus, and Malta in May 2005, who have also kept their unilateral exchange rate commitments. Finally, Slovakia joined in November 2005; it is the only ERM II country without any other commitment than the standard $\pm 15\%$ fluctuation band.

¹ There are, however, opponents of this mainstream view. Williamson (2000) is one of the examples, arguing in favor of the intermediate options (the so-called “basket, band and crawl” system). Some recent literature also argues in favor of managed floating (e.g. (Bofinger, Wollmershaeuser, 2001), (Goldstein, 2002), (Frankel, 1999), (Fischer, 2001)).

² It should be noted, though, that the Slovenian managed floating de facto mimicked a crawling peg arrangement until ERM II entry and a very narrow fixed peg from ERM II entry until euro adoption.

TABLE 1 Monetary Policy Strategies of New EU Member States

	Monetary policy strategy	Currency	Features
Bulgaria	Exchange rate target	Bulgarian lev	Currency board pegged to the euro introduced in 1997.
Cyprus	Exchange rate target	Cyprus pound	ERM II participation since 2 May 2005 with a $\pm 15\%$ fluctuation band, de facto close to the central parity. Euro adoption in 2009.
Czech Republic	Inflation targeting	Czech koruna	Target set at 3 % (± 1 p.p.), lowered to 2 % (± 1 p.p.) from January 2010. Managed floating of the exchange rate.
Estonia	Exchange rate target	Estonian kroon	ERM II participation since 28 June 2004 with a $\pm 15\%$ fluctuation band. Currency board to the euro introduced in 1992, maintained as a unilateral commitment.
Hungary	Combined exchange rate and inflation target	Hungarian forint	Exchange rate target: peg to the euro with a $\pm 15\%$ fluctuation band. Inflation target: 3.5 % (± 1 p.p.) by end-2006, and 3 % (± 1 p.p.) medium-term target from 2007.
Latvia	Exchange rate target	Latvian lat	ERM II participation since 2 May 2005 with a $\pm 15\%$ fluctuation band. Fluctuation band of $\pm 1\%$ as a unilateral commitment.
Lithuania	Exchange rate target	Lithuanian litas	ERM II participation since 28 June 2004. Currency board to the euro introduced in 1994, maintained as a unilateral commitment.
Malta	Exchange rate target	Maltese lira	ERM II participation since 2 May 2005 with a $\pm 15\%$ fluctuation band. De facto at the central parity as a unilateral commitment. Euro adoption in 2009.
Poland	Inflation targeting	Polish zloty	Inflation target: 2.5 % (± 1 p.p.; yearly average) as from 2004. Free floating of the exchange rate
Romania	Inflation targeting	Romanian leu	Inflation target: 4 % and 3.8 % (± 1 p.p.) for end-2007 and 2008, respectively. Managed floating of the exchange rate.
Slovakia	Inflation targeting under ERM II	Slovak koruna	ERM II participation since 25 November 2005 with a $\pm 15\%$ fluctuation band. The inflation target for 2006-2008 is set below 2.5 % for end-2006 and below 2 % at end-2007 and at end-2008.
Slovenia	Member of eurozone since 1 Jan 2007	Euro	

Source: ESCB

3. The Exchange Rate as a Matter of Common Concern

The advent of the Economic and Monetary Union (EMU) brought new challenges for monetary policy and the corresponding exchange rate arrangements. The Treaty provided the legal basis for taking pre-specified steps to form the EMU, committing all Member States except the UK and Denmark, which negotiated opt-out clauses, to an irreversible process towards single currency adoption.

The Treaty provides that EMU is to be achieved in three stages. In the first stage (1990–1993), free movement of capital between Member States, closer coordination of economic policies, and closer cooperation between central banks was attained. The second stage (1994–1998) aimed at promoting the convergence of the economic and monetary policies of the Member States to ensure price stability and sound public finances. In the third stage (from 1999), the European Central Bank (ECB) was established, the Member States' exchange rates were irrevocably fixed, and the single currency, the euro, was introduced.

Nonetheless, the procedures of the Treaty, which were originally designed for creating the monetary union in the context of the EMS, are also to be applied to the enlargement of the euro area under the quite different circumstances that now prevail in the exchange rate arrangements. As we shall see below, this raises some open issues, and has led many economists and policy makers to call for a flexible interpretation of the procedures.

3.1 The Exchange Rate as a Common Concern in Polar Regimes

The twelve EU newcomers are the first countries to have entered the EU after the single currency was introduced. Upon their accession, they thus became Member States of the EMU with a derogation from euro adoption. They are thus required to implement policies aiming at future euro area entry.

In principle, it should be possible for the new Member States to bring in with them their existing exchange rate regimes. However, under Article 124 of the Treaty, the new Member States are required to treat their exchange rates as a “matter of common concern”. The single market should not be endangered by excessive nominal exchange rate fluctuations, which would disrupt trade flows between Member States. In order to protect the smooth functioning of the Single Market, competitive devaluations are not allowed.

It is, however, not straightforward to say what the “common concern” clause means in the current situation. It was clear under a multilateral soft-peg exchange rate regime such as the EMS. The aim was to avoid unilateral actions by national authorities, actions for which there was otherwise ample room (devaluations, monetary and fiscal policy actions incompatible with maintaining the exchange rate system, etc.), and which could destabilize the whole system with negative consequences for all participants. The shift towards either free-floating or hard-pegs, though, brings challenges in the interpretation of common concern.

In countries with free floating, usually combined with an inflation targeting regime, no specific “exchange rate” policy is applied. There is thus limited scope for coordination or indeed common concern in this regard. In practice, it is true that inflation targeting countries often do manage the exchange rate to some extent. They

BOX 1 The Convergence Criteria

The *criterion on price stability* requires that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability.

The *exchange rate convergence criterion* requires participation for at least two years in the ERM II and observance of the normal fluctuation margins close to the central parity provided for by the mechanism without severe tensions for at least two years and without devaluation of the central rate.

The *criterion on long-term interest rates* requires that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability.

The *criterion on the government budgetary position* means that a Member State has a ratio of planned or actual government deficit to GDP that does not exceed 3 %.

The *criterion on government debt* means that a Member State has a ratio of government debt to GDP that does not exceed 60 %.

try to avoid sudden swings in the exchange rate in either direction, as in small open economies these swings could push the inflation rate out of the desired target range. Nonetheless, to the extent that policy responds only to excess exchange rate volatility and fundamentally unjustified trends, it can hardly be compared to the competitive devaluations of the past.

Similarly, for the hard peg countries the practical meaning of common concern is fairly limited. Competitive devaluations are absent from hard peg regimes by definition, in order to enhance the credibility of such regimes. This fact was – quite naturally given the historical context – not fully accommodated and acknowledged when the chapters on common concern regarding the exchange rate were formulated.

Hence, the “common concern” clause has limited practical meaning in the current circumstances, besides mutual consultations on exchange rate and other policy issues.

As Member States with a derogation, the new countries participate in such consultations within the EU and ESCB institutional framework. Such coordination in general concerns all economic policies, which are expected to work towards fulfillment of the convergence criteria, not just the exchange rate criterion. However, the choice of monetary and exchange rate strategy is, until the third stage of the monetary integration process, primarily the responsibility and prerogative of the Member States concerned.

4. ERM II Membership

The convergence criteria introduced by the Treaty (see *Box 1*), which the Member States are required to fulfill in order to be allowed to join the euro area, are meant to act as some form of “club rules”. They protect the current members from possible distractions caused by the misbehavior of other club members, in particular the new-

comers. The emphasis on nominal criteria reflected the view that the EMU would not be viable if some degree of nominal convergence was not attained prior to the introduction of the single currency. The absence of a sufficient degree of prior nominal convergence would create a major source of instability and pose a risk to the credibility of the price stability objective of the ECB.

4.1 The Features of ERM II

In the ERM II stage, the “common concern” for exchange rate developments becomes formalized. There are requirements and procedures that have to be fulfilled jointly by the Member States and the EU institutions. These include the determination of the central parity and fluctuation margins upon entry into the mechanism, coordinated interventions should the margins be reached, and joint agreement on possible adjustments of the central parity in the ERM II.

The ERM II was established by a European Council Resolution of 16 June 1997 as a successor arrangement to the EMS and ERM. The mechanism is based on fixing the participating currencies against the euro within a fluctuation band. Each country participating in the ERM II has a defined central rate (parity) against the euro and a fluctuation band for movements around the central rate. For the standard fluctuation band a $\pm 15\%$ margin applies. In the event of exchange rate pressures, both the national central bank and the ECB will intervene to keep the exchange rate within the fluctuation band. The interventions are in principle automatic and unlimited at the margins, but they should not endanger the price stability of the euro area.

Maintenance of exchange rate stability, required for meeting the exchange rate convergence criterion, is closely linked to the ERM II. However, as described in more detail in the following part, the two terms are not interchangeable. While participation in the ERM II is a necessary condition for fulfilling the exchange rate stability criterion, it is possible for a country to participate in the ERM II and yet not fulfill, or even be heading towards fulfilling, the exchange rate convergence criterion.

Participation in the mechanism is voluntary, but Member States with a derogation are expected to join the mechanism. Greece and Denmark participated as of the start of the mechanism on 1 January 1999. Greece, however, joined the euro area on 1 January 2001. On the other hand, Sweden and the UK have not applied for ERM II participation. Denmark thus remains the only “old” EU country currently participating in the ERM II, together with the above-mentioned six new EU Member States.

4.2 Advantages and Potential Challenges of ERM II

According to the EU institutions, the ERM II should help to ensure that Member States outside the euro area participating in the mechanism direct their policies towards stability, fostering economic convergence. The mechanism should thus provide those Member States with a reference for their conduct of sound economic policies. At the same time, the mechanism aims at protecting Member States from unwarranted pressures in the foreign exchange markets.

This view of the advantages of the ERM II is certainly justified by the historical experience of some current euro area members. At the same time, though, it may not fully reflect the recent exchange rate regime developments. The ERM II can be

classed under the label of intermediate regimes, which have received a lot of criticism recently. As we have argued, the current consensus is that macroeconomic stability can be achieved better and more safely with polar exchange rate regimes. This argument may be even stronger for transition economies, which are subject to large inflows of foreign capital, which, in turn, may make a soft peg regime even harder to sustain.

Moreover, the standard fluctuation band of $\pm 15\%$ permits substantial exchange rate volatility, so it is also questionable to what extent the role of the ERM II is sufficiently stabilizing. It needs to be combined with another nominal anchor for the economy, such as an inflation target. This, however, may lead to multiplicity and mutual inconsistency of monetary policy targets, harming the credibility of the overall policy framework. Moreover, the multilateral character of the ERM II, referring mainly to the possible participation of the ECB in interventions at the $\pm 15\%$ margin, is in practice very much limited by the very short term financing (VSTF) facility. Thus for transition economies, and in the current situation, there seems to be no value, or very limited value, added by the ERM II.

That is why most of the new Member States have declared in their euro adoption strategies an intention to stay in the ERM II for the shortest required period of two years (plus the period necessary for the political and logistical procedures leading to euro adoption). By doing so, they aim to fully exploit a major advantage of the ERM II compared to other soft peg regimes, namely, a clear exit point in the form of euro adoption.³ A smooth transition through the ERM II could also be facilitated by progress in structural and cyclical convergence and necessary reforms in the new Member States. On the EU institutions' part, a flexible approach to the interpretation of the exchange rate stability criterion (see below) could be a major contribution to coping with the ERM II stage under the new circumstances.

5. Assessments of the Exchange Rate Convergence Criterion

The exchange rate criterion is defined, in accordance with Article 3 of Protocol No. 21 (ex 6) of the Treaty, as follows: *"The criterion on participation in the Exchange Rate Mechanism of the European Monetary System [...] 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 Exchange Rate Mechanism (ERM) underlying the European Monetary System (EMS) was based on bilateral parities among the participating countries, with bilateral "normal" fluctuation margins of $\pm 2.25\%$ around the central bilateral rate for a number of currencies and "wide" margins of $\pm 6\%$ for the other Member States. Before the 1993 ERM crisis, the prevailing $\pm 2.25\%$ fluctuation bands provided a yard-

³ The Baltic states, however, have been forced to postpone euro adoption beyond their original target dates, mainly due to adverse inflation developments. This means that ERM II participation in these countries will exceed the required minimum period.

stick for interpreting the exchange rate criterion. However, because of the widening of the bands to $\pm 15\%$ prompted by the crisis, the interpretation of the criterion became less clear cut. Thus, the formulation about normal fluctuation margins without severe tensions has given rise to alternative but not necessarily conflicting practices when interpreting the criterion.

Article 121 of the Treaty stipulates that both the European Commission and the European Monetary Institute (the predecessor of the ECB) are to examine the state of convergence of the Member States. These convergence reports are then to be submitted to the Council of the EU, which, based on the recommendation of the European Commission, judges whether a given country fulfils the necessary conditions for euro adoption. The decision on the 11 Member States ready to participate in the single currency was based on the first two convergence reports issued by the Commission and the European Monetary Institute in 1998. In accordance with Article 122(2) of the Treaty, at least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall release a new convergence report. The reports draw on the previous reports. Thus, the convergence reports of 1998 are the most instructive, since they were the launching reports covering the first wave of euro area participants.

An important difference exists here between the responsibility of the European Commission and that of the ECB. Although both institutions are required to prepare convergence reports when a given country is analyzed to see whether it complies fully with the convergence criteria, it is the European Commission that makes the direct recommendation to the Council.

It is interesting to analyze how the convergence reports prepared by the two EU institutions interpret the convergence criteria. In accordance with the equal treatment principle, the way the criteria were interpreted in the past would also strongly influence how they would be applied to the new euro area acceding countries. This is confirmed by item 8 of the statement of the ECOFIN meeting held in April 2003: *“The assessment of the fulfilment of the Maastricht convergence criteria [...] will ensure equal treatment between future Member States and the current participants in the euro area.”*

5.1 Positions of the EMI/ECB and the European Commission

The ECB in its convergence reports considered a currency stable if it had been traded close to its unchanged central parity. Whether or not there had been severe tensions on the foreign exchange market was assessed on so-called tension indicators such as exchange rate volatility, short-term interest rate differentials, and the extent of exchange market interventions.

The practice of the European Commission was different and much more explicit than that of the EMI and ECB. According to its convergence report of 1998, the widening of the fluctuations margins was originally meant to be transitory to prevent the collapse of the ERM. At the same time, the report also acknowledges that wider bands should somehow be accounted for during the convergence assessment, as no officially announced return to the $\pm 2.25\%$ occurred. As a result, the European Commission introduced the so-called median currency, which was defined as the currency whose deviation from its ECU central parity was the “median” deviation among

the participating currencies. For the exchange rate criterion to be fulfilled, a given currency's exchange rate to the median currency's bilateral parity should be kept within a fluctuation band of $\pm 2.25\%$.

The asymmetry of the exchange rate convergence criterion stated in the Treaty is reflected on page 153 of the European Commission's 1998 Convergence Report: "[...] it seems reasonable to exclude movements above the 2.25% range against the median currency as a possible cause for non-fulfilment of the criterion." The application of the exchange rate convergence criterion, like that of the other convergence criteria, in the subsequent reports has been on the same basis as in 1998. Hence, the fluctuation band around the median currency is 2.25% on the weaker side and much wider – perhaps up to 15% – on the stronger side. The criterion is silent on revaluation of the central parity though.

Different assessments have also been made concerning the duration of ERM participation. Finland and Italy entered and re-entered the ERM in October and November 1996, respectively. At the time of the assessment in March 1998, both of them had spent less than two years in the ERM. The EMI took into consideration their respective 16.5 and 15 month stays as the reference period for examining exchange rate stability, whereas the European Commission treated the two countries as if they had spent 24 months in the ERM by examining their exchange rates between March 1996 and February 1998.

Depreciation against the central parity beyond the $\pm 2.25\%$ limit was observed for two countries (France and Ireland), if the EMI reference period applied to Finland and Italy is considered. However, if the 24-month period for Finland and Italy is considered, as done by European Commission, four countries deviated by more than 2.25% on the weaker side. As a matter of fact, all these deviations occurred at the beginning of the examination period. This was reflected by both the EMI and the European Commission concluding that the criteria had been fulfilled.

On the stronger side, the exchange rate appreciated by up to 10% against the central parity in Finland, Ireland, Italy, Portugal, Spain, and Denmark. The asymmetry in the assessment applied and the convergence criteria were met.

Since the convergence criteria are part of the Treaty, they can only be changed by renegotiating the Treaty. However, the evaluation of the extent to which the criteria are met should not be understood as a purely mechanical verification of certain conditions. There is a lot of room for discretion in the interpretation of the criteria, which can have both positive and negative aspects. The discretion is partly constrained by the equal treatment principle, which should not, however, come at the cost of applying sound economic logic.

Specifically in terms of the exchange rate criterion, it is important not to dwell on the semantic difference between the "normal" and "standard" fluctuation range. Instead, it should be acknowledged that the trend real exchange rate appreciation observed in many catching-up economies may lead to pressures above the 2.25% band. Yet, it is in line with economic fundamentals and should thus not be automatically categorized as inconsistent with fulfilling the criterion.

The ECB in its policy position of December 2003 points out that the assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate while also taking into account factors that may have led to an ap-

preciation, which is in line with what was done in the past. The ECB further stresses that the width of the fluctuation band within the ERM II will not prejudice the assessment of the exchange rate stability criterion. Moreover, the issue of the absence of “severe tensions” is, according to the ECB, addressed by examining the degree of deviation of exchange rates from the ERM II central rates against the euro, by using indicators such as short-term interest rate differentials vis-à-vis the euro area and their evolution, and by considering the role played by foreign exchange interventions.

6. Czech Euro Adoption Strategy

A potential conflict may arise between inflation and exchange rate objectives for an inflation targeting economy. This conflict may be a crucial factor in searching for the optimal conduct of monetary policy prior to euro adoption. It is also critical in deciding on the timing of ERM II entry and euro adoption.

The severity of this conflict is the higher the lower is the degree of economic convergence to the EU. An aligned economy with synchronized cycles could in principle achieve a stable exchange rate even under inflation targeting with very limited direct exchange rate management. Similarly, an exchange rate targeting country could accommodate domestic inflation and meet the convergence criteria with a high degree of convergence.

An additional challenge stems from the asymmetry in the convergence criteria. An asymmetric shock pushing inflation above the inflation reference value induces a monetary tightening in inflation targeting countries. This exerts pressure for an appreciation of the exchange rate, directing inflation back to the target. Since on the strong side the wide fluctuation band applies, inflation targeting accommodates such shocks safely. However, if an asymmetric shock reduces inflation, symmetric inflation targeting directs inflation up by decreasing the interest rate. This may induce depreciation pressures and the inflation targeting country might have to intervene in order to meet the exchange rate criterion. This could be treated as severe tensions. Moreover, it would make the communication of monetary policy confusing. On the contrary, hard peg countries could find it difficult to cope with shocks pushing the inflation rate upward but not downward, due to the asymmetric nature of the inflation criterion.

6.1 Joint Document

The Czech euro adoption strategy released in 2003 as a joint document of the Czech Government and the Czech National Bank reflected these concerns. The document recommends that the Czech Republic join the euro area as soon as economic conditions allow for doing so, implying that the timing depends to a large extent on the degree of alignment and on the nominal convergence process.

The strategy also included an indicative euro adoption target date. In particular, it stated: *“Provided that the Maastricht criteria are fulfilled, including a successful consolidation of public finances, a sufficient level of real convergence is achieved and adequate progress is made with structural reforms guaranteeing sufficient economic alignment with the EU Member States, the Czech Republic can be expected to join the euro area around 2009–2010.”*

Given the challenges for inflation targeting countries, the euro adoption strategy regarded the ERM II merely as the gateway to joining the euro area, aiming to minimize participation in this mechanism to a period of two years (plus the period necessary for assessment of the convergence criteria and logistical preparation for euro adoption). Therefore, the decision on the timing of entry hinges on the outlook for the fulfillment of the convergence criteria and on the evaluation of the Czech economy's degree of alignment with the euro area economies. In other words, the strategy stated that the Czech Republic should enter the ERM II only after conditions have been established which enable it to introduce the euro at the time of the assessment of the exchange rate criterion, which is two years after joining the ERM II.

To assess progress in these areas and give recommendations on ERM II entry, the strategy introduced a regular yearly assessment of the fulfillment of the Maastricht criteria, as well as of economic alignment with the eurozone. None of these assessments in 2004–2006 resulted in a positive recommendation on ERM II entry. Fiscal deficits were identified as a major obstacle to future fulfillment of the convergence criteria, as well as a problem for the future smooth functioning of the Czech economy in the euro area, given the absence of cyclical alignment with the monetary union. The assessments also pointed to the low flexibility of the Czech economy, and in particular of the labor market.

The negative recommendation on ERM II entry in 2006 implies that the future euro adoption date has shifted beyond the year 2010. This means that the original euro adoption strategy has not been fulfilled, at least as regards the timing of euro adoption. The strategy has thus been put on a review, which should be finished by August 2007. The results of this review are not yet public. It is clear, though, that the updated strategy should once again emphasize the need for consolidated fiscal policy and a well-functioning labor market as factors of key importance for the future smooth functioning of the economy within the ERM II and after the subsequent introduction of the euro.

Entry into the euro area will complete the process of integration into European monetary structures. The Czech Republic will be able to participate fully in formulating and implementing the single European monetary and exchange rate policy, which aims at strengthening macroeconomic stability in Europe.

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