The acquis in the area of exchange rate policy and euro adoption

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DG Economic and Financial Affairs
European Commission

These slides accompany the explanation of the acquis to Albania and North Macedonia and can only be used for that purpose. Their content is subject to further development of the acquis and interpretation by the Court of Justice of the European Union'

Introduction

Institutional path to become a full member of EMU and adopt the euro.

3 phases:

→ Pre-accession

→ EU Member State with a derogation

→ Euro adoption

Pre-accession Phase

Copenhagen criteria:

Policies targeting a well-functioning <u>market economy and competitiveness</u>

Ability to take on the obligations of membership including adherence to the aims of political, <u>economic and monetary union</u>.

- **Securing macroeconomic and financial stability**
- **Effective and credible monetary policy framework, fiscal and structural policies need to be supportive**
- **Key factor: institutional capacity to implement a set of coherent policies**

Status of new Member States

By joining the EU, NMS become part of EMU (as Member States with a derogation):

- **Commitment to adopt the euro (only UK, DK opt-outs)**
- **Accession treaties allow time to achieve convergence: "Member States with a derogation" (Article 139)**
- **NMS expected to direct policies towards achievement of the conditions to join the euro area**
- **Adoption of the euro by abrogation of the derogation (ruled by Article 140 (2) TFEU)**

Economic policy co-ordination:

Members States with a derogation:

- **Prepare and implement *Convergence Programmes***
- **Participate in surveillance procedures/peer reviews**
- **Exchange rate policy treated as a matter of common interest (Art. 142) – part of the *acquis***
  - **Avoid real exchange rate misalignments**
  - **No excessive nominal exchange rate fluctuations**
  - **ERM II participation expected at some stage**

ERM II – Legal background

Intergovernmental but recognised by the Treaty; plays important role in convergence assessment;

- Established by intergovernmental agreement: **Amsterdam (European Council) Resolution** adopted on 16 June 1997

  http://ec.europa.eu/economy_finance/publications/publication6325_en.pdf

- **Central Banks' Agreement of 1 September 1998** lays down the operating procedures of ERM II (adjusted each time an ERM II member joins the euro area)

https://www.ecb.europa.eu/ecb/legal/107663/1350/html/index.en.html

Main Principles of ERM II (1)

- Participation is voluntary
- ERM II entries, central rates, fluctuation bands and realignments are decided by consensus of all participants (Finance Ministers and NCB Governors of participating non-EA MS, EA Finance Ministers and the ECB; Commission is involved in the procedure but not a participant)
- Link to economic policy:
  - ERM II commitments: monitored by the General Council of the ECB and the EFC (ERM II composition)

Main Principles of ERM II (2)

- Fluctuation margins (+/- 15%) around the central parity, which however should remain the focus
- Interventions automatic and unlimited at the margins but without prejudice to the ECB price stability objective; short-term financing available
- Possibility of co-ordinated intra-marginal intervention
- Current ERM II Members: Denmark

Main Principles of ERM II (3)

- **Fixed but adjustable peg - adjustments should be timely in case of emerging misalignments**
- **Different exchange rate regimes accommodated, though clear incompatibilities include:**
  - **free floating,**
  - **crawling pegs,**
  - **pegs against an anchor other than the euro;**
- **Closer arrangements (e.g. DK) as well as tighter unilateral commitments (e.g. EE) possible**

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ERM II Member States 2004-2018

	Date of ERM II entry	*Multilateral or unilateral commitment for the exchange rate within ERM II*	*EA entry/comments*
Denmark	1 Jan 1999	Narrow +/- 2.25% band	In ERM/ERM II since 1979
Estonia	28 Jun 2004	Currency board*	Euro area member as of 1 January 2011
Cyprus	2 May 2005	-	Euro area member as of 1 January 2008
Latvia	2 May 2005	Narrow band of +/- 1%*	Euro area member as of 1 January 2014
Lithuania	28 Jun 2004	Currency board*	Euro area member as of 1 January 2015
Malta	2 May 2005	To maintain exchange rate at the central parity*	Euro area member as of 1 January 2008
Slovenia	28 Jun 2004	-	Euro area member as of 1 January 2007
Slovakia	28 Nov 2005	-	Euro area member as of 1 January 2009

* Unilateral commitment within the ERM II mechanism

Considerations for ERM II strategies

- Integral part of overall policy framework
- ERM II participation not necessarily immediately after accession
- ERM II framework offers flexibility => room for realignments, if necessary, notably for the catching-up economies (e.g. Slovakia)
- Not a "waiting room" but a "training room" to foster convergence – need for credible policies
- Pre-commitments and close cooperation with the ECB (i.e. Banking union) to ensure smooth transition to ERM II

Overview: Stages for adopting the euro

'PRE-INS'

Accession to EU: Adoption of Treaties and legislation on EMU

MEMBERS OF EMU

(with a derogation)

Joining ERM II

At least 2 years

Meet convergence criteria

Convergence Reports

Commission Proposal

Council decision: Abrogation of derogation – adoption of conversion rate

Changeover: member of euro area

Convergence assessment

The Convergence Report

- <u>assessment of the progress made</u> in the fulfilment by Member States with a derogation of their obligations regarding the achievement of economic and monetary union.
- at least once every two years or at the request of a Member State with a derogation, <u>the Commission and the ECB have to report to the Council</u> (Article 140(1) of the TFEU)
- basis for the Council's assessment on whether the MS shall adopt the <u>euro or not</u>

The Convergence Report

Content:

- An examination of legal compatibility (central bank independence, legal convergence)
- An examination of the achievement of a high degree of sustainable (economic) convergence, by reference to the fulfilment of a number of criteria
- Qualitative assessment of other factors (product, labour and financial market integration, balance of payments, unit labour costs and other price indices)

Sustainable (economic) convergence

Article 140 (1) of the TFEU: "Achievement of a high degree of sustainable convergence" required:

- Based on the following criteria:
  - High degree of price stability
  - Sustainability of the government financial position
  - Exchange rate stability in ERM II context
  - Convergence of long-term interest rates
  - Additional factors (BoP, integration of markets, ULC and other price indices)
- Test the ability to function well with the single currency and contribute to euro area stability
- Protocol on the convergence criteria (No 13): more detailed specifications

Price Stability Criterion

Definition:

Article 140 (1) 1st indent of the TFEU :

“ […] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability.”

Article 1 of Protocol (No 13):

- **Reference value = average of, at most, the 3 best performers’ inflation rate over last 12M + 1.5pp**
- **Sustainability of price performance: the Convergence report also examines ULC, labour productivity, wages, import prices…**
- **HICP: Consumer price index on a comparable basis**

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Government fiscal criterion

Definition:

Article 140 (1) 2nd indent of the TFEU:

The MS should not be under an excessive deficit procedure as defined in Article 126(6), i.e.:

- **Ratio of the planned or actual government deficit to GDP < 3% ; or substantial and continuous decline towards 3% ; or exceptional and temporary excess over 3%**
- **Ratio of government debt to GDP < 60% or satisfactory pace of reduction towards the threshold**

Exchange rate stability

<u>Definition</u>:

Article 140 (1), 3rd indent of the TFEU:

"The observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European monetary system, for <u>at least two years</u>, without devaluating against the euro"

<u>Other issues:</u>

- **ERM II participation "without severe tensions" required by Article 3 of Protocol (No 13)**
- **Exchange rate close to the central rate**
- **But factors leading to an appreciation may be taken into account (Athens Council statement 2003)**

Long-term interest rates

Definition:

Article 140 (1) 4th indent of the TFEU:

"The durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European monetary system being reflected in the long-term interest rate levels."

Article 4 of Protocol (No 13)

Long-term interest rate below the reference value, i.e. the arithmetic average of the previous 12-month average of the long-term interest rate of, at most, the 3-best performing Member States in terms of price stability + 2%

Measurement of long-term interest rates

“Interest rate shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”

Bond issuer	Long-term bonds issued by the central government or comparable securities
Maturity	As close as possible to ten years’ residual maturity. Any replacement of bonds should minimise maturity drift; the structural liquidity of the market must be considered
Denomination	National currency
Choice of bonds	The selected bonds should be sufficiently liquid. This requirement should determine the choice between benchmark or sample approaches, depending on national market conditions
Aggregation	Where there is more than one bond in the sample, a simple average of the yields should be used to produce the representative rate.

Adopting the euro

Abrogation of the derogation – Article 140 (2):

- proposal by the Commission
- consultation of European Parliament
- recommendation by the EA MS (new with TFEU)
- discussion in the European Council
- ECOFIN Council decision by QM of all MS

The procedure on the accompanying Council regulations – Art. 140(3)

- amending Regulations on the introduction of the euro/on the conversion rates
- proposal by the Commission
- consultation of the ECB
- ECOFIN Council decision by unanimity of euro-ins and MS concerned

Abrogation of derogation: rights and obligations under the TFEU

Provisions of the Treaties that do not apply to MS with a derogation (Art. 139):

- *Art. 126 (9) and (11): Full application of SGP*
- *Art. 127: Tasks of the ESCB → single monetary policy*
- *Art. 128: Euro notes and coins*
- *Art. 132: Legal instruments of the ECB*
- *Art. 138: External representation of the euro*
- *Art. 143 ceases to apply (BoP facility)*

Possibility for closer economic policy co-operation by euro area MS (Art. 136) and co-ordination via the Eurogroup (protocol No 14)

Final considerations on euro adoption

- **Euro area enlargement is an open process, governed by a rules-based framework based on sustainable convergence**
- **Policies need to be attuned to country-specific circumstances; ownership is key**
- **Thorough preparation is critical, both at macro and micro level**
- **New framework of EMU surveillance: joint commitment and responsibility for smooth functioning of EMU**

Further information

- ECFIN website on euro adoption: https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area_en

  Previous Convergence Reports: https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/convergence-reports_en
- Lisbon Treaty: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:C2010/083/01&from=EN
- EMU: Legal and political texts (Compendium) https://ec.europa.eu/info/publications/economy-finance/economic-and-monetary-union-main-legal-texts-and-policy-documents-further-strengthening-economic-and-monetary-union-2018_en
- ECB: Policy position of the ECB's Governing Council on exchange rate issues relating to the acceding countries www.ecb.int/pub/pdf/other/policyaccexchangerateen.pdf