INSIDE EU, OUTSIDE EMU: INSTITUTIONAL AND LEGAL ASPECTS OF THE EXCHANGE RATE MECHANISM II

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ABSTRACT

I nuovi Stati membri hanno espresso la propria intenzione di adottare l'euro il prima possibile, probabilmente prima della fine del decennio. La partecipazione ai nuovi accordi europei di cambio (ERM II) è uno dei criteri che dovranno essere soddisfatti prima che sia possibile considerare il passaggio all'euro. Lo studio intende fornire un esame generale del contesto giuridico e istituzionale dell'ERM II. Al fine di inserire l'analisi dell'ERM II in una prospettiva più generale vengono anche ripercorsi gli sviluppi storici e i negoziati che hanno condotto a tale accordo. Viene infine trattato il ruolo dell'ERM II nel criterio di convergenza relativo al tasso di cambio.

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1 INTRODUCTION

Since 1 January 1999, the EU Member States have been divided in terms of participation in Economic and Monetary Union (EMU). Currently, 12 out of the 25 Member States in total have moved to the third stage of EMU and have adopted the euro (the "euro area Member States"). The remaining 13 EU Member States have not introduced the euro; two of these, Denmark and UK, both have a Treaty-bound special right not to participate in the euro.

As long as not all Member States have adopted the euro, Articles 121 and 124 of the Treaty establishing the European Community ("the Treaty") stipulate the existence of an exchange rate mechanism. The present Exchange Rate Mechanism II (ERM II) links the currencies of the Member States participating in ERM II to the euro. This provides incentives among the participating Member States to pursue stability-oriented economic and monetary policies, which helps to create convergence and to foster exchange rate stability. This stability supports the functioning of the single market and facilitates later full integration into the euro area. In this paper we take a closer look at the legal and institutional framework of ERM II. This analysis is placed into a more general perspective that includes the historical developments and negotiations leading up to ERM II. In addition, the role of ERM II in the exchange rate convergence criterion is also briefly discussed.

2 THIRTY YEARS OF MONETARY COOPERATION

In 1972, following the launch of the Werner Plan for Economic and Monetary Union, the Governors of the national central banks (NCBs) of the then six Member States and of the three countries that would join the European Community (EC) on 1 January 1973, established through the Basel Agreement a fixed exchange rate system with fluctuation bands of ±2.25%, known as the "Snake". During its existence from 1972 to 1978, the Snake was characterised by frequent exchange rate adjustments as well as the coming – and especially going – of participating Member States. The lack of success of the Snake, coupled with the dismal economic situation at the beginning of the 1970s, caused the Werner Plan to suffer a major setback.

The idea of monetary stability in Europe was revived with the creation of the European Monetary System (EMS) in December 1978. The aim of the EMS, which started operations in March 1979, was to promote monetary stability and closer economic cooperation. At its core was the Exchange Rate Mechanism. A central parity against the European Currency Unit (ECU) was fixed for each participating currency. Based on these rates, bilateral "central rates" were established against all other member currencies of the ERM, constituting the so-called parity grid. The fluctuation bands around the bilateral central rates were ±2.25%.[2] The first few years of the EMS were characterised by frequent exchange

2 Except for the Italian lira, for which it was set at ±6%. On 8 January 1990 the fluctuation band for Italy was narrowed to ±2.25%.

rate realignments, which closely resembled a continuation of the Snake, with no more substantial change than that of a broader group of participating countries. However, from 1983 onwards the economic policies of a number of countries became stability-oriented to a degree that made it possible to maintain a stable exchange rate against the Deutsche Mark, which had the status of anchor currency. Regular realignments of central rates still occurred, however, until 12 January 1987, when the system changed in nature as the participating countries shifted towards avoiding such realignments. From January 1987 to September 1992 there were no realignments in the system. The system was supported by improved convergence of prices and costs.[3] Positive, albeit declining, inflation differentials accumulated over time, however, and, coupled with fixed nominal exchange rates[4], resulted in a deterioration in competitiveness, especially in Italy and Spain. The increasing fundamental divergences and the full capital liberalisation adopted from 1 July 1990 by most Member States, as well as speculative attacks[5], led to crises in September 1992 when the UK and Italy left the ERM. The Spanish peseta and the Portuguese escudo were devalued in November 1992 and again in May 1993, while the Irish pound was devalued in January 1993. In August 1993 the EMS was partly suspended when its fluctuation limits were extended to ±15% to remove potential "one-way" speculative bets and to restore stability. After ratification by all Member States, the Maastricht Treaty, which established among other things the political and institutional framework for the process of convergence towards EMU, came into force on 1 November 1993. The EMU project of the Maastricht Treaty, with its well-determined objectives, institutions and deadlines, turned out to be a catalyst for the path towards Monetary Union. The establishment of the European Monetary Institute (EMI) at the beginning of 1994 also provided new momentum. The EMI helped in preparing the subsequent stages of the EMU process which led to the introduction of the euro in 1999.

3 NEGOTIATIONS ON ERM II

Deliberations on the establishment of a new exchange rate mechanism in the third stage of EMU commenced in autumn 1995. The blueprint of the mechanism developed gradually through discussions in EMI and in the EC Monetary Committee, as well as in the informal ECOFIN meetings between central bank governors and finance ministers in Verona, Dublin and Noordwijk from spring 1996 to spring 1997.

The natural starting point for these discussions was the existing exchange rate arrangement, the ERM. Given the lack of Treaty provisions specifying institutional arrangements regarding internal exchange rate regimes, there was an absence of clear authority and a lack of clear legal basis in the Treaty on how to regulate the new ERM, labelled ERM II. Some countries, as well as the

3 T. Papasyrou (2004), "EMU Strategies: Lessons from Greece in View of EU Enlargement", paper presented at the Hellenic Observatory, The European Institute (London School of Economics).
4 In Spain a nominal appreciation took place during part of the period.
5 P. De Grauwe (1997), "Exchange Rate Arrangements between the Ins and the Outs", CEPR Discussion Paper, No 1640.

Commission, argued that in monetary and exchange rate matters the exclusive competence, at least for the "ins", should belong to the Community.[6] The majority of countries, however, found it appropriate to retain from ERM I the structure of two parallel agreements among governments and among central banks, given the respective competences and responsibilities. Another issue raised in the discussions was whether participation in the new system should be made compulsory, or remain voluntary as in ERM I. The Commission argued that Member States with a derogation (the "pre-ins") would be expected to join the new mechanism. Those existing countries with a special status constituted a unique case in the view of the Commission. If the convergence situation were favourable, they should have the same opportunity to join as Member States with a derogation. Most Member States, with a few exceptions, favoured some degree of voluntariness, with the UK insisting on this.[7]

A central parameter of the discussions on the design of the new system was of course the new economic and institutional environment that the move to the third stage of EMU would create. Clearly, the euro was expected to play a central role in the mechanism, given the expected stability and size of the euro area[8], as well as the fact that the non-participating Member States would be expected to participate in the euro at a later stage. Two options regarding the fundamental arrangement of the system were put forward. The first was a continuation along the lines of ERM I, with the fixing of central parities and fluctuation bands between all participating currencies, thereby creating a parity grid. In such a system, the fluctuations of each currency against the other currencies would be limited. The second option – supported by the EMI and the Commission – was purely to define central parities for the non-euro currencies vis-à-vis the euro. Under this option, there would only be limitations to the fluctuations relative to the euro. The euro would thus be the hub of the system, while the non-euro currencies would constitute the spokes. This solution resembled that of the Bretton Woods system, in which the dollar acted as the hub. Under a hub-and-spoke system there are no bilateral central exchange rate parities or fluctuation margins between the spokes. Hence, fluctuations among the spokes could in principle be up to twice the size of the currency fluctuations against the euro. Depending on the size of the permitted fluctuations against the euro, the fluctuations between the participating non-euro currencies could potentially be of a size detrimental to the efficient working of the single market. It turned out during the discussions that there was almost unanimity among the countries in favour of the hub-and-spoke model, assuming that the decision on the central parities were to be multilateral. Since the currencies would no longer be on an equal footing, it was not possible to copy all the rules directly from the previous exchange rate agreements into the new agreement (although naturally a large number of new rules have their roots in the previous agreements, as further elaborated below).

6 This view is supported, for example, by R. Smits in *The European Central Bank – Institutional Aspects*, (The Hague: Kluwer Law International, 1997).

7 See De Grauwe, op. cit.

8 In ERM I the Deutsche Mark was normally considered to play the role of an informal anchor, but the role was not formalised and was occasionally challenged.

The question concerning the size of the standard fluctuation band, and whether to allow narrower bands, proved to be the most contentious issue during the negotiations. The majority of countries found that the latest period in ERM I, with relatively broad bands of ±15% around the central parities, had worked quite well and had secured a certain degree of stability. A few others, however, argued that a system with such broad bands was tantamount to a "non-system". While central parities could still play a role as exchange rate objectives, interventions at the margins of the fluctuation bands would, according to this view, be highly unlikely. Rather, such interventions would be preceded by a realignment of the central parities. The experience in the period 1993-1996 showed that the currencies in ERM I had not moved to the margins of the fluctuation bands, and hence mandatory intervention had not been needed. Regarding the possibilities for formal or informal narrower bands, the discussion again revealed differences in opinion. Some felt that narrower bands could invite speculators to test these bands, creating the risk of losses for the NCBs involved, as happened during the crisis of 1992-93. Furthermore, some feared that the possibility of narrower bands might influence the interpretation of the exchange rate criterion in the Treaty and hence potentially discriminate against later entrants to EMU. Others argued for narrower bands, based on the convergence position of the Member State in question. Some countries also argued that arrangements on narrower bands should be decided on an ad hoc basis, while others expressed a preference for a standard arrangement for narrower bands, to avoid a proliferation of all kinds of arrangements. A compromise was reached, namely that the agreement should explicitly state that narrower bands do not influence the interpretation of the exchange rate criterion. The agreement on an escape clause from mandatory intervention if this conflicted with the primary objective of price stability also helped quell fears of losses from speculative attacks.

4 ERM II LEGAL DOCUMENTS

ERM II is an intergovernmental arrangement based on the following two legal documents:

- Resolution of the European Council on the establishment of an exchange rate mechanism in the Third Stage of Economic and Monetary Union, Amsterdam, 16 June 1997 (OJ C 236, 2.8.1997, p. 5).
- Agreement of 1 September 1998 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in Stage Three of Economic and Monetary Union (OJ C 345, 13.11.1998, p. 6), as amended by the Agreement of 14 September 2000 (OJ C 362, 16.12.2000, p. 11), by the Agreement of 29 April 2004 (OJ C 135, 13.5.2004, p. 3) and by the Agreement of 16 September 2004 (OJ C 281, 18.11.2004, p. 3).

The main features of the mechanism are described in the Resolution and include the following:

- Voluntary participation in the mechanism for all non-euro area Member States (Article 1.6);

- A central rate against the euro (Article 2.1), which explicitly makes the euro the anchor currency;
- A standard fluctuation band of ±15% around the central rate (Article 2.1);
- Automatic and unlimited interventions at the margin, in principle. However, the Resolution explicitly states that participating NCBs can suspend intervention if this were to conflict with their primary objective, i.e. the maintenance of price stability (Articles 1.5 and 2.1);
- The right of all parties to the agreement to initiate a confidential procedure aimed at reconsidering central rates (Article 2.3), which has to be done in a timely fashion (Article 1.5);
- The possibility of formal narrower fluctuation bands than the standard one, backed up in principle by automatic intervention and financing (Article 2.4), as is the case with the standard band;
- The availability of very short-term financing, with the details determined in the central bank agreement (Article 2.6).

While participation in the mechanism is voluntary for all non-euro area Member States, Member States with a derogation are nevertheless expected to join the mechanism at some stage. The Resolution makes no mention of entry conditions and provides no reasons for a refusal of an application. The only provision in this regard in the Resolution is the demand for common agreement on the central rates and standard fluctuation band by the ministers of the euro area Member States, the ECB and the ministers and central bank governors of the non-euro area Member States participating in ERM II, following a common procedure involving the European Commission and after consultation of the Economic and Financial Committee (EFC). Ministers and NCB governors of the non-euro area Member States not participating in ERM II will take part in the procedure but will not have voting rights (Article 2.3).

Compared with the EMS Resolution from 1978, the ERM II Resolution is less detailed and at the same time more flexible in a number of areas.[9] The size of the standard fluctuation band allows for a significant degree of flexibility in exchange rate movements. At the same time, the ERM II Resolution makes it possible to take Member States' different degrees of convergence into consideration. If economic performance has converged very closely to that of the euro area, a Member State can request a formal narrower band. The ministers of the euro area Member States, the ECB and the minister and NCB governor of the non-euro area Member State in question take a decision after a request following a common procedure involving the European Commission and after consultation of the EFC. Ministers and NCB governors of other Member States will take part in the procedure, but will not have voting rights (Article 2.4). The central bank agreement makes it possible to conclude informal bilateral agreements between the ECB and the participating non-euro area NCBs on closer exchange rate arrangements (Article 15.3). Furthermore, the participating non-euro area NCBs naturally still have the option to unilaterally stabilise their exchange rates within the band.

9 See Deutsche Bundesbank (ed.) (1998), "Operational Features of the New European Exchange-rate Mechanism", *Deutsche Bundesbank Monthly Report*, October.

The possibility of suspending intervention, as well the possibility of reconsidering central rates, makes maintaining price stability a priority. However, any decision to suspend compulsory intervention would have to take all relevant factors into account, including the credible functioning of the ERM (Article 2.1). In ERM I, NCBs were subject to the obligation to intervene when the exchange rate reached the limit of the band. This difference is also found in the ERM I and ERM II central bank agreements. The latter explicitly mentions in Article 3 the possibility of suspending intervention if this conflicts with the primary objective of price stability. The ERM I agreement, on the other hand, does not mention any suspension of intervention. However, the difference between ERM I and ERM II has been questioned. The Bundesbank thus had an informal agreement with the German government to ensure that the Bundesbank could suspend intervention if the Bundesbank considered Germany's monetary stability to be at risk.[10] Conversely, Padoa-Schioppa (2003)[11] concludes that the safeguards granted to the Eurosystem in ERM II are much stronger than those granted to the Bundesbank in ERM I.

5 OPERATIONAL FEATURES OF ERM II

The central bank agreement lays down the operating procedures of the mechanism. The agreement covers interventions, very short-term financing and monitoring.

At the margins of the fluctuation band, the NCBs involved shall intervene by buying the weak currency or selling the strong one to market participants. To avoid settlement risk, a "payment after payment" procedure is employed. According to this procedure (in Annex I of the agreement), in interventions at the margins, the NCB concerned shall release its payment only after receiving confirmation that the amount due has been credited to its account. The participating non-euro area NCBs act as correspondent banks of the ECB and of the "in" NCBs. So-called intramarginal interventions between margins of exchange rate fluctuation, either unilaterally or coordinated, can also be conducted (Article 4). Depending on the intervention currency, such non-compulsory interventions may be subject to prior approval. If the intervention currency is different from the euro and exceeds the agreed limits, prior agreement must be obtained from the issuing non-euro area Member State (Article 5.1). If the intervention currency is the euro, a non-euro area NCB shall immediately notify the ECB if it has used euro in amounts exceeding the agreed limits (Article 5.2). The distinction between non-euro intervention currencies and the euro is a result of the increased international role of the euro.

For the purpose of intervention, the ECB and the participating non-euro area NCBs have established "very short-term financing facilities". This ensures that

10 See De Grauwe, op. cit.; N. Bartholdy and J. Thomsen (2002), "Euro 2002", *Danmarks Nationalbank Monetary Review*, 1st Quarter 2002, pp. 19-31.
11 T. Padoa-Schioppa (2003), "Trajectories towards the Euro and the Role of ERM II", *International Finance*, 6:1, pp. 129-44.

all participants have access to sufficiently large amounts of partner currencies and enhances the credibility of intervention commitments. For interventions at the margin, the financing is in principle available automatically and is unlimited in amount (Article 7.1), but can be suspended if it conflicts with the primary objective of maintaining price stability (Article 7.3). The financing has an initial maturity of three months (Article 6.1), but can be renewed subject to restrictions on duration and size (Articles 10 and 11). The very short-term financing facility can also be used for intramarginal intervention, subject to the agreement of the NCB issuing the intervention currency. The ceilings of the ECB and of the NCBs of the "ins" are set at zero, which indicates that these banks will not engage in intramarginal intervention.[12] NCBs wanting to draw on the facility, whether for interventions at the margin or intramarginally, should first make appropriate use of their foreign reserves (Articles 7.2 and 8b).

A direct comparison of the two central bank agreements under ERM I and ERM II also reveals a number of differences regarding operational issues. Most of the differences, although not all, follow from the introduction of the euro and the change of the mechanism from a parity grid into a hub-and-spoke system.

From an economic point of view, the most important difference relates to the methods for settling financing operations. Under the ERM I agreement, a creditor central bank was obliged to accept settlement by means of ECUs of an amount equal up to 50% of its claim, unless the creditor central bank's assets in ECU were smaller than its forward sales of ECUs to the European Monetary Co-operation Fund (Article 16.1). This represented a compromise between the NCBs that wanted an upper limit on the amount of ECUs they were obliged to accept, and those NCBs that wanted an unlimited use of ECUs for settlement.[13] The ECU was a standard basket of all currencies in the European Community, so in case a currency after a period of intervention were to devalue, it would also result in a lower value of the ECU vis-à-vis the rest of the participating currencies. Hence, a creditor central bank ran the risk of facing a loss on its credits due to settlement in ECUs if there were any changes in the central parities. In ERM II, settlement in principle shall be carried out by means of holdings in the creditor's currency (Article 14). This removes the risk of losses to the creditor central bank. In both agreements the methods of settlement are without prejudice to other forms of settlement agreed by creditor and debtor central banks.

Second, the ERM II agreement leaves intramarginal intervention to the discretion of the participating NCBs. In ERM I, intramarginal intervention was also a tool for NCBs according to Article 2.2 in the Agreement. However, according to Article 3.1 in the ERM I Agreement, rates for the currencies in terms of ECUs that constituted "thresholds of divergence"[14] were established with the help of a divergence indicator. If a currency crossed the divergence threshold, it was

12 See "Operational Features of the New European Exchange-rate Mechanism", op. cit.

13 See J. Thomsen, *Det europæiske monetære samarbejde* (Copenhagen: Handelshøjskolens forlag, 1990). Informally, the Basel-Nyborg agreement suspended the 50% rule without changing Article 16.1.

14 According to Article 3.2 of the Resolution and to Article 3.1 of the Agreement, the threshold of divergence was fixed at 75% of the maximum spread of divergence for each currency.

presumed that the authorities concerned would correct the situation by taking adequate measures as set out in Article 3.6 of the ERM I/EMS Resolution. The measures listed in Article 3.6 of the Resolution are a mixture of intervention, domestic monetary policy measures, changes in central rates, and other measures of economic policy. The proponents of the divergence indicator saw it as an objective indicator to trigger consultations in case of divergence and as a tool to oblige participating Member States with stronger currencies to shoulder part of the necessary adjustments instead of leaving the Member States with the weaker currencies to shoulder the burden. However, there was no obligation to conduct policy measures when a Member State had crossed the divergence threshold, so in practice the divergence indicator did not have any appreciable impact on the functioning of the ERM I system.

The General Council of the ECB, comprising the President and Vice President of the ECB's Executive Board, as well as the governors of the NCBs of all EU Member States, monitors the functioning of ERM II. The General Council also serves as a forum for monetary and exchange rate policy coordination as well as the administration of the intervention and financing mechanism specified in the agreement.

6 ERM II AS A CONVERGENCE CRITERION

While the main feature of ERM II is to help participating Member States to secure a stable economic environment, participation in ERM II is also one of the convergence criteria to be fulfilled in order to join the euro.[15] Article 121 of the EC Treaty and Article 3 of the Protocol (on the convergence criteria referred to in Article 121 of the Treaty) state that the national currency in question must remain within the normal fluctuation margins provided for by the ERM of the EMS without displaying any severe tensions for at least two years prior to the date of examination. In particular, each Member State must not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative during the same period.

Regarding the duration of ERM participation, historical experience shows that the criterion has been interpreted somewhat more freely. When Italy and Finland were approved for euro participation in May 1998, both respective currencies had only been participating in ERM I for around 18 months. However, at the onset of the euro on 1 January 1999, both Member States had been participating for more than two years. At the time of the EMI and the Commission's assessment of the state of convergence of the Member States in the convergence reports of March 1998, the EMI chose to consider the reference period to be the time spent by the two countries in the ERM up to the assessment, while the Commission chose to analyse the preceding 24 months up to the assessment, even though not all of this time was spent in the ERM.

15 The other convergence criteria relate to inflation, the interest rate, sustainable public finances and compatibility of national legislation with the Treaty.

The extension of the fluctuation bands from ±2.25% to ±15% after the ERM crisis in August 1993 and thus preceding the entry into force of the Maastricht Treaty on 1 November 1993 has since given rise to alternative, though not necessarily conflicting, views and practices when interpreting the criterion.[16] It is evident that exchange rate fluctuations of 30% are too wide to be interpreted as exchange rate stability in an economically meaningful way.[17] Therefore it is interesting to study how the convergence reports have interpreted the criterion. It turns out that the EMI/ECB and the Commission used somewhat different measures regarding the assessment of currency stability. The EMI/ECB convergence reports emphasised exchange rates measured by ten-day moving averages that were close to the ECU/euro central rates without explicitly defining the "close to" criterion. Up to the introduction of the euro, the Commission used the concept of the median ERM currency to take partial account of the wider band. The median currency is defined as the currency with the "median" deviation from its ECU central parity among the participating currencies. This currency was chosen on a daily basis. For a currency to fulfil the exchange rate criterion, its bilateral exchange rate against the median currency's official bilateral parity should be kept within a fluctuation band of ±2.25%. The use of the median currency allowed a higher degree of flexibility, as bilateral exchange rates between two participating currencies using this approach could deviate by up to ±4.5%, instead of the original ±2.25% in ERM I. The Commission explicitly mentioned that this assessment was not mechanical. Whether larger fluctuations constitute severe tensions depends on their size and duration, and on whether they occur on the weaker or stronger sides of the fluctuation band. As Egert and Kierzenkowski have shown[18], regardless of the method chosen there have been occasions when currencies which would later be irrevocably fixed traded outside a range close to their central rates. This shows that the final judgement on the fulfilment of the criterion involves a degree of flexibility and discretion. The deviations, however, tended to be limited and temporary and were mainly found at the beginning of the reference period. The primary exceptions to this are Ireland and Greece, whose currencies traded on the stronger side of the central rates. Furthermore, both countries revalued their currencies. This illustrates the asymmetric nature of the exchange rate criterion, which is more lenient towards revaluation (on which the criterion remains silent) and appreciation than towards devaluation or depreciation. The underlying economic rationale for this differentiation is that revaluations or appreciations are not viewed as dangerous for price stability and do not adversely affect the competitiveness of other Member States.

In accordance with the principle of equal treatment, future assessments of the exchange rate criterion will follow the same approach. The Informal ECOFIN Meeting in Athens stated that the assessment of exchange rate stability against

16 Cf. B. Egert and R. Kierzenkowski (2003), "Asymmetric Fluctuation Bands in ERM-I and ERM-II: Lessons from the Past and Future Challenges for EU Acceding Countries", William Davidson Institute Working Paper, No 597.

17 Cf. B. Egert, T. Gruber and T. Reininger, "Challenges for EU Acceding Countries' Exchange Rate Strategies after EU Accession and Asymmetric Application of the Exchange Rate Criterion", in Oesterreichische Nationalbank (ed.), *Focus on Transition 2* (2003).

18 Egert and Kierzenkowski, op. cit.

the euro for the new Member States will focus on their exchange rates being close to the central rate, while also taking into account factors that may have led to an appreciation, in line with past policy.[19]

7 THE NEW EU MEMBER STATES

Ten countries joined the EU on 1 May 2004, namely the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. Upon entering the EU, the new Member States also became members of EMU as "Member States with a derogation". The new Member States have all expressed their intention to adopt the euro as soon as possible, probably before the end of the decade.[20] The next step in this monetary integration is participation in ERM II. With effect from 28 June 2004, Estonia, Lithuania and Slovenia joined ERM II, joining Denmark, which had been a member of ERM II since it began on 1 January 1999 (and the sole participant in ERM II between 1 January 2001, when Greece joined the euro area, and 28 June 2004). Subsequently, Cyprus, Latvia and Malta joined ERM II with effect from 2 May 2005, bringing the number of participating countries to seven.

All new countries were smoothly admitted into ERM II with the standard fluctuation band of ±15%.[21] It was mutually agreed that Estonia and Lithuania would join the mechanism with an unchanged central parity against the euro as the central ERM II parity. The two countries would also continue their currency board arrangements as unilateral commitments, thus placing no additional obligations on the ECB. In the case of Slovenia, it was agreed that the market exchange rate of the Slovenian tolar against the euro on Friday 25 June 2004 would be chosen as the central rate. Cyprus and Latvia joined with an unchanged central parity against the euro as the central ERM II parity. The Latvian authorities have declared that they will unilaterally maintain the exchange rate of the Latvia lats against euro at the central rate with a fluctuation band of ±1%. Upon entry to ERM II the Maltese lira was re-pegged to the euro from a basket of currencies including the euro, the pound sterling and the US dollar. The market rate of the Maltese lira against euro on Friday 29 April 2005 was chosen as the central rate. The Maltese authorities have declared that they will unilaterally maintain the exchange rate of the lira at the central rate. When the new countries joined ERM II, all six of them took upon themselves policy commitments regarding fiscal policies and structural reforms as detailed in the communiqués on ERM II participation. This represents something new compared to the communiqué on the entry of Denmark and Greece to ERM II.

In the period of less than a year that Estonia, Lithuania and Slovenia have been members of ERM II, the fluctuations of the nominal exchange rates inside the

19 Informal ECOFIN document on "Acceding Countries and the ERM II" of 5 April 2003.
20 European Commission (2004), *"Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee, the Committee of Regions and the European Central Bank: First Report on the Practical Preparations for the Future Enlargement of the Euro Area"* (Brussels, 10 November).
21 Denmark has entered into an agreement with a narrower fluctuation band of ±2.25%.

fluctuation bands have been very limited in Slovenia, while the nominal exchange rates of Estonia and Lithuania have not diverged from their respective central rates due to these countries' unilateral commitment to a currency board arrangement. The period of time that Cyprus, Latvia and Malta have been members of ERM II is too short to make conclusions regarding the exchange rate behaviour.

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