THE ERM II ISSUES – AN INTERPRETATION OF THE SLOVENIAN APPROACH

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Abstract:

This paper overviews the joint strategy of the Bank of Slovenia and the Slovenian Government for the policy management in the ERM II and the eventual adoption of the euro. The current prospects of the Slovenian economy are favorable for an early entry into the ERM II so that the currency union can be acceded as soon as possible. The ERM II-connected risks, in particular an asymmetric credit financed demand boom, require a new policy mix to be set in place. While the monetary policy will focus on the tight management of nominal the exchange rate, the role of inflation restraint and shock absorption will rely on the fiscal and income policies.

Key words: ERM II, Maastricht criteria consistency, policy mix

Povzetek:

Prispevek povzema skupno strategijo Banke Slovenije in Vlade Republike Slovenije za delovanje ekonomskih politik v okviru ERM II in končni prevzem eura. Trenutni izgledi za slovensko gospodarstvo so ugodni za zgodnji vstop v ERM II tako da bi lahko pristopili k denarni uniji v najkrajšem možnem času. Tveganja povezana z bivanjem v ERM II, še posebno s kreditno dejavnostjo pospešen asimetrični šok domačega povpraševanja, pozivajo k vzpostavi nove kombinacije makroekonomskih politik. Medtem ko bo denarna politika prednostno orientirana k stabiliziranju nominalnega tečaja tolarja, bo vloga omejevanja inflacijskih pritiskov in proticikličnega delovanja pripadala fiskalni in dohodkovni politiki.

Ključne besede: ERM II, Medsebojna skladnost maastrichtskih kriterijev, kombiniranje ekonomskih politik

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1. INTRODUCTION

On the 1st of May, Slovenia will join the European Union. As all the new accession states, it enters the Union with a derogation clause, the commitment to eventually adopt the euro for domestic currency. While the adoption of the euro is binding, the timing and the policy strategy leading to it is a responsibility and a prerogative of the member states.

In the "Joint program of the Slovenian Government and the Bank of Slovenia for the ERM II entry and the euro adoption" (henceforth Joint program) are presented and motivated the key elements for the euro adoption strategy. Both institutions agree that the Slovenian economy is ready for the adoption of the euro and therefore decide to implement the steps necessary for acceding the currency union as soon as possible. The Joint program also discusses the key elements of the risks associated with the adoption of the euro, the policy mix to be implemented during the stay in the ERM II and the setting of the central parity.

Motives for Slovenia to join the euro area are numerous and benefit from a large political and public support. The most important reason to enter the euro currency union appears to be the substantial gains from trade.[2] The causes for these gains are usually attributed to the elimination of the exchange rate risks, increased competition and a room for technology adoption, lower transaction costs and improved transparency of prices. Another reason is a decrease in the country's risk premium and therefore lower long run cost of capital. Finally, the currency union such as EMU provides a framework for strong policy discipline enforcement. Conversely, joining the currency union implies giving up the monetary policy as a tool for macroeconomic stabilization and the exchange rate as a possible shock absorber. But since the macroeconomic fluctuations of the Slovenian economy are very much synchronized with that of the euro area, the common monetary policy is expected to be the also the adequate one from the domestic viewpoint. Nevertheless, while there is a consensus that the adoption of the euro is a positive sum game in the long run, the strategies that are being set in place to arrive at this goal are very diverse from country to country.

This paper reviews the strategy of the Bank of Slovenia designed for the ERM II entry and inside ERM II policy management. No single strategy on euro adoption is *a priori* optimal and the accession countries will select their approaches on a case by case basis, given the particular circumstances they face: the current macroeconomic situation, difficulties in fulfilling some of the Maastricht criteria, the design and adaptability of their current monetary policy framework, the ability of other macroeconomic policies, the fiscal and income, to substitute the monetary policy as shock absorbers, etc.[3] In line with the Joint program, the author argues that current and foreseen macroeconomic circumstances are favorable for Slovenia to enter the ERM II and adopt the euro as soon as possible. When in the ERM II, the main risks are connected with and asymmetric demand boom, accommodated by an excessive credit expansion. Such a shock is plausible in particular because of a rapid convergence in the interest rates to the lower euro area levels. It may endanger the price stability, produce excess real appreciation and a consecutive loss in competitiveness and deteriorate the country's external position and growth. To counteract adverse shocks, and given that the monetary policy will be mostly in charge of the exchange rate stability, a new policy mix is required and is presented in the Joint program. As a consequence of the loss of the monetary policy independence, the burden of the price stability and the role of a shock

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[2] Frankel and Rose (2002), for example, claim that the trade volume increases significantly after the adoption of a common currency. In addition, there appear to be substantial spillovers from trade to the economic growth.

[3] The somewhat polar cases in that respect, the Austrian and the Greek, are presented in Hochreiter and Tavlas (2003).

absorber will rely on the fiscal policy and an increased wage flexibility. Given the current macroeconomic prospects, the implementation of the Joint program should result in a favorable outcome in the ERM II, with no particular difficulties or macroeconomic loses, and potentially high long run gains in the euro area.

The rest of the paper is organized as follows. Section two introduces the current stance of the Slovenian economy and its compliance with the Maastricht criteria. Section three presents the *pros* and *cons* of the early entry into the EMU. Section four reviews some elements to be taken into account in the joint agreement on the central parity. The ERM II-connected risks and the policy mix likely to be implemented inside the ERM II are exposed in section 5. The last section concludes by discussing the "waiting" and the "training" room interpretations of the ERM II in the context of the Slovenian economy.

2. THE CURRENT ECONOMIC STANCE AND THE ALIGNMENT OF THE WITH THE MAASTRICHT CRITERIA

Slovenia is a small open economy with a development level already surpassing the lowest among the current EU members. The current GDP per capita in PPP standards is roughly 73 percent of the EU average and is much larger than that of Greece or Portugal at their dates of EMU entry.[4] The structure of the economy is very similar to the EMU and highly heterogeneous across sectors. The business cycle fluctuations appear to be fairly synchronized with the EU, with the exception of some supply shocks in the recent years, which were merely of a fiscal nature.[5] The openness of the economy to trade exceeds 120 percent of GDP and more than 60 percent of the total trade is carried out with the EU. The real convergence to the more developed European countries is accompanied by a moderate real appreciation due to Balassa-Samuelson type of effects, which do not *a priori* constitute an obstacle for achieving price stability.[6] The economic structure, the synchronization of economic activity and the trade orientation towards EU provide strong arguments for Slovenia to enter the EU and eventually adopt the euro.

In comparison to most Central European acceding countries, Slovenia displays a somewhat particular situation with respect to the current compliance with the Maastricht criteria: the fiscal deficit criterion is fulfilled but the inflation (and exchange rate) criterion is not yet met. The usual the situation is usually the converse in most accession countries. Table 1 shows the current compliance with the Maastricht criteria for the euro area, the Czech Republic, Hungary, Poland and Slovenia.

The fiscal Maastricht criteria, the government deficit and the debt to GDP ratio, are fulfilled and sustainable. The government deficit is expected to remain around 1.5 percent of the GDP in the forthcoming years. These deficit projections take into account the probable deterioration of the fiscal balance consequent to the EU entry: the reshuffling on the expenditure side in connection with the EU transfers and the increased inefficiency of the VAT collection due to the abolishment of customs controls at the frontiers. The government debt to GDP ratio is below 30 percent of the GDP. It is among the lowest in the enlarged EU

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[4] Respectively 66,8 percent and 64,7 percent of the EU average. Source: Eurostat.

[5] See Korhonen and Fidrmuc (2003), Frenkel and Nickel (2002). For a broader survey of convergence indicators, see for example Backé and Thimann (2004).

[6] Kozamernik (2003), Žumer (2002) and the references therein identify a Balassa-Samuelson effect of between 1 an 1.5 percentage points, in terms of a mark-up of the industrial leader's inflation. Kozamernik (2003) also explores some alternative scenarios related to plausible future catching-up processes of the real economy. See Balassa (1964) for the economic mechanisms underlying the real appreciation process.

and unlikely to jeopardize the corresponding Maastricht criterion of 60 percent in the medium run.

Table 1: The Maastrich Criteria

	Inflation	Long-term int. rate (%)	Govt.balance (% BDP)	Debt (% BDP)
	last 12 months[1]	last 12 months[1][2]	2003	2003
Euro area	2.0	4.17	-2.7	70.4
Convergence criteria	*2.6*	*6.13*	*-3.0*	*60.0*
Czech Republic	0.4	4.69	-12.9	37.6
Hungary	5.0	8.74	-5.9	59.0
Poland	0.9	6.97	-4.1	45.4
Slovenia	5.2	5.01	-1.8	27.1

[1] Last 12 months average.
[2] Government bond RS54 (issued in October 2003)
Sources: SURS, MF, EUROSTAT, Pre.Accession Economic Programme, Central banks.

Conversely, the nominal convergence still has to be finalized. Although the last available inflation figure is 3.5 percent year-on-year, the figure corresponding to the Maastricht criterion on price stability is 5.2 percent.[7] As the time horizon to complete the disinflation process is short, the restrictiveness of the monetary policy stance is being reinforced by fiscal measures. The policy mix in place in particular requires from the fiscal authorities and the government to limit the increases in administered prices so as not to exceed on average the inflation objective, to restrain the rises in the excise taxes and avoid indirect tax increases. Maintaining the administered prices inflation in vicinity of the headline inflation implies unchanged relative prices and prevents the transmission from the administered to the free prices. This should result in an inflation-neutral fiscal policy before the ERM II entry. At least neutral fiscal policy stance is necessary to accelerate the disinflation process and avoid that the fiscal cost-push shocks generate a persistence in inflation as in the past few years. The recent disinflation performance and the current projections of the future inflation developments are in line with the fulfillment of the Maastricht criterion in due time.

The Bank of Slovenia evaluates the recent intense reduction in inflation as sustainable.[8] This is because the disiflation is being achieved with the preservation of the macroeconomic fundamental equilibria, in particular the current account and the fiscal balance. It is crucial since there is no need for corrective outbursts in inflation in the forthcoming years, that could arise from persistent or unsustainable macroeconomic disequilibria. That the disinflation process is credible and perceived as sustainable by the markets also shows up in the low long run nominal interest rates, already in line with the Maastricht criterion as shown in *table 1.*

3. THE TIMING OF THE ERM II ENTRY – WHY AS SOON AS POSSIBLE?

The objective assigned advocated in the Joint program is that Slovenia should enter the euro area as soon as possible. Given the required two years qualification period, the ERM II entry must be no later than in the last quarter of 2004 if the euro is to be adopted in the

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[7] The Maastricht criterion is compared with the average of the last twelve year-on-year inflation figures.

[8] Monetary policy implementation report of the Bank of Slovenia, October 2003.

beginning of 2007. The decision to enter as early as possible has many advantages in the Slovenian case but these had to be weighed against the reasons to wait for a possibly better entry circumstances.

The reasons to wait are connected with potential macroeconomic effects of EU entry, the risk of an insufficient stabilization of inflation or the adoption of a more transition countries tailored interpretation of the Maastricht criteria. The most important risk connected with an early ERM II entry appear to be possible aggregate demand developments related to the EU entry. A demand boom may overheat the economy and produce the inflationary pressures above the Maastricht criterion. The particular danger is that such a shock may be asymmetric and therefore no ECB counteracting policy could be expected. The reasons this type of shock may hit the economy may be a rapid decrease in the nominal (and real) interest rates as the national monetary stance is converging to that of the ECB or the EU entry-connected effects on consumption ("feel good effects", decreased risk premia, etc.). These are however business cycle effects and waiting for the ECB stance to be less expansionary or the possible consumption shocks to die out may be well advised. The second reason to wait is the risk that the inflation process may not be finished upon the ERM II entry. This may result in an excess real appreciation and the loss of competitiveness with all their harmful effects on the economy. If these two risks are not avoided, they may disequilibrate the economy during the ERM II and, at least, lengthen its stay in a system where economy's adjustment to shocks is not always easy, as argued later on. The final reason may be to wait and learn from the experience of other countries – in particular, the *ex-post* reinterpretation of the Maastricht criteria may be adapted to the specificity of the accession countries. It is well known that due to the real convergence process and the resulting real appreciation (for example Balassa-Samuelson effects) an inconsistency is likely to arise between the inflation and exchange rate criteria. This is true even if the "right" policies are implemented, so that there may be cases where the compliance with Maastricht criteria would require to artificially depress the economy and lower the inflation to the (sub-optimal!) criterion level.[9] If the interpretation of the price stability is adapted to these problems, a country with an opportunistic waiting strategy may spare itself a real loss in output.[10]

In the Slovenian case, the risks connected with an early entry are believed to be manageable and there exist strong arguments in favor of an early entry. One argument could be to benefit as soon as possible from the currency union, but the difference in these long run effects are assumed to be small between the alternatives and are not determinant in the decision to postpone the ERM II entry for a few years or not. The arguments for an early entry are separated in two groups: those connected with the ERM II institutional setting and those more related to the current macroeconomic circumstances.

The fist group of arguments in favor of an early entry envisages the ERM II as a "training room" or even a "disciplinary devise" for the available macroeconomic policies. Note first that already upon the entry in the EU the monetary policy, together with the exchange rate management, must be conducted as a matter of "common concern". A managed float regime resulting in a depreciation trend of the nominal exchange rate (decreasing in correspondence with the disinflation dynamics) could be misinterpreted as a competitive devaluation and not allowed. Given the necessity of maintaining the exchange rate stability, the independence of the monetary policy is therefore basically lost already after the EU

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[9] Given the required stability in the nominal exchange rate.

[10] *Ex-ante*, a reinterpretation of the inflation criterion in this respect is unlikely because of the incentive constraints that the EU institutions want to exert on accession country macroeconomic policies. Also, at the moment even *ex-post* such an event appears unlikely.

entry, leading to the progressive (fearfully fast) equalization of the nominal interest rates.[11] The management of the macroeconomic policy will therefore rely on the fiscal policy. Entering the ERM II forces the fiscal policy to behave optimally as there is no more room for a corrective action from the monetary or exchange rate policies. Perhaps even more important, not entering in the ERM II as early as possible gives a negative signal about the willingness of the fiscal policy adjustment and my therefore increase the inflation expectations. The clear commitment to an early entry seems to have, even beforehand, strongly reinforced the credibility of the current policy mix and the disinflation process. Finally, the commitment to the central parity is expected to help anchoring the inflation expectations and locking the inflation at low levels.

The second group of arguments considers the current and foreseen macroeconomic developments. Given plausible macroeconomic forecasts, in particular for the aggregate demand and inflation, the Maastricht criteria are expected to be met without (significant) costs in the real activity.[12] Also, in case of increased demand, the negative output-gap (roughly –1 percent at the moment) provides some room for the inflationary pressures to be restrained. In addition, the current account and a relatively favorable fiscal position are evaluated to bring a sufficient ability to absorb shocks, even if they are asymmetric, without backing up from the European counterparts. Finally, the very low exchange rate and inflation variability around their trend observed in recent years provide high confidence that the central parity remains unchanged during the stay in the ERM II.[13]

4. THE AGREEMENT ON THE CENTRAL RATE

The agreement on the central parity involves a mutual agreement between the ECB, the European Commission, the euro system central banks and the national central bank and government. A dialogue should precede any communication on participation, making all information on the central rate confidential before the actual entry in the ERM II. This section therefore discusses some general guidance in setting the central rate.

There seems to be a wide consensus, is the author's belief, that the central parity should correspond as close as possible to the long-run equilibrium real exchange rate. A deviation from this equilibrium could lead to a sub-optimal economic performance. On the one hand, if the central parity is too depreciated, it could increase the inflation pressures though import prices or an overheating in the economic activity. On the other hand, a too appreciated parity could deteriorate the country's competitiveness, depress the economic activity and open the current account.

Conceptually, the long run equilibrium exchange rate to consider in setting the central parity is the Fundamental Equilibrium Exchange Rate (FEER). It is the level of the real exchange rate, simultaneously consistent with the internal and external equilibrium, when the economic fundamentals (GDP, foreign demand for imports, etc.) are at their long run equilibrium values.[14] Of course, there are numerous difficulties related to the identification of this equilibrium exchange rate, necessitating a cautious interpretation of the obtained

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[11] Unless the BoS switches to a free float inflation targeting, but with substantial risks on the nominal exchange rate fluctuations.

[12] See for example the Monetary Policy Implementation Report of the Bank of Slovenia, October 2003.

[13] Kontolemis (2003) shows the inflation and exchange rate variability in accession countries.

[14] More on the FEER concept can be found for instance in Williamson (1994).

estimates.[15] The FEER estimates available for Slovenia up to now show that the current real exchange rate is fairly in line with the FEER estimates, with a tendency to be slightly overvalued in the last years.[16] This result is expected, since the care for the nominal exchange rate stability has avoided major misalignment and has been, in the long run, a good guide for the price adjustment in the tradable sector. That the tradable sector relative price is found in vicinity of the equilibrium level is therefore not a surprise.

Should one incorporate the elements of the (expected) future evolution of the FEER in setting the central parity? The FEER may indeed vary over time due for example to the trend desequilibrium in the trade balance, the long run developments in the terms of trade, etc. Such changes may require the adjustment in the real exchange rate to equilibrate the current account in the long run. Nevertheless, these are long run and low frequency movements and should not enter the nominal exchange rate or central parity setting considerations. There is enough room for the price adjustment to equilibrate the real exchange rate in correspondence with the FEER in the long run. Therefore, the parity should be set as close as possible to the current FEER to get the best concordance of the real exchange rate over the longest period. This holds even if such a parity level may be misaligned respectively to the current short run business cycle effects.

The last element discussed is connected to the asymmetric risk characterizing the inside-ERM II exchange rate dynamics. While the unilateral revaluation of the central parity is allowed, a devaluation must be renegotiated with all the parties involved and, in addition, restarts the two-year qualification period. Because of this asymmetric risk some observers advocate a depreciated rather than appreciated central parity.[17] In the context of Slovenia, such a strategy seems not to be worth undertaking. First, the good shape in the current and expected fundamentals do not indicate that there is likely to be a need for an exchange rate corrective adjustment in the forthcoming medium run. Second, a pass-through to inflation from a depreciated central parity can be rapid and complete, especially with a loss of monetary policy independence. In fact, the monetary policy is in this context accommodative of the simultaneous cost-push supply and expansive demand shock resulting from the depreciation in the central parity. And third, in case of a tightly managed float, market expectations about deviations from the foreseen nominal exchange path may produce exchange rate pressures or even a speculative attack on the currency up-front the ERM II entry.[18]

5. THE ERM II RISKS AND THE ADAPTED POLICY MIX

5. 1. The Risks Faced During the Stay in the ERM II

The risks connected with the ERM II are regrouped into three categories: an asymmetric aggregate demand boom, exchange rate pressures and possible inconsistency between the exchange rate stability and the inflation criterion.

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[15] This is particularly so in the context of accession countries because of short spans of reliable data, possible structural breaks, etc.

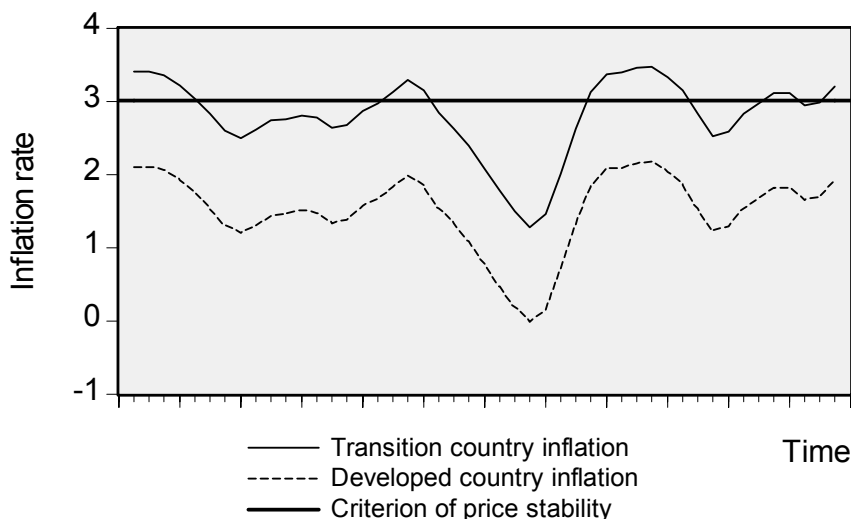[16] See Genorio and Kozamernik (2003) and the citations therein.

[17] Schadler et al. (2004).

[18] There is, however, another argument in favor of a central parity depreciated with respect to the market rate. It generates the expectations about future depreciation in the nominal exchange rate and therefore allows to maintain higher nominal interest rates. Such a restrictive monetary policy stance may be welcome in case of excess aggregate demand risks. Nevertheless, a resulting nominal exchange rate path would necessarily present a depreciation trend, which is incompatible, *a priori*, with the ERM II exchange rate stability criterion. For this reason this possibility is ruled out.

Credit generated demand booms are likely to break out at the offing of the ERM II. The exchange rate stability required within the ERM II implies the convergence in the nominal interest rates. In countries with high interest rates, reflecting the needs for restrictive monetary stance, the ERM II entry may therefore significantly reduce the nominal and thus real interest rates. It could in turn cause a fall in saving ratios, asset price bubbles and an asymmetric demand boom. In this event, upward pressures on inflation may arise, in particular if the output is pushed above its potential. The EU entry-connected potential shocks on consumption, the "feel good" effects and the decrease in the risk premium may further exacerbate the demand pressure. Such a shock may endanger the Maastricht criterion on price stability, but could also deteriorate the external position of the country. Purchases of durable goods on markets where foreign competition limits the possibilities for price increases moderate the inflation pressures, but worsen the current account. Eventually, an unsustainable deterioration of the current account may generate speculations on the exchange rate and endanger the central parity.

The economy may also be subject to exchange rate pressures or exchange rate instability. Free capital flows can potentially generate an excessive instability in the exchange rate, which is not in line with the exchange rate stability criterion. One source of capital movements is the FDI or sales of assets from privatization or takeovers. These types of inflows are considered as exogenous, inelastic to the interest rate differentials on the domestic and foreign financial markets. They can in principle be successfully sterilized and therefore do not represent an immediate threat to the exchange rate stability. The second source are the portfolio investments or the speculative capital flows. Their effects are much more difficult to offset as they are driven by market expectations. The speculative flows are potentially unlimited if the market expectations do not concord with the exchange rate policy objective. In such a case, the central bank may not be successful in stabilizing the exchange rate at a desired level and the market expectations may end up to be self fulfilling. Not only the exchange rate stability or the central parity are in danger, the costs of a "successful" speculative attack to the financial sector and the real economy may be substantial.

Figure 1: A long run appreciation trend but similar business cycle dynamics

Transition country inflation
Developed country inflation
Criterion of price stability

The risks must in addition be put in perspective with the long run appreciation movement common to the transition economies, reducing significantly the maneuvering margin for policy response in case of an inflationary shock. The real appreciation is a natural companion of the catching-up process in the transition countries, independent in the long run

from the nominal developments. The real appreciation trend is due to the Balassa-Samuelson effects, a rapid growth in the private consumption increasing the non tradable goods relative price, a non tradable goods oriented government spending, price liberalization in monopolistic sectors, etc. Keeping the nominal exchange rate stable, therefore implies a higher natural equilibrium level of inflation in comparison to the more developed European counterparts. That reduces significantly the maneuvering margin of domestic macroeconomic policies in response to an asymmetric inflationary shock. Indeed, the Maastricht criterion on price stability is in this context much more difficult to comply with. Not only is this criterion under threat in case of a demand expansion above the potential output, but costs-push shocks from taxation or oil shocks must also be considered with caution.[19] Figure 1 illustrates the risk of inflation exceeding the inflation criterion, in a country with a natural real appreciation trend of 1.3 percentage points p.a., with otherwise similar business cycle and policy response dynamics. The average developed country inflation is set (arbitrary) to 1.5 percent and the inflation criterion to 3 percent. In this case a moderate long run appreciation generates an equilibrium inflation of 2.8 p.p.. The transition country inflation nevertheless very often increases above the criterion.

In the Slovenian case, a Balassa-Samuelson effect evaluated to lay between 1 an 1.5 percent p.a. is consistent with an equilibrium level of inflation between 2.5 an 3 percent p.a.. Technically, the price criterion could therefore be met without additional policy intervention, in equilibrium. However, any shock on inflation requires an immediate offsetting macroeconomic policy reaction as there is no room for the inflation to increase above its equilibrium level, if the inflation criterion is to be met.

5. 2. The Design of the Policy Mix in the ERM II

The efficacy and the credibility of the policy mix are essential for a successful participation in the ERM II. All macroeconomic policies should align with the primary objective, the adoption of the euro together with the price stabilization and the fiscal consolidation it requires. The cooperative policy mix set in place in the Joint program is a major advantage of the Slovenian economy respectively to many accession countries, where the monetary and the fiscal policy act in a less coordinated way. The Bank of Slovenia and the Slovenian Government therefore also committed to a mutual information of all developments that may affect the effective implementation of the Joint program.

A major change in the ERM II policy mix is in the monetary policy objective. In the spirit of joining the EMU, it will be primarily oriented towards maintaining the exchange rate stability. Given the absence of capital flow constraints, it means that the BoS' interest rates will be predetermined by those of the ECB, with the difference of the risk premium that is already around 1 percent and may be rapidly shrinking towards virtually zero. The loss of the independent monetary policy will end up making the monetary conditions pro-cyclical, especially in case of an asymmetric (or a more intense) shock relatively to the EMU. Indeed, if the business cycle is synchronized with the one in the EMU, then the ECB's stance will also be optimal for the domestic situation. Nevertheless, additional policy restraint must be made available because the expected demand up-turn might be much more pronounced that the one expected in the EMU, for the reasons outlined in the previous section,.

The burden of the macroeconomic management and the care for the inflation objective will rely on the fiscal policy. The most important dimension of the fiscal policy is the planning of the public non-investment spending so as to act as a counter-cyclical stabilizer. Again, such

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[19] To some extent the government can counteract the oil shock by an adequate excise tax adjustment. Such action proved successful in Slovenia after the 2003 Iraqi crisis oil shock.

an action is crucial in case of an asymmetric demand shock, preventing the output to increase above its potential and produce inflationary pressures. In addition, the budget should foresee a sufficient buffer stock for the Stability and Growth Pact to be respected in case of adverse shocks. Another obvious dimension of the fiscal policy is (the continuation of) the restraints on the fiscal cost-push effects on inflation. This above all precludes rises in excise duties and tariffs above the levels necessary to comply with EU regulations. Also, the administered price increases are to be bound so that they not exceed on average the overall inflation objective, i.e. the inflation in line with fulfillment of the Maastricht criteria in due times. On the income policy side, the wage and transfer growth in the public sector should be restrained to prevent the deterioration of the fiscal deficit and to exert a signaling effect on other sectors, in particular monopolistic sectors unconstrained by foreign competition. In that perspective, the government should seek at abolishing or limit (simple-rule) indexing of wages and social transfers to the past inflation. Finally, to facilitate the management of the effects of foreign capital flows on the exchange rate stability, a coordinated management with the Bank of Slovenia is to be implemented for the proceeds from the sale of shares of state-owned capital in firms to nonresidents.

Additional policy measures are expected to support the above core of the ERM II policy mix. Other social partners are expected to act in the same direction. The agreement on the wage increases aims at limiting the real wage growth at one percentage point below the growth of labor productivity, reducing the labor cost effect on inflation, but also generating a positive employment trend. Also, additional wage flexibility is needed for a successful absorption of asymmetric shocks. Another element in stabilizing the economy in case of a credit-financed demand shock is a further improvement of financial supervision and the implementation of dynamic provisioning when the economy is on the expansion path of the business cycle. Finally, as already mentioned, for a successful ERM II necessitates an appropriately chosen central parity.

A clear communication of the policy to the public provides a support for a successful expectation management. It is necessary that the market is convinced about the readiness of the policy makers to comply with their commitments. The credibility of the commitment to the Joint program is high since there is an explicitly announced convergence in the objective of both institutions. To this end, efforts must be oriented towards maintaining the macroeconomic fundamental equilibria, the fiscal balance, the current account and the competitiveness. In their Joint program, the Bank of Slovenia and the Slovenian Government consider the risks to be manageable if the above policy mix is implemented.

5. 3.   Narrow Bands Versus Wide Bands

Once established, the central parity should be perceived as an irrevocable nominal anchor for the economy. In that respect, the public should expect through the whole stay in the ERM II that the central parity will also eventually become the conversion rate at the adoption of the euro. Inconsistent expectations about the final conversion rate and the central parity might end up to be self fulfilling, leading to a speculative attack, destabilizing the economy and lengthen the participation in the ERM II. The optimal choice of the band width is most probably determined by the country's know-how in the exchange rate management and by the way it can orient the expectations about the latter.

Many countries advocate the use of wide bands during the stay in the ERM II. This seems in general the case of the inflation targeters. They consider the exchange rate stability subordinated to the primary objective – the price stability. In case of wide bands, the monetary authorities can freely decide when to intervene to redirect the nominal exchange

rate towards the central parity. Also, a quasi-floating regime decreases the vulnerability of a country to a speculative attack, at least as long as the exchange rate evolves inside the wide bands, i.e. the +/-15 percent bands. At the wide bands +/-15 percent the interventions are in principle unlimited and automatically supported by the ECB. This is not the case with the narrow bands, where the interventions are unilateral, unless a bilateral agreement is negotiated with the ECB. And the ECB is at the moment fairly reluctant to enter such an agreement with the accession countries.

However, strong arguments also exist in favor of the narrow bands. They signal the commitment of the authorities to a hard peg and increase the strength of the nominal anchor. Also, they provide an unambiguous interpretation of the compliance with the nominal exchange rate stability criterion. Frequent or persistent fluctuations outside the +/- 2.25 percent bands around the central parity, or an explicit trend in the exchange rate dynamics, may (will?) not be qualified as exchange rate instability. In addition, if the exchange rate moves away from the central parity, the speculations on the terminal date of the ERM II or an adjustment of the central parity may take place. This risk is minimized if the exchange rate is maintained close to the central parity.[20] Anyway, the independence of the monetary policy is at least temporarily abandoned when the central bank intervenes to orient the exchange rate back toward the parity. Finally, if the goal is to enter the euro, believing in the benefits of the currency union, it seems natural just beforehand to try mimicking the exchange rate regime that is closer to the currency union, i.e. the narrow bands, hard peg or even a fixed rate.

There are some additional arguments, somewhat particular to the Slovenian situation, that may speak in favor of an installment of the narrow bands. In its implementation of the managed float exchange rate regime, the Bank of Slovenia has acquired experience and designed its instruments to stabilize the exchange rate around the desired trend. In that sense, the Bank of Slovenia has already achieved a sufficient exchange rate stability.[21] Of course, in the ERM II no depreciation trend is allowed, which simply boils down for the Bank of Slovenia to stabilize the exchange rate dynamics around the horizontal trend. Yet another argument for narrow bands or a hard peg is the good record in economic fundamentals (low fiscal deficit and equilibrated current account) and a sufficient room for adverse shock absorption. With 32,2 percent[22] of the GDP, the condition of sufficiently high foreign currency reserves to maintain the hard peg is also fulfilled.

It seems from this discussion that in the case of Slovenia the arguments for the narrow bands prevail. Nevertheless, given the unlike commitment from the ECB to support the narrow bands, the most probable behavioral strategy of the central bank will be unilateral, unannounced and not binding narrow bands. The Bank of Slovenia is certainly keen to keep its discretion on the unilateral interventions that may be necessary to maintain the nominal exchange rate on the desired path.

6. CONCLUSIONS

This paper on euro adoption concludes by discussing, from the Slovenian perspective, the "training room" or "waiting room" aspects of the ERM II. On the one hand, the "training room"

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[20] The EU warns of an inadequacy of a pure inflation targeting with ERM II. There is an inconsistency with maintaining the independence of the monetary policy, while stabilizing the exchange rate around the central parity. One instrument is used for two objectives, yet another aspect of the impossible trinity. See ECFIN-EFC /58-04-EN.

[21] For instance, see Kontolemis (2003).

[22] December 2003. Source: Bank of Slovenia.

aspect of envisages the ERM II as the regime that enforces the implementation of sound and consistent macroeconomic policies. The ERM II incentive for the macroeconomic policies to behave bases on the compliance with the Maastricht criteria, taken in a way as the definition for macroeconomic stability. Also, the ERM II countries are subject to monitoring, and advice, from the EU institutions. Finally, the "training room" aspect interprets the ERM II as the test of the appropriateness of the central parity before entering the currency union.[23] On the other hand, the ERM II is often interpreted as a "waiting room" with no particular advantage for the economic policy conduct, but introducing potentially costly restrictions and risks in the country's economy.

The recent more rigorous disinflation-oriented policy mix could be attributed to the "training room" aspect of the ERM II. This ERM II policy mix has already been in part implemented in the last year or so, with an acceleration of the disinflation process. In particular, the fiscal policy has ceased with intense tax increases that, acting as cost-push shocks, produced the impression of inflation persistence in Slovenia during the last few years. The clear commitment of the Government to the ERM II early entry and the consistency of its policy with the restrictive stance of the Bank of Slovenia strongly improved the credibility of the policy mix. Together with the restrictive monetary policy, the slowdown in economic activity and the moderate wage growth, this shift in the fiscal policy was necessary for a sustainable reduction in inflation, i.e. without deteriorating the economic fundamentals.

The "training room" beneficial effects of the increased fiscal policy rigor have nevertheless to be evaluated with respect to the ERM II-connected risks. Some of the main risks connected with the ERM II were presented in this paper, but it is fair to argue that for the new accession countries these risks are exacerbated. This holds especially for the necessary simultaneous compliance with the inflation and the exchange rate stability, because of the natural appreciation trend these countries are subject to. By "natural" is understood that this is a real economy process such as the Balassa-Samuelson effect, neutral in the long run to monetary policy or exchange rate interventions. The trend real appreciation is therefore not a result of a misbehavior of the domestic macroeconomic policies and therefore should not be sanctioned as such. The "equal treatment" in the observance of the Maastricht criteria should take this element into account, but it does not. In the case of Slovenia, these effect account for roughly a mark-up of 1 to 1.5 percentage points over the most developed EU countries. It does not *a priori* prevent the compliance with the criteria without unnecessary economic cost, but the margin of maneuver for the macroeconomic policies are significantly reduced.

The risk of the ERM II is not only a non-compliance with the Maastricht criteria and a consecutive longer stay in the regime. Because of a constrained exchange rate path, it can at all moment, at least theoretically, conduct to an attack on the currency with potentially devastating effects on the real economy. Of course, such an event is in general a result of inconsistent macroeconomic policies and a logical sanction of the markets. But the crises can occur even if sound a macroeconomic policy mix is implemented. It can be due for example to a contagion from other countries, a misperception of policies in place or even because of self-fulfilling expectations.

The ERM II thus, paradoxically, presents more risks than the EMU itself. Sure, there is a possibility of parity adjustment, but in that case the qualification period starts again.[24] The

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[23] Padoa-Schioppa (2003) arguments that the ERM II should be considered as a "training" room, not "waiting" room.

[24] The qualification period is not reset to zero in case of an appreciation of the parity, but the central bank can in principle always avoid an appreciation by selling a sufficient amount of domestic currency.

implementation of the rigorous policy mix is at best accelerated by the ERM II. It would have to be eventually set in place anyway with the entry in the currency union. It is therefore argued that, from the Slovenian perspective, the ERM II presents much more aspects of a "waiting room" than a "training room". A "waiting room" with *a priori* manageable but always present risks.

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