

research snapshot

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The Design of the European Exchange Rate Mechanism (ERM) II Limits Incentives for the Adoption of the Euro

What is this research about?

Since the introduction of the euro in 1999, sixteen European Union (EU) member states have adopted the common currency. Eleven member states still remain less than full participants of the European Economic and Monetary Union (EMU). As one of the preconditions of entry into the eurozone, potential entrants are required to adopt successfully the framework of the Exchange Rate Mechanism (ERM) II for a minimum of two years. ERM II stipulates the maintenance of a stable exchange rate peg vis-à-vis the euro, typically with a fluctuation margin no greater than +/- 15%. The ERM II participants are mostly made up of smaller new EU member states. Some of the larger economies – such as the United Kingdom, Poland, Czech Republic and Hungary – have not entered ERM II. While their individual circumstances and motivations vary, this paper provides a unifying framework for analyzing the incentives to enter ERM II as a decision distinct from the goal of adopting the euro.

What you need to know:

Although a number of countries may want to join the euro, the ERM II exposes aspiring members to short term risks and should be reformed.

What did the researcher do?

Utilizing a comparative study of the Czech Republic and Hungary, two recent EU entrants and aspirants for full EMU membership, this paper studies the potential pitfalls in the transition to EMU, specifically with respect to the required two year participation in ERM II.

What did the researcher find?

The paper attributes exchange rate regime choices in the two countries to the history of public debt, inflation, and the sources of investment financing. Differences in financial market development and international liabilities underscore the risks and benefits of ERM II, and lead to a conflict between short and long-term policy objectives. This suggests that the framework of ERM II should perhaps be

reconsidered in light of the new challenges that potential euro-area entrants face. In an environment characterized by large and volatile capital flows, maintaining an explicit exchange rate band can be quite costly. One possible solution would be to widen the target band, as in 1993 when participating currencies came under attack. An alternative could be to support a target band of +/-15%, but without the explicit obligation to intervene to preserve the peg. Greater uncertainty about intervention to defend the band would likely discourage speculative attacks, while the criterion of exchange rate stability could be still assessed on a case-by-case basis for new entrants.

How can you use this research?

Policymakers and capital market participants can use this research to understand the determinants of exchange rate policies in small open economies.

About the Researcher

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Citation

Kimakova, A. (2009). Financial markets and exchange-rate regimes in transition to EMU. *Intereconomics*, 44(3), 142-148. Available online at <http://bit.ly/OCpIOT>

Keywords

Euro, European Union, Exchange rate regimes, Czech Republic, Hungary

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