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What Challenges Do the Central European and Mediterranean States Face in Trying to Join the Third Stage of European Monetary Union?

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Abstract

One of them is the need to satisfy the conditions of full membership in the Economic and Monetary Union (”EMU”) and the adoption of the Euro as their official currency. The Article then sets out the procedure to join the system for coordinating national currency exchange rates to the Euro, called the Exchange Rate Mechanism II (”ERM II”) and presents the economic situation in the new Member States in light of the convergence criteria. This gave birth to the so-called Pre-Accession Fiscal Surveillance Procedure (”PFSP”), which aims to prepare the new Member States for participation in the multilateral surveillance and economic policy coordination procedures currently in place in the EU as part of EMU. The Member States which satisfied the convergence criteria and entered the final stage of EMU, thus joining the centralized monetary policy of ECB and accepting the Euro as their currency, obviously should continue relatively strict budgetary policies and continue to avoid excessive deficits. Hence, it is extremely doubtful whether new Member States will be allowed to adopt the Euro after participation of fewer than two years in ERM II. No mention is made of real convergence as a criterion for entry into the third stage of EMU and adoption of the Euro.

LL.M. PERSPECTIVE

WHAT CHALLENGES DO THE CENTRAL EUROPEAN AND MEDITERRANEAN STATES FACE IN TRYING TO JOIN THE THIRD STAGE OF EUROPEAN MONETARY UNION?

*Andrej Fatur**

INTRODUCTION

Following the ratification of the Treaty of Accession,[1] signed in Athens in April 2003, ten Central European and Mediterranean States[2] joined the European Union ("EU") on May 1, 2004. This event undoubtedly represents one of the most striking and far-reaching achievements in the history of both the new Member States and of EU. Less than fifteen years ago, all new Member States' regimes (except Cyprus and Malta) were based on centrally-planned economic and socialist values. In order to

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1. Treaty between the Kingdom of Belgium, the Kingdom of Denmark, the Federal Republic of Germany, the Hellenic Republic, the Kingdom of Spain, the French Republic, Ireland, the Italian Republic, the Grand Duchy of Luxembourg, the Kingdom of the Netherlands, the Republic of Austria, the Portuguese Republic, the Republic of Finland, the Kingdom of Sweden, the United Kingdom of Great Britain and Northern Ireland (Member States of the European Union), and the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia, the Slovak Republic, Concerning the Accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic to the European Union, O.J. L 236, (2003) [hereinafter Treaty of Accession].

2. Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia. *See id.*

fully comply with the strict regulation of the integration process set forth by EU, the new Member States had to make tough (and often extremely unpopular) reforms to transform their countries into modern democracies and functioning market economies.[3]

Nevertheless, certain undeniably difficult challenges still lie ahead. One of them is the need to satisfy the conditions of full membership in the Economic and Monetary Union ("EMU") and the adoption of the Euro as their official currency. In accordance with the provisions of the E.C. Treaty[4] and the Athens Treaty of Accession,[5] new Member States participate in EMU from the date of accession as a Member State, though in a special form.

This Article presents the challenges that the new Member States face in trying to join the final stage of EMU. Taking into consideration the complexity and broad implications of this process, this examination is limited to legal and selected economic issues.

This Article has four main components. First, it outlines the general features of EMU and its institutional structure. Next, this Article presents the measures already taken by new Member States with regard to the free movement of capital and EMU, accompanied by a review of the existing legal framework of EMU and a discussion on the policy implications for the new Member

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3. *See* Roger J. Goebel, *Joining the European Union: The Accession Procedure for the Central European and Mediterranean States*, 1 LOY. U. CHI. INT'L L. REV. 15, 37-45 (2004) [hereinafter Goebel, *Joining the European Union*] (outlining reforms carried out by new Member States to meet economic standards required for accession); *see also* Copenhagen European Council, Conclusions of the Presidency, 26 E.C. BULL., no. 6, at 12-16 (1993) [hereinafter Copenhagen European Council] (declaring that all of the Central European Nations that entered into Europe Agreements and might ultimately join the European Union ("EU"), must satisfy three pre-conditions, known as the "Copenhagen Criteria": 1) stable institutions guaranteeing democracy and the rule of law, with full respect for basic human rights and the protection of minorities; 2) a functional market Economy, with free market competition, and the ability to "cope with competitive pressure and market forces within the Union;" and 3) the ability and the administrative infrastructure necessary to fulfill all of the obligations of membership, including that in the Economic and Monetary Union).

4. Consolidated version of the Treaty establishing the European Community, art. 122, O.J. C 325/33, 37 I.L.M. 79, incorporating changes made by Treaty of Nice amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts, Feb. 26, 2001, O.J. C 80/1 (2001) (amending Treaty on European Union ("TEU"), Treaty establishing the E.C. ("E.C. Treaty"), Treaty establishing the European Coal Steel Community ("ECSC"), and Treaty establishing the Euratom and renumbering articles of TEU and E.C. Treaty) [hereinafter E.C. Treaty].

5. Treaty of Accession, *supra* note 1, art. 4, O.J. L 236.

States after joining EU. The analysis is focused on the Treaty-based conditions for attaining the final stage of EMU, commonly called the convergence criteria, their legal basis, and possible application within the new Member States.

The Article then sets out the procedure to join the system for coordinating national currency exchange rates to the Euro, called the Exchange Rate Mechanism II ("ERM II") and presents the economic situation in the new Member States in light of the convergence criteria. In its fourth and final part, this Article discusses the necessary measures to be adopted by the new Member States and sketches the formal procedure to join the third stage of EMU. Finally, the Article provides an estimate of the time schedule for fulfillment of the convergence criteria in the new Member States.

I. *THE INSTITUTIONAL STRUCTURE OF ECONOMIC AND MONETARY UNION ("EMU")*

A. *Institutional Structure of EMU*[6]

1. General

EMU is a part of the European Community ("E.C." or "Community"). The EMU Treaty provisions were added by the Treaty of Maastricht.[7] As in the E.C. generally, the ultimate center for policy-making is the European Council, which provides for the policy guidelines of EMU.[8] The European Council is composed of the heads of state or government of each EU

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6. For a detailed analysis of EMU provisions in the E.C. Treaty, see RENE SMITS, THE EUROPEAN CENTRAL BANK – INSTITUTIONAL ASPECTS (1997); see also Jorn Pipkorn, *Legal Arrangements in the Treaty of Maastricht for the Effectiveness of the Economic and Monetary Union*, 31 COMMON MKT. L. REV. 263 (1994).

7. *See* Treaty on European Union, Feb. 7, 1992, O.J. C 224/1 (1992), [1992] 1 C.M.L.R. 719 [hereinafter TEU] (amending Treaty establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11, *as amended by* Single European Act, O.J. L 169/1 (1987), [1987] 2 C.M.L.R. 741 [hereinafter SEA]). The TEU, adopted as part of the Treaty of Maastricht, was signed at Maastricht, the Netherlands, on February 7, 1992, and entered into force on November 1, 1993. *See id.*

8. *See* E.C. Treaty, *supra* note 4, art. 8, O.J. C 325/33. The Treaty provides that:

> A European System of Central Banks ["ESCB"] . . . and a European Central Bank ["ECB"] . . . shall be established in accordance with the procedures laid down in this Treaty; they shall act within the limits of the powers conferred upon them by this Treaty and by the Statute of the ESCB and of the ECB . . . annexed thereto.

Id.

Member State, along with the President of the Commission.[9] It meets, on average, two to three times per year.[10] The European Council is an extremely powerful and influential body in EU, though it holds no direct institutional or legislative power.[11]

The Council of Ministers ("Council"), which represents the Member States at the ministerial level, plays the central legislative role in EMU. The Council reports to the European Council to receive guidance on major policy issues.[12] The Council also either informs or consults the European Parliament as required by specific Treaty provisions.[13] The Council adopts the relevant legislation or decisions in this field, either by a unanimous or qualified majority vote, depending on the relevant Treaty provision.

The European Commission ("Commission"), the central administrative body in the E.C., is also generally responsible for initiating E.C. legislation.[14] In the EMU sector of the Community, the Commission is generally charged with proposing policies or recommendations to the Council, assisting the Council in the surveillance of economic activities of the Member States, and monitoring implementation of EMU measures.

Pursuant to the Maastricht Treaty, an Economic and Financial Committee ("EFC"),[15] with advisory status, was set up to review the monetary and financial situations of the Member States and Community, the general payments system of the Member States, and to report thereon to the Council and the Commission. EFC is also empowered to deliver opinions at the request of the Council, the Commission, or on its own initiative, for submission to those institutions. It contributes to the work of the Council regarding capital movements, government deficits, com-

9. *See, e.g.*, GEORGE A. BERMANN ET AL., CASES AND MATERIALS ON EUROPEAN UNION LAW 40-42 (2002).

10. *See id.*

11. *See id.*

12. *See id.*

13. *See* E.C. Treaty, *supra* note 4, arts. 99(2), 99(4), 100, 104(11), 105(6), 106(2), 107(6), 114(3), 117(1), 121(2), O.J. C 325/33. The assent of the European Parliament is required only for institutional changes. *See id.* art. 107(5).

14. *See* BERMANN ET AL., *supra* note 9, at 42-44.

15. *See* E.C. Treaty, *supra* note 4, art. 114(1), O.J. C 325/33. At the start of the third stage of EMU, the Economic and Financial Committee ("EFC") replaced the Monetary Committee which was set up to promote coordination of the policies of the Member States to the full extent needed for the functioning of the internal market and had similar tasks later to the EFC. *See id.*

mitments of public authorities, access to financial institutions and the guidelines for the economic policies of the Member States.[16] EFC consists of two committee members representing each Member State, the Commission, and the European Central Bank ("ECB"), which will be discussed below.[17]

2. The European Monetary Institute, European Central Bank and the European System of Central Banks

The first preparatory stage in EMU (not even described in the Maastricht Treaty), began with the start of full free movement of capital in 1991[18] and essentially consisted of intergovernmental cooperation and early planning.[19] The Maastricht Treaty[20] prescribed the start of a second stage in January 1, 1994.[21] During the second stage, economic coordination was intensified and each Member State was supposed to try achieving the convergence criteria[22] to join the final stage.

The European Monetary Institute ("EMI")[23] took up its duties at the start of the second stage of EMU.[24] It had a legal function and was directed by a Council consisting of a President[25] and the Governors of the individual National Central

16. *See id.*

17. *See id.*

18. *See, e.g.*, Juan Luis Millán Pereira, *Economic Restructuring and the European Monetary Union*, 9 U. MIAMI INT'L & COMP. L. REV. 45, 53-54 (2001) (discussing European Monetary System, the predecessor of EMU, and its successful establishment of a stable, but adjustable exchange rate system); Dr. Dieter Kugelmann, *The Maastricht Treaty and the Design of a European Federal State*, 8 TEMP. INT'L & COMP. L.J. 335, 340 (1994) (noting that first stage fixed the exchange rates of European currencies in relation to one another).

19. *See* Pereira, *supra* note 18, at 53-55 (describing first stage of EMU and its predecessor and their reliance on governmental cooperation).

20. *See* TEU, *supra* note 7, O.J. C 224/1.

21. *See* Kugelmann, *supra* note 18, at 340 (noting that Treaty of Maastricht called for commencement of second stage on January 1, 1994).

22. *See infra* notes 58-66, 151-166 and accompanying text (discussing convergence criteria).

23. *See id.* art. 117. The European Monetary Institute ("EMI") replaced the Committee of Governors of NCBs and European Monetary Cooperation Fund which were dissolved at the start of the second stage of EMU. *See id.*

24. For more detailed description of the composition, role and functions of EMI, see Pipkorn, *supra* note 6, at 282-84 and SMITS, *supra* note 6, at 49-51.

25. The President was appointed by common accord of the governments of the Member States at the level of Heads of State or Government, on a recommendation from the Council of EMI, and after consulting the European Parliament and the Council of Ministers ("Council"). *See* SMITS, *supra* note 6, at 49-51.

Banks ("NCBs"), one of whom was also appointed Vice-President by the Council. Its statute is laid down in a Protocol annexed to the E.C. Treaty. Unlike the third stage of EMU, monetary policy in the second stage expressly remained in the hands of NCBs.[26] EMI's role and tasks, set forth in Article 117(2) and (3), were principally to comprise the monetary policies of the Member States.[27] EMI also prepared legislation, policies, and studies designed to ensure smooth transition to the third stage of EMU, in which the autonomous ECB and European System of Central Banks ("ESCB") would conduct a unified monetary policy.[28]

ESCB[29] commenced the control of monetary policy at the start of the third stage of EMU[30] in January 1999 for those States that joined in that final stage. ESCB is composed of the ECB and all NCBs of Member States, including those which do not participate in the final stage of EMU.[31] ECB, at the core of ESCB, has a legal personality.[32] ECB's central operational unit is the Governing Council of ECB, which consists of the six members of the ECB's Executive Board together with one governor each from those NCBs whose countries have joined the final stage of EMU.[33] The Executive Board, responsible for the day-to-day work of the ECB, comprises the President, the Vice-President and four other Members, appointed for eight year terms by the Member States which have joined the final stage of EMU.[34]

26. *See* E.C. Treaty, *supra* note 4, art. 117(2) & (4), O.J. C 325/33.

27. In the exercise of its coordinating tasks EMI was entitled to formulate or submit opinions and recommendations in the field of monetary and exchange-rate policy in the second stage of EMU. *See id.* art. 117(4).

28. *See* EUROPEAN COMMISSION, GENERAL REPORT ON THE ACTIVITIES OF THE EUROPEAN UNION 1994 ¶¶ 40-41 (1994); *see also* EUROPEAN COMMISSION, GENERAL REPORT ON THE ACTIVITIES OF THE EUROPEAN UNION 1995 ¶¶ 70-75 (1995); EUROPEAN COMMISSION, GENERAL REPORT ON THE ACTIVITIES OF THE EUROPEAN UNION 1996 ¶¶ 84-85 (1996).

29. *See* E.C. Treaty, *supra* note 4, art. 8, O.J. C 325/33; *see also* Roger Goebel, *European Economic and Monetary Union: Will EMU Ever Fly?* 4 COLUM. J. EUR. L. 250, 276-85 (1998) [hereinafter Goebel, *Will EMU Ever Fly?*].

30. *See* E.C. Treaty, *supra* note 4, art. 123, O.J. C 325/33.

31. *See id.* art. 107(1).

32. *See id.* art. 107(2). Legal personality means that an organization has its own legal identity under international law, i.e., the ability to contract, own property, to sue and be sued, employ, and bear liability. *See, e.g.*, Alexander Gillespie, *Iceland's Reservation at the International Whaling Commission*, 14 EUR. J. INT'L L. 977, 995 (2004). The NCBs retain their own legal personality under national law.

33. *See id.* arts. 107(3) & 112(1).

34. *See id.* art. 112(2). They are appointed from among persons of recognized standing and professional experience in monetary or banking matters by common accord of the governments of the Member States at the level of Heads of State or Govern-

For the purpose of coordination, the President of the Council and a Member of the Commission may attend meetings of the Governing Council in a non-voting capacity.[35] In parallel, the President of the ECB can participate in Council meetings when the Council is discussing matters relating to the objectives and tasks of the ESCB.[36]

In accordance with Article 108 of the E.C. Treaty, the ESCB, ECB and NCBs are completely independent in their decision-making and cannot seek or accept advice from any other E.C. institution or Member State.[37] The primary objective of ESCB is set out in Article 105(1) which states:

> The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources, and in compliance with the principles set out in Article 4.

Article 105(2) sets out the basic tasks of ESCB: to define and implement the monetary policy of the Community; to conduct foreign-exchange operations; to hold and manage the official foreign reserves of the Member States; and to promote the smooth operation of payment systems. The Treaty also confers on ECB another crucial power, namely the "exclusive right to authorize the issue of banknotes within the Community."[38] Both ECB and NCBs may issue such notes, the "only such notes to have the status of legal tender within the Community."[39] Finally, ECB has also been granted a substantial degree of regulatory power.[40]

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ment, on a recommendation from the Council, after it has consulted the European Parliament and the Governing Council of the ECB.

35. *See id.* art. 113(1).

36. *See id.* art. 113(2).

37. *See id.* art. 107.

38. *See id.* art. 106(1).

39. *See id.*

40. The European System of Central Banks ("ESCB") has the power to make regulations to the extent necessary to implement the tasks defined in Article 3(1), Articles 19(1), 22, and 25.2 of the Statute of the ESCB and in cases which shall be laid down in the acts of the Council referred to in Article 107(6) of the E.C. Treaty. *See id.* art. 110.

B. *Basic Framework of EMU*

1. Brief Historical Background

The roots of EMU trace as far back as the first E.C. Treaty, which provided for the coordination of the economic and monetary policies, but rather summarily.[41] The original Article 105(2) of the E.C. Treaty, as early as 1958, established Monetary Committee to review the monetary and financial situations of the Member States.[42] The first step towards significant monetary union began in 1970[43] with the Werner Report.[44] Based upon this Report, the Council adopted Regulation 907/73[45] establishing the European Monetary Cooperation Fund ("EMCF") to provide short-term monetary support and facilitate concerted monetary action. Most Member States entered a system to reduce exchange rate fluctuations to a narrow band, popularly called "the snake."

The next significant development in this area was the European Monetary System ("EMS"),[46] which actually became the initial stage of EMU. EMS had three basic components:[47] (1) an artificial currency, the ECU; (2) exchange rates which are permitted to fluctuate only in a narrow band;[48] and (3) a system of

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41. *See id.* arts. 3(g), 103-16 (as originally ordered and numbered).

42. *See* Treaty establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11, art. 105(2) [hereinafter E.E.C. Treaty].

43. Council Decision of 6 Mar. 1970, O.J. L 59/44 (1970) O.J. Eng. Spec. Ed. Series II, Vol. X, at 11 (Council decision to set up a working group chaired by Professor Werner).

44. *See* Report on the Realization by Stages of Economic and Monetary Union, 3 E.C. BULL. no. 11 (1970). The Werner Report proposed a system of irreversible convertibility of national currencies, free from fluctuation, regulated by a Community system of central banks modeled after the Federal Reserve. The Report's proposal that the EEC Treaty be amended in order to achieve monetary union, did not, of course, result in any action. *See* Goebel, *Will EMU Ever Fly?*, *supra* note 29, at 257. For further details on the Werner Report and Community action to implement it, see SMITS, *supra* note 6, at 15-19.

45. *See* Council Regulation of 3 April 1973, O.J. L 907/73 2 (1973) (establishing a European Monetary Cooperation Fund).

46. *See* 11 E.C. BULL., no. 6, at 17-18 (1978).

47. *See* Goebel, *Will EMU Ever Fly?*, *supra* note 29, at 259-60. For a detailed description of EMS, see European Commission, The EMS: Ten Years of Progress in European Monetary Cooperation 3 E.C. OFF'L PUB. OFF 3 (1989).

48. This system for the stabilization of exchange rates between the currencies of the Member States was called the Exchange Rate Mechanism ("ERM"). Fluctuation margins of plus or minus 2.25% were established around exchange rates, but Member States with weaker currencies might opt for a margin up to ± 6% on the understanding that these margins would be reduced gradually.

credit and loan reserves to stabilize Member States' currencies in times of crisis.

C. *The Maastricht Treaty Provisions on EMU*

EMU consists of the coordination of Member State economic policies and the transfer of monetary policy control to ESCB and ECB, together with the introduction of a single currency, the Euro. The Intergovernmental Conference ("IGC") which dealt with EMU issues concluded its deliberations in Maastricht in December 1991.[49] According to Professor Roger Goebel,[50] no aspect of the Maastricht Treaty on European Union ("TEU")[51] is of greater practical importance than the provisions on EMU. Article 2 of the TEU lists creation of an economic and monetary union and a single currency as among the principal objectives of EU.[52] In addition, the new Article 4 of the E.C. Treaty states that the Community activities shall include the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and which is conducted in accordance with the principle of an open market economy with free competition.[53] Concurrently with these principles, there shall be the irrevocable fixing of exchange rates leading to the introduction of a single currency (the Euro) and the definition and conduct of a single monetary policy and exchange-rate policy. The primary objective of monetary policy and exchange-rate policy is to maintain price stability. In order to make this possible, an immense program for achieving EMU was devised. The E.C. Treaty provides that EMU is to be achieved in three stages.

The first stage, which started on July 1, 1990,[54] consisted essentially of an attempt at greater convergence of the national economies, free movement of capital and payments among Member States and between Member States and Nations outside

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49. *See, e.g.*, Roger Goebel, *The European Union in Transition: The Treaty of Nice in Effect, Enlargement in Sight: A Constitution in Doubt*, 27 FORDHAM INT'L L.J. 455, 460 (2004).

50. *See* Goebel, *Will EMU Ever Fly?*, *supra* note 29, at 271.

51. *See* TEU, *supra* note 7, O.J. C 224/1.

52. *See id.* art. 2.

53. *See* E.C. Treaty, *supra* note 4, art. 4, O.J. C 325/33.

54. Started July 1, 1990 and ended on December 31, 1993.

EU, and the strengthening of the cooperation between NCBs. Furthermore, State overdraft facilities with its NCB and privileged access of financial institutions to its NCB were abolished.[55] The Council was to assess the progress made with regard to economic and monetary convergence; in particular, with regard to price stability, sound public finances, and the progress made with implementing Community law concerning the internal market.[56] The Member States had to start the process leading to independence of their central banks and to avoid excessive deficit.[57]

The second stage, which ran from January 1, 1994 to December 31, 1998,[58] began with the creation of EMI, which was replaced five years later at the beginning of the third stage by ECB. During the second stage, the Member States were obliged to make every effort to meet convergence of the economic and monetary policies of the Member States (to ensure stability of prices and sound public finances), the so-called convergence criteria. The most important decision to be made in 1998 at the end of the second stage of EMU was which Member States could participate in the third stage of EMU, and consequently, in the single currency system.

Whether the Member States which joined the Euro-area on January 1, 1999, actually fulfilled the convergence criteria necessary to join the third stage of EMU, is somewhat debatable. According to some commentators, the relatively vague provisions on convergence criteria, discretionary powers of the decision-making bodies, and strong political imperatives to achieve a single currency resulted in allowing some Member States to join the third stage of EMU that would not have qualified if the convergence criteria had been strictly applied.[59]

With the commencement of the third stage on January 1, 1999,[60] the exchange rates were irrevocably fixed, the Euro was introduced as a virtual currency on the foreign-exchange mar-

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55. *See* E.C. Treaty, *supra* note 4, art. 101(1) & (2), O.J. C 325/33.

56. *See id.* art. 116(2).

57. *See id.* art. 108.

58. *See id.* art. 116.

59. *See, e.g.*, Paul Beaumont & Neil Walker, *The Euro and European Legal Order*, *in* LEGAL FRAMEWORK OF THE SINGLE CURRENCY 169, 174-75 (Paul Beaumont & Neil Walker eds., 1999); Peter B. Kenen, *The Transition to EMU*, 4 COLUM. J. EUR. L. 359 (1998).

60. *See* E.C. Treaty, *supra* note 4, art. 121, O.J. C 325/33.

kets and for electronic payments, followed by the introduction of Euro notes and coins starting January 1, 2002. In the third stage, the participating Member States no longer decide or implement their own monetary policies. This role is transferred to ESCB.

II. *THE "INS" AND THE "OUTS" — STATUS OF THE NEW MEMBER STATES IN THE FRAMEWORK OF EMU AFTER JOINING THE EU*

A. *Brief Overview of the Measures Already Taken by the New Member States*

Although a wide range of very important legislative and policy actions concerning the free movement of capital and EMU must still be adopted by the new Member States, considerable efforts and reforms have already been undertaken. A series of Europe Agreements provide the initial legal framework for the measures taken by new Member States before accession to EU.[61] The provisions of these Europe Agreements provide for the gradual liberalization of current payments and movement of capital, investment promotion and protection, as well as economic and financial cooperation.[62] Since then, the Association

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61. Association Agreements were entered into by the European Community and each of the new Member States. The Europe Agreements with Czechoslovakia, Hungary, and Poland were signed on December 16, 1991. *See* 24 E.C. BULL., no. 12, at 95-96 (1991). The Europe Agreement with Romania was signed on February 1, 1993. *See* 26 E.C. BULL., no. 1/2, at 69 (1993). The Europe Agreement with Bulgaria was signed on March 8, 1993. *See* 26 E.C. BULL., no. 3, at 58 (1993). The Agreement with Czechoslovakia was replaced by separate Agreements with the Czech Republic and the Slovak Republic on October 4, 1993. *See* 26 E.C. BULL., no. 10, at 70-71 (1993). The Council approved negotiations with Estonia, Latvia, and Lithuania on November 28, 1994. *See* E.U. BULL., no. 11, at 77 (1994).

Apart from Cyprus and Malta which entered into their Association Agreements in 1971 and 1973, respectively, all other new Member States, i.e., Central European Countries, entered into the Association Agreements in the course of the 1990s. These agreements, also known as "Europe Agreements," are much more comprehensive than past European Community association agreements and were, due to their nature, also the basis for the beginning of the European Eastward Enlargement. *See* Roger J. Goebel, *The European Union Grows*, 18 FORDHAM INT'L L.J. 1092, 1176-78 (1995); *see also* Pre-Accession Strategy, *available at* http://Europa.eu.int/comm/enlargement/pas/index.htm (last visited Oct. 8, 2004).

62. *See* The Europe Agreements: Interactive Comparison, *available at* http://www.asser.nl/hee/index.htm (last visited Oct. 8, 2004); *see also* HANDBOOK ON EUROPEAN ENLARGEMENT, A COMMENTARY ON THE ENLARGEMENT PROCESS, KLUWER INTERNATIONAL (Andrea Ott & Kirstyn Inglis eds., 2002), *available at* http://www.asser.nl/hee.htm (last visited Oct. 8, 2004).

Councils[63] have been keeping the transition process on track by regularly examining the accomplishments of the economic reform in the new Member States.[64]

The real push towards transition came with the beginning of the negotiation procedure for accession to EU. In June 1993, the Copenhagen European Council concluded that membership requires that an "accession country . . . have the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union."[65] The new Member States focused their efforts on the final goal - compliance with the *acquis communautaire.*[66] Apart from recognizing their status as Member State with derogation within the meaning of Article 122 of the E.C. Treaty no additional transitional measures were granted to the new Member States in the area of

63. Association Councils represent the institutional framework of the Europe Agreements. Association Councils are defined under Title IX, Institutional, General and Final Provisions of each Europe Agreement. *See* The Europe Agreements: Interactive Comparison, *available at* http://www.asser.nl/hee/index.htm (last visited Oct. 8, 2004); *see also* HANDBOOK ON EUROPEAN ENLARGEMENT, A COMMENTARY ON THE ENLARGEMENT PROCESS, KLUWER INTERNATIONAL (Andrea Ott & Kirstyn Inglis eds., 2002), *available at* http://www.asser.nl/hee.htm (last visited Oct. 8, 2004). Each Europe Agreement has its own Association Council. The Association Councils supervise the implementation of the Europe Agreements and examine any major issues arising within its framework and any other bilateral or international issues of mutual interest. They meet at the ministerial level once a year and when circumstances require. The Association Councils consist of the members of the Council and members of the Commission, on the one hand, and of members appointed by the government of individual candidate countries, on the other.

64. Willem Duisenberg, EU Enlargement, Some Views From the ECB, Speech at the Bank of Greece in Athens, Greece, Oct. 15, 1999, at 7 (1999), *available at,* http://www.ecb.int/press/key/date/1999/html/sp991015.en.html (last visited Oct. 21, 2004).

65. *See* Copenhagen European Council, *supra* note 3.

66. During the pre-accession phase, the new Member States carried out the economic reforms and policies needed to fulfill the economic criteria set by the European Council in Copenhagen in June 1993. They also adopted the required EMU related legislation to become a Member State with derogation. These are:

- Completion of the orderly liberalization of capital movements (Article 56, E.C. Treaty);
- Prohibition of any direct public sector financing by the central bank (Article 101, E.C. Treaty) and of privileged access of the public sector to financial institutions (Article 102, E.C. Treaty);
- Alignment of the national central bank statutes with the Treaty, including the independence of the monetary authorities (Articles 108 and 109, E.C. Treaty).

For a comprehensive review of the principle of *acquis communautarie,* see Goebel, *Joining the European Union, supra* note 3, at 33-36.

EMU by the Athens Treaty of Accession.[67]

Nevertheless, probably the most important framework for cooperation in the area of EMU from a practical point of view was provided by the Accession Partnerships.[68] At its meeting in Luxembourg in December 1997, the European Council decided that Accession Partnerships would be the key feature of the enhanced pre-accession strategy, mobilizing all forms of assistance to the new Member States within a single framework. One of the economic priorities of the Accession Partnerships was the establishment of an annual fiscal surveillance for the new Member States. This gave birth to the so-called Pre-Accession Fiscal Surveillance Procedure ("PFSP"),[69] which aims to prepare the new Member States for participation in the multilateral surveillance and economic policy coordination procedures currently in place in the EU as part of EMU. PFSP has three main components — the Fiscal Notification,[70] the Pre-Accession Economic Program ("PEP")[71] and the Multilateral Dialogue.[72] PEPs are updated an-

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67. *See* Treaty of Accession, *supra* note 1, art. 4, O.J. L 236.

68. *See* Conclusion of the European Council on the enhanced pre-accession strategy, European Union Enlargement, Luxemburg, E.U. BULL., no. 12, at 3 (1997). In this manner, the Community targets its assistance towards the specific needs of each candidate country so as to provide support for overcoming particular problems with a view to accession. *See* Council Regulation No. 622/98, O.J. L 85 (1998) (on assistance to the applicant States in the framework of the pre-accession strategy, and in particular on the establishment of Accession Partnerships).

69. *See* European Commission, Directorate General, Economic and Financial Affairs, *The Macroeconomic Policy Framework for EU Membership and Euro-area Participation – the Role of Budgetary Policy*, Presented at Conference on EU Accession – Developing Fiscal Policy Frameworks for Sustainable Growth 7-8 (2002), *available at* http://Europa.eu.int/comm/economy_finance/events/2002/brussel2/macro_en.pdf (last visited Oct. 8, 2004) [hereinafter European Commission, *Macroeconomic Policy Framework*].

70. The first annual notification of debt and deficit levels was submitted by all the new Member States to DG ECFIN by April 1, 2001. The format of the notification will be identical to that which the Member States currently undertake twice a year. *See* European Commission, Directorate General for Economic and Social Affairs, *European Economy, Enlargement Papers No. 17, Main Results of the April 2003 Fiscal Notifications Presented By the New Member States* 3 (2003), *available at* http://Europa.eu.int/comm/economy_finance/publications/enlargement_papers/elp17_en.htm (last visited Oct. 8, 2004).

71. Pre-Accession Economic Programs have two objectives. First, to outline the medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession. Second, they offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU with derogation from the adoption of the Euro upon accession, particularly in the areas of multilateral surveillance and coordination of economic policies.

72. *See* Press Release, ECOFIN Council, 2,312th Council Meeting in Brussels, Belgium (2000), *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=EoIPRES/00/453&format=HTML&aged=1&language=EN&guiLanguage=EN

nually and should be regarded as early precursors of the Convergence and Stability Programs which the Member States were obliged to prepare in 1998 and which have been updated on an annual basis.[73]

B. *EMU — Legal Framework and Policy Implication for the New Member States*

It was clear long before the conclusion of the negotiation procedure that new Member States would not be able to "opt out"[74] of EMU as Denmark[75] and the United Kingdom[76] had done.[77] Thus, Article 4 of the Athens Treaty of Accession provides that "each of the new Member States shall participate in

(last visited Oct. 16, 2004). ECOFIN Multilateral dialogue was requested by the ECOFIN Council in order to establish a regular in-depth dialogue between new Member States and Member States, at various levels. *See id.* To this end, members of the EFC and their counterparts from the new Member States meet to discuss the result of the pre-accession procedure. *See id.* These high level meetings also serve to prepare the economic dialogue at ministerial level. *See* European Commission, *Macroeconomic Policy Framework*, *supra* note 69, at 8.

73. *See* Council Regulation No. 1466/97, O.J. L 209/1 (1997) (on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies) [hereinafter Economic Surveillance Regulation].

74. Although no official "opt out" clause was granted to Sweden, it never joined the third stage of EMU. While Sweden would probably satisfy the convergence criteria, Sweden never made its central bank independent and technically does not satisfy a Treaty-based criterion for joining. The September 2003 referendum on joining the third stage of EMU was unsuccessful despite the huge effort of Swedish government. At present, it appears that the other Member States will acquiesce in Sweden's failure to take the necessary measure to join the third stage. From the new Member States' Article, the Swedish precedent might be important in case a candidate country would not want to adopt the Euro, although fulfilling the nominal convergence criteria and attain the sustainable real convergence. While undoubtedly an interesting theoretical question, it seems that it will not have a major influence on the situations of most new Member States, because their backgrounds are completely different from Sweden's. Due to their histories of socialistic economies and unstable currencies, they are already declaring their aspirations to adopt the Euro as quickly as possible. *See* Goebel, *Will EMU Ever Fly?*, *supra* note 29, at 307.

75. *See* CHIARA ZILIOLI & MARTIN SELMAYER, THE LAW OF THE EUROPEAN CENTRAL BANK 137-42 (2001); *see also* SMITS, *supra* note 6, at 137-38.

76. *See* TEU, *supra* note 51, O.J. C 224/1, Protocol on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland, O.J. C 191 (1992).

77. *See* Duisenberg, *supra* note 64, at 9-10 (stating "it has been decided that no 'opt-out' clauses, such as those negotiated by the United kingdom and Denmark, shall be available to new Member States"); *see also* Christian Noyer, Some ECB Views on the Accession Process, Speech on the Occasion of The Central and Eastern European Issuers and Investors Forum, Vienna, Austria, Jan. 17, 2001, at 4 (2001), *available at* http://www.ecb.int/press/key/date/2001/html/sp010117.en.html (last visited Oct. 18, 2004) (stating "[t]he new entrants will, as far as EMU is concerned, have the status of 'Mem-

Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 122 of the E.C. Treaty."[78]

The third stage of EMU commenced on January 1, 1999.[79] The new Member States, upon accession, assumed the rights and obligations which exist for States during the third stage.[80] Thus, the new Member States have the status of Member States with a derogation, as defined by Article 122,[81] while the date of their actual adoption of the Euro and entry into ECB monetary control will depend on the legal and economic convergence of the individual candidate States.[82]

Their individual economic policies then become a matter of common concern and are subject to economic policy coordination[83] and multilateral surveillance procedures.[84] The main instruments for coordination are the Broad Economic Policy

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ber State with derogation.' No 'opt-out' clauses will be available for the future new [M]embers").

78. *See* Treaty of Accession, *supra* note 1, art. 4, O.J. L 236.

79. *See* E.C. Treaty, *supra* note 4, art. 121(4), O.J. C 325/33.

80. *See* ZILIOLI & SELMAYER, *supra* note 75, at 144 (stating that "[a] new [M]ember [S]tate therefore will accede automatically to the third stage. This follows from Article 121 (4), first sentence, EC in conjunction with [P]rotocol No. 24 on the transition to the third stage of the economic and monetary union, where is laid down that on January 1, 1999 'the Community' moved to Stage Three: thus all Member [S]tates, except where Community law states otherwise, as is the case in the Danish and UK Protocols"). For a different view, that the Member States with a derogation do not participate in Stage Three, see RALPH MEHNER-MELAND, CENTRAL BANK TO EUROPEAN UNION 41 (1995).

81. For Member States with a derogation, Articles 104(9) & (11), Articles 105(1)-(5), Article 106, Article 110, Article 111, and Article 112(2)(b) of the E.C. Treaty do not apply. *See* E.C. Treaty, *supra* note 4, O.J. C 325/33. The exclusion of such a Member State and its national central bank from rights and obligations within the ESCB is laid down in chapter IX of the Statute of the ESCB. *See id.*, Protocol on the Statute of the European System of Central Banks and of the European Central Bank, O.J. C 191/68, at ch. 9 (1992) [hereinafter Statute of the ESCB and ECB]. For the Member States with derogation, Articles 119 and 120 of the E.C. Treaty still apply. *See* E.C. Treaty, *supra* note 4, arts. 119-20, O.J. C 325/33.

82. Duisenberg distinguishes three stages with different sets of criteria before the new Member States will be able to become participating Member States: EU membership which requires implementation of EMU – related *acquis*; then on date of accession they will join EMU with the status of "countries with a derogation" with commitment to eventual adoption of the Euro; finally, once they achieve a sufficient degree of convergence, they are expected to participate in ERM II. *See* Duisenberg, *supra* note 64, at 10. Following this, when the Maastricht convergence criteria are met, the new Member States will adopt the Euro and become full participants of EMU. *See id.*

83. *See* E.C. Treaty, *supra* note 4, art. 99, O.J. C 325/33.

84. *See* Economic Surveillance Regulation, *supra* note 73, O.J. L 209/1.

Guidelines ("BEPG")[85] and Stability and Growth Pact ("SGP").[86] Though the new Member States do not participate in the Monetary Union immediately after accession, participation in the Euro-area is the ultimate goal and obligation of new Member States.[87] In order to join the third stage and become full members of EMU, the new Member States will first have to join Exchange Rate Mechanism II ("ERM II")[88] and then fulfill the convergence criteria.[89]

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85. *See* E.C. Treaty, *supra* note 4, art. 99(2), O.J. C 325/33.

86. The Stability and Growth Pact ("SGP") sets out rules for the EU, establishing a framework within which Member States have agreed to coordinate their fiscal policies. While monetary policy in the Euro-area has been unified and is now conducted by the European Central Bank ("ECB"), fiscal policy remains a matter for national governments. *See* HOUSE OF LORDS, SELECT COMMITTEE ON EUROPEAN UNION, THIRTEENTH REPORT, 2003, Cmnd. 668, at 8. The fiscal policies of the Member States are, however, subject to the constraints of the SGP. *See id.* Whether or not a Member State has adopted the Euro, Member States are free to structure the expenditure and the revenue side of their budgets according to their own national preferences. *See id.* Member States have agreed to a SGP framework for the coordination of fiscal policy, with a view to maintaining sound public finances. *See id.*

87. *See* 26 E.C. BULL., *supra* note 3, at 12-16.

88. Council Resolution of 17 June 1997, O.J. C 236 (1997) (on the establishment of an exchange-rate mechanism in the third stage of Economic and Monetary Union and stating that "[w]ith the start of the third stage of economic and monetary union, the European Monetary System will be replaced by the exchange-rate mechanism as defined in this Resolution . . . . The exchange-rate mechanism will link currencies of Member States outside the Euro-area to the Euro").
The basic features of the Exchange Rate Mechanism II ("ERM II") are as follows:

- membership in ERM II is open only to EU members;
- central rates and fluctuation bands of participating countries' currencies against the Euro are set by common procedure (involving Finance Ministers, European Central Bank ("ECB") and the National Central Banks ("NCBs"), governors and the European Commission);
- the standard fluctuation band is ± 15%, while not excluding the possibility of setting a narrower band;
- intervention support of the ECB to the NCBs is automatic at the margins of the band (marginal interventions); any interventions within the band (intra-marginal interventions) need not be (but may be) supported by the ECB;
- the ECB and NCBs have a formal right to suspend intervention should the price stability objective be jeopardized; and
- realignments of central parity are made by the common procedure, which both the ECB and the Member States have the right to initiate.

See id.

89. In order to adopt the Euro, Member States have to achieve a high degree of sustainable economic convergence which means a low inflation rate, healthy public finances, low level of interest rates and stable exchange rates. The economic strength of Member States is assessed on the basis of the fulfillment of the "Maastricht convergence criteria" set out in Article 121 of the E.C. Treaty. *See* E.C. Treaty, *supra* note 4, art. 121, O.J. C 325/33. The criteria entail:

In immediately broader terms, this implies that the economic union provisions apply to them in full,[90] and that in the area of monetary union, they are subject to the provisions which applied during the second stage.[91] Therefore, new Member States shall, until official adoption of the Euro, keep their national currencies, retain their power over monetary policies and foreign currency reserves and, subject to requirements prescribed in Article 124 of the E.C. Treaty, also continue to be competent in exchange-rate matters.

Although the new Member States became members of ESCB,[92] they are not members of ECB. In accordance with the provisions of Article 123 of the E.C. Treaty, new Member States will not be involved in the appointment of the members of the Executive Board of ECB until they adopt the Euro. The Governors of the NCBs of the new Member States became members of the General Council of ECB,[93] but not the more important Governing Council. The General Council's membership comprises the President and Vice President of ECB plus the governors of

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- *The achievement of a high degree of price stability*; this 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;
- *The sustainability of the government financial position*; this will be apparent from having achieved a government budgetary position without an excessive deficit as determined in accordance with Article 104(6);
- *The observance of the normal fluctuation margins* provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without losing value compared to the currency of any other Member State; and
- *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.*

See id. (emphasis added).
The criteria are further detailed in a Protocol attached to the Treaty. *See* E.C. Treaty, *supra* note 4, Protocol on the convergence criteria referred to in Article 109j of the Treaty establishing the European Community, O.J. C 224/1, at 121 (1992), [1992] 1 C.M.L.R. at 770-71 [hereinafter Protocol on Convergence Criteria].

90. The main exception being, that the sanctions in case of excessive deficits (Article 104 of the E.C. Treaty), can not be applied to these States and that Article 119 and 120 (escape clause) continue to apply. *See* SMITS, *supra* note 6, at 135.

91. *See* E.C. Treaty, *supra* note 4, art. 116, O.J. C 325/33.

92. *See id.* art. 107; *see also* Statute of the ESCB and the ECB, *supra* note 81, art. 1.

93. Article 123(3) E.C. Treaty contains the reference to General Council of ECB. *See* E.C. Treaty, *supra* note 4, art. 123(3), O.J. C 325/33. More detailed provisions on it are in Article 45 of the Statute of the ESCB and the ECB. *See* Statute of the ESCB and the ECB, *supra* note 81. The responsibilities of the General Council are defined in Article 47. *See id.* art. 47.

the NCBs of all EU Member States. The General Council coordinates monetary policies of all EU Member States; it has oversight of the advisory and reporting activities of ECB, the collection of statistical information, the conditions of employment of the staff of ECB, and also holds general discussions about progress within the Euro-area.[94]

In accordance with the conclusion of the Luxembourg European Council in December 1997, the Ministers of the Member States participating in the Euro-area may meet informally among themselves to discuss issues connected with their shared specific responsibilities for the single currency. Matters of common interest will be discussed by Ministers of these Member States in the so-called "Eurogroup" meetings. Nevertheless, any binding decisions must be taken by the ECOFIN Council (finance ministers of all Member States) in accordance with the procedures laid down in the E.C. Treaty.[95] This approach might change in the future. The controversial Article III (88-90) on an ECOFIN Council for the Euro-zone in the Draft Constitution for Europe provides that economic coordination measures relating to the States participating in the Euro-zone may only be adopted by Council members representing Euro-zone States.[96] However, this proposal has been severely criticized by Member States outside the Euro-zone.

The new Member States must show their adherence to the aims of EMU. Compliance with the relevant parts of Title VII of the E.C. Treaty and the other EMU *acquis* imply:

- treatment of economic policies as a matter of common concern and coordination of economic policies between the Member States through participation in Community procedures;[97]
- avoidance of excessive government deficits and adherence to the relevant provisions of SGP;[98]
- compliance of the national central bank's statutes with the

94. *See id.*

95. Resolution of the European Council of 13 December 1997 on economic policy coordination in Stage Three of Economic and Monetary Union and Treaty Articles 109 and 109(b), Luxembourg, Dec. 13, 1997, E.U. BULL., no. 12, at 17 (1997) [hereinafter Luxembourg Resolution].

96. *See* Draft Treaty Establishing a Constitution for Europe, art. III (88-90), O.J. C 169 (2003).

97. *See* E.C. Treaty, *supra* note 4, arts. 98 & 99, O.J. C 325/33.

98. *See id.* art. 104.

E.C. Treaty and the Statute of ESCB;[99]
- progress towards the achievement of a high degree of sustainable convergence;[100]
- treatment of exchange rate policies as a matter of common interest and, possibly, participation in the exchange rate mechanism.[101]

The Member States must conduct their economic policies with a view to achieving the Article 2 objectives and in the context of Article 98 of the E.C. Treaty.[102] Under Article 99 of the E.C. Treaty, Member States agree to "regard their economic policies as a matter of common concern" and coordinate them in accordance with the broad guidelines on economic policy established by the ECOFIN Council[103] acting by qualified majority on the basis of conclusions reached by the European Council.[104] This procedure begins each Spring, when all Member States submit their drafts of the subsequent year's budgets and economic forecasts to the Commission for review.[105] On the basis of the Commission's analysis and recommendations, the ECOFIN Council adopts draft economic policy guidelines for the Community and each Member State and submits them to the European Council for conclusions. E.C. Treaty Article 99(3) and (4) then set up a multilateral surveillance procedure[106] within the Council in order to monitor the consistency of economic policies of the Member States with the aforementioned guide-

99. *See id.* art. 109.

100. *See id.* art. 121.

101. *See id.* art. 124.

102. *See* E.C. Treaty, *supra* note 4, arts. 2 & 98, O.J. C 325/33.

103. The Luxembourg European Council in December 1997 in its resolution on economic policy coordination declared that under the terms of the E.C. Treaty, the ECOFIN Council is the center for the coordination of the Member States economic policies and is empowered to act in relevant areas. *See* Luxembourg Resolution, *supra* note 95. In particular, ECOFIN Council is the only body empowered to formulate and adopt the economic policy guidelines which constitute the main instrument of economic coordination. *See id.*

104. The Treaty requires all Member States, whether or not they are included in the final stage of Monetary Union, to submit to a process of economic policy coordination, a process that significantly restricts unilateral national economic decision making. *See* E.C. Treaty, *supra* note 4, art. 99, O.J. C 325/33.

105. *See* Economic Surveillance Regulation, *supra* note 84, art. 4.

106. Pipkorn comments that this procedure is inspired by Decision 9/141 EEC of the Council on progressive convergence, O.J. L 78/23 (1990). *See* Pipkorn, *supra* note 6, at 273.

lines.[107] If the Member State's economic policies are inconsistent with the guidelines or risk jeopardizing the proper functioning of EMU, the Council may make any necessary recommendations public.[108] Article 99(5) enables the Council to adopt detailed rules for surveillance procedures pursuant to Article 252 of the E.C. Treaty. Under Article 100 of the E.C. Treaty, the Council may decide upon the measures appropriate to the economic situation, particularly when severe difficulties arise in the supply of certain products.[109]

In order to ensure the proper functioning of EMU and facilitate maintenance of price stability, provisions of the E.C. Treaty also limit certain financial activities of EU and Member States. Thus, Article 101 prohibits any direct public sector financing by the central banks, and Article 102 prohibits privileged access of the public sector to financial institutions. Finally, Article 103 provides that neither EU nor any Member State will be liable for, or assume commitments of, the Governments of the (other) Member States, or of public bodies at a lower level than that of the central Government.[110]

Not only must the new Member States immediately join in the economic coordination governed by E.C. Treaty Article 99, but they must strive to avoid excessive governmental deficits pursuant to E.C. Treaty Article 104.[111] Avoiding excessive deficits is one of the principal convergence criteria that must be satisfied before a State can join the third stage of EMU.[112] Pursuant to Article 104 of the E.C. Treaty, the Commission has the duty to monitor Member States' compliance with the Council's guidelines on budgetary discipline and makes judgments on the existence or otherwise of excessive deficits. The Commission uses

107. *See* SMITS, *supra* note 6, at 69-74; *see also* BERMANN ET AL., *supra* note 10, at 1214-15 (2002).

108. *See* E.C. Treaty, *supra* note 4, art. 99(4), O.J. C 325/33.

109. *See id.* art. 100.

110. *See id.*

111. Excessive Deficit Procedure ("EDP") is set out in Article 104 of the E.C. Treaty and the Protocol on the EDP, which is annexed to the E.C. Treaty. *See* E.C. Treaty, *supra* note 4, art. 104, O.J. C 325/33; *see also id.*, Protocol 20 on the Excessive Deficit Procedure [hereinafter EDP Protocol], which supplements Article 104.

112. Member States in the second stage of EMU shall in accordance with Article 116, E.C. Treaty, endeavor to avoid excessive government deficit only. *See* E.C. Treaty, *supra* note 4, art. 116, O.J. C 325/33.

two criteria for this task:[113]

- Whether the ratio of the planned or actual government deficit to gross domestic product ("GDP") exceeds three percent. Deficits above this limit will be considered excessive except when temporary and due to exceptional circumstances; and
- Whether the ratio of government debt to GDP exceeds sixty percent, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The Member States which satisfied the convergence criteria and entered the final stage of EMU, thus joining the centralized monetary policy of ECB and accepting the Euro as their currency, obviously should continue relatively strict budgetary policies and continue to avoid excessive deficits. For this reason, the European Council at Amsterdam in June 1997, endorsed the famous Stability and Growth Pact ("SGP"),[114] intended to ensure ongoing governmental budgetary discipline.[115]

The SGP commenced on January 1, 1999, when eleven Member States achieved stage three of EMU. The SGP essentially consists of two Council Regulations.[116] The first regulation supplements the economic coordination procedures set out in E.C. Treaty Article 99.[117] This is Council Regulation 1466/97,[118] commonly called the "Multilateral Surveillance Regulation." The Regulation prescribes a system for the review by the Commission and the Council of each State's annual and multi-annual

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113. These criteria are derived from the EDP Protocol. *See* EDP Protocol, *supra* note 111.

114. *See* Resolution of the European Council, O.J. C 236 (1997) (on the Stability and Growth Pact).

115. *See, e.g.*, BERMANN ET AL., *supra* note 107, at 1218 (stating "SGP was intended to insure that Member States would continue strict monetary policies and budgetary discipline after they entered to final stage of EMU").

116. A 1997 Amsterdam European Council Resolution provides guidance to the Member States, the Commission and the Council on the application and implementation of SGP. The States committed themselves to the medium-term target of achieving budgets that are "close to balance or in surplus." The idea is that attaining such a position would give the Member States a safety margin which would allow them to deal with cyclical fluctuations, while always keeping the government deficit below the reference value of three percent of GDP. *See* Resolution of the European Council on the Stability and Growth Pact, O.J. C 236 (1997).

117. *See supra* notes 101-09 and accompanying text.

118. *See* Council Regulation No. 1466/97, O.J. L 209/1 (1997) (on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies) [hereinafter "Multilateral Surveillance Regulation"].

budgetary and economic forecasts, whether the State is within the Euro-zone, or still outside of it.[119] One of the Regulation's goals is to prevent the emergence of an excessive deficit at an early stage. To this end, it establishes two key preventative measures:

- regular surveillance of Member States' respect of budgetary commitments;[120] and
- early warnings in the event of non-respect of budgetary targets.[121]

The main tools of multilateral surveillance are the Member States' annual stability[122] or convergence programs.[123] The Regulation defines the contents of these programs and sets out rules for their submission, examination and monitoring. In these programs, Member States set out their short- and medium-term budgetary strategies to reach and sustain budget positions that are "close to balance or in surplus."[124] Along with the adjustment path towards meeting the medium-term budgetary objective of the SGP, Member States also submit the expected path of the general governmental debt ratio.[125] The Member States submit their programs to the Commission at the end of each calendar year.[126] The Commission then assesses them and, on the basis of the Commission's recommendation, the Council delivers an opinion.[127] In the event of a significant divergence of the budgetary position of a Member States from the medium-term budgetary objective, or the adjustment path towards it, the second preventive measure can be activated. This procedure is referred to as the early-warning mechanism.[128] It involves the

119. Member States in the Euro-zone submit stability programs; Member States outside the Euro-zone submit convergence programs. In contrast to stability programs, the convergence programs also deal with monetary policy and aim at achieving sustained convergence.

120. *See* E.C. Treaty, *supra* note 4, arts. 5 & 9, O.J. C 325/33.

121. *See id.* arts. 6 & 10.

122. *See id.* art. 3.

123. *See id.* art. 7.

124. *Id.* arts. 3(2)(a) & 7(2)(a).

125. Member States in Euro-zone submit stability programs; Member States outside the Euro-zone submit convergence programs. In contrast to stability programs, the convergence programs aim to achieve sustained convergence in order to ultimately join the Euro-zone.

126. *See* Economic Surveillance Regulation, *supra* note 84, arts. 4 & 8.

127. *See id.* arts. 5 & 9.

128. *See id.* arts. 6 & 10.

Council, on the basis of a Commission recommendation, addressing an early warning to the Member State, urging and recommending corrective actions.[129]

Council Regulation No. 1467/97[130] provides a detailed clarification of the sanction mechanisms, building on the Excessive Deficit Procedure Protocol, as set out in Article 104 of the E.C. Treaty. Once the deficit of a Member State goes above three percent of Gross Domestic Product ("GDP"), the Council must conclude that the country has an excessive deficit, unless the breach is due to exceptional circumstances, is temporary and the deficit remains close to the reference value. The Regulation defines what is meant by "exceptional and temporary" for this purpose, thus essentially indicating when the three percent limit may be exceeded.[131]

The Commission has to apply rather strict standards in order to qualify a deficit over the reference value as exceptional. As a rule, a deficit is automatically considered exceptional by the Commission only if the Gross Domestic Product ("GDP") of the State involved fell by at least two percent fell by at least two percent of GDP in the year in question. In addition, the Council may consider a deficit exceptional even if the State's annual GDP fell by less than two percent, in the light of the abruptness of the downturn or the accumulated loss of output relative to past trends.

The Council has, accordingly, some discretionary room in deciding whether a deficit owing to a severe economic downturn is exceptional and hence not excessive. Where an excessive deficit is judged by the Council to exist, the Member State con-

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129. The Commission explains the early-warning mechanism as follows: "The purpose of the early warning is to send a signal to the Member State concerned that the budgetary targets, which had been endorsed by the Council, have not been adhered to. It also gives the Member States sufficient time to take corrective measures if appropriate so as to avoid budget deficits approaching the [three percent] of GDP reference value. As such, it is an important signaling device on the need for enhanced vigilance. The SPG foresees a clear sequencing of events, with an early warning being issued prior to recourse being made to the dissuasive elements of the SGP, namely the excessive deficit procedure." COMMISSION OF THE EUROPEAN COMMUNITIES, PUBLIC FINANCES IN EMU—2002, EUROPEAN ECONOMY 45-46 (2002), *available at* http://europa.eu.int/comm/economy_finance/publications/European_economy/public_finances2002_en.htm (last visited Oct. 12, 2004).

130. Council Regulation No. 1467/97, O.J. L 209/6 (1997) (on speeding up and clarifying the implementation of the excessive deficit procedure).

131. *See id.* arts. 2(2) & (3).

cerned must take measures that aim to bringing deficits below the three percent of GDP reference value. A repeated failure to take corrective measures could eventually lead to the imposition of sanctions, which ultimately take the form of fines up to one-half of one percent of GDP.[132] The Regulation specifies the rules on sanctions, together with guidance on their application, and sets deadlines for implementing the different steps in the procedure. It sets a deadline for decisions on sanctions and requires a non-interest-bearing deposit from the Member States concerned, which is to be converted into a fine if, two years later, the excessive deficit persists.[133] When there is progress in correcting the excessive deficit, sanctions can be abrogated.[134] The request for a deposit, however, will be lifted only once the Council concludes that the excessive deficit has been corrected and fines are never reimbursed.[135]

According to the Commission, the new Member States will be quickly and fully integrated into the existing EU procedures of budgetary surveillance and economic policy coordination, applying the same rules to the new Member States as to existing Member States. For example, they were immediately included in the 2004 update of the national economic policy guidelines.[136] The Council is to start providing country-specific recommendations and the new Member States will for the first time be included in the Implementation Report on the economic policy guidelines in January 2005.

With respect to budgetary surveillance, the new States are supposed to comply with the reporting deadlines (before March 1 and before September 1) on fiscal notifications in 2004.[137] Indeed, if necessary, the Commission could start an EDP process concerning a new State.[138] However, since the new Member

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132. *See id.* arts. 6-7, 11-12.

133. *See id.* art. 13.

134. *See id.* art. 14.

135. *See id.* art. 15.

136. *See* EUROPEAN COMMISSION, COMPREHENSIVE MONITORING REPORT ON THE STATE OF PREPAREDNESS FOR EU MEMBERSHIP OF THE CZECH REPUBLIC, ESTONIA, CYPRUS, LATVIA, LITHUANIA, HUNGARY, MALTA, POLAND, SLOVENIA AND SLOVAKIA 21 (2003), *available at* http://europa.eu.int/comm/enlargement/report_2003/pdf/summary_paper 2003_full_en.pdf (last visited Oct. 12, 2004) [hereinafter EUROPEAN COMMISSION, COMPREHENSIVE MONITORING REPORT].

137. *See id.*

138. *See id.*

States have the status of the Member States with derogation,[139] the provisions of EDP do not apply fully. If, as part of the monitoring and surveillance process outlined in Council Regulation 1466/97, the Council, on the basis of a Commission recommendation, would conclude that a new Member State's budgetary position significantly diverged from its medium-term budgetary target, the Council could address an "early warning" recommendation to the new Member State to take the necessary adjustment measures to prevent the occurrence of an excessive deficit.[140]

If the divergence persisted or worsened, the Council would make a recommendation to take prompt corrective measures.[141] In the event of the Council finding that the candidate country had an excessive deficit under Regulation 1467/97, the Council would make a recommendation to the candidate country with a view to bringing the situation to an end within a given period. As a Member State with a derogation, however, the new Member State could not be sanctioned for running an excessive deficit or for any other budgetary position that did not comply with the rules of SGP.

The new Member States submitted their first Convergence Programs by May 15, 2004, essentially an update of their Pre-Accession Economic Plans ("PAEPs").[142] The new Convergence Programs should be submitted, in line with the Council's Code of Conduct,[143] between mid-October and December 1, 2004.[144]

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139. *See* E.C. Treaty, *supra* note 4, art. 121, O.J. C 325/33.

140. *See* Economic Surveillance Regulation, *supra* note 84, art. 10(2).

141. *See id.* art. 10(3).

142. *See* EUROPEAN COMMISSION, COMPREHENSIVE MONITORING REPORT, *supra* note 136, at 21.

143. "Code of Conduct on the Content and Format of Stability and Convergence Programs," endorsed by the ECOFIN Council on July 10, 2001, incorporates the essential elements of Council Regulation 1466/97 into guidelines to assist the Member States in drawing up their programs. *See* Press Release, ECOFIN Council, Results of the Council of Economics and Finance Ministers, 10 July 2001 - Taxation and Financial Services, MEMO/O1/261 (2001). The guidelines set out in the Code constitute a code of good practice and a checklist to be used by Member States in preparing stability or convergence programs. *See id.* The Code encompasses a set of standardized tables. *See id.* It also suggests that the annual updates are all submitted in the autumn, within a period of one and a half months. *See id.* The aim of the guidelines is to facilitate the evaluation of the programs by the Commission and Council. *See id.*

144. *See* EUROPEAN COMMISSION, COMPREHENSIVE MONITORING REPORT, *supra* note 136, at 22.

C. *ESCB — The Revision in Structure of the Governing Council of ECB*[145]

As described above, the highest decision-making body of the Euro-system is the Governing Council of ECB, which consists of the six members of ECB's Executive Board and the governors of those NCBs, whose countries have adopted Euro. In order to facilitate efficiency of the Governing Council, the European Council adopted a decision amending the Statute of ESCB/ECB with regard to voting rights.[146]

The procedure for its adoption was as follows.[147] On December 20, 2002, ECB announced that it was going to put forward a recommendation for reform of the voting procedures in the Governing Council. The Governing Council formally adopted a proposal on February 3, 2003, just two days after the Nice Treaty came into force.[148] On February 19, 2003 the Commission issued its Opinion on the ECB proposal.[149] On March 10, 2003, the Economic and Monetary Affairs Committee of the European Parliament rejected the ECB's proposal.[150] On March 21, 2003, the European Council endorsed the ECB proposal and agreed to its proposed reform of the voting modalities of the Governing Council.[151]

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145. *See* HOUSE OF LORDS, SELECT COMMITTEE ON EUROPEAN UNION, FORTY-SECOND REPORT, 2003, at 37–45, *available at* http://www.publications.parliament.uk/pa/ld200203/ldselect/ldeucom/170/17001.htm (last visited Oct. 12, 2004) [hereinafter HOUSE OF LORDS, FORTY-SECOND REPORT].

146. *See* Decision of the Council, 2003/223/EC, O.J. L 83/66 (2003) [hereinafter ESCB/ECB] (meeting in the composition of Heads of States or Governments on March 21, 2003; on amendment to Article 10.2 of the Statute of the European System of Central Banks and European Central Bank). It is regrettable that the enabling clause provided by the Treaty of Nice was drawn so tightly as to prevent the Commission and the ECB from considering more radical proposals for reform of the Governing Council and instead limited them to considerations of its voting procedures.

147. *See* HOUSE OF LORDS, FORTY-SECOND REPORT, *supra* note 145.

148. The Treaty of Nice was signed on March 10, 2001 and came into force on February 1, 2003. *See* Treaty of Nice amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts, Mar. 10, 2001, O.J. C 80/1 (2001).

149. *See* EUROPEAN COMMISSION, COMPREHENSIVE MONITORING REPORT, *supra* note 136, at 84.

150. *See* Documents for the meeting of the Economic and Monetary Affairs Committee of the European Parliament on March 10, 2003, *available at* http://www.europarl.eu.int/meetdocs/committees/econ/20030310/ECON20030310.htm (last visited Nov. 1, 2004).

151. *See* ESCB/ECB, 2003/223/EC, O.J. L 83/66 (2003).

The new voting system is based on rotation of the voting rights of the NCB governors, with only the six members of the Executive Board retaining a permanent vote.[152] The frequency of the rotation will not be the same for all governors, with different groups being created based on the GDP of the country concerned, slightly modified by a formula based on the size of the financial industry sector.[153]

The revision will happen in two stages. When there are more than fifteen, but fewer than twenty-two Member States, the Member States of the Euro-area will be divided into two groups.[154] In this first stage of reform, the five largest Member States (measured by the ranking indicator) will form the first group, having four votes. The remaining smaller countries will share the other eleven votes. In the second stage[155] of reform (to be implemented from the point when the Euro-area expands to twenty-two or more Members), the Member States will be divided into three groups. The first group will remain confined to the five largest Member States, who will still share four votes. The second group will comprise the next largest countries; half the total number of Euro-area Member States, rounding up if necessary; these countries will share eight votes. The third group will contain the remaining six to nine countries, and will have three votes.

The described reform is very controversial and was subject of severe criticism.[156] The principal criticisms can be summarized as follows:[157] (1) the Governing Council would still be too large, making it inefficient; (2) the proposal was unclear on a number of points; (3) the proposal is far too complex and is therefore not transparent; (4) the proposal emphasizes nationality as the basis for who can vote; and (5) the speed by which the proposal was adopted by the Council did not allow the requisite time for parliamentary scrutiny.

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152. *See id.*

153. *See id.* ¶ 1.

154. *See id.* ¶ 2.

155. *See id.* ¶ 2.

156. *See, e.g.*, Daniel Gros, *Reforming the Composition of the ECB Governing Council in view of Enlargement: An Opportunity Missed!*, 32 C.E.P.S. POL'Y BRIEFS, May 2003, *available at* http://shop.ceps.be/BookDetail.php?item_id=1028 (last visited Oct. 12, 2003).

157. *See* HOUSE OF LORDS, FORTY-SECOND REPORT, *supra* note 145, at 40-42 (providing detailed analysis of critics of reform of the voting procedures in the Governing Council of the ECB).

Criticisms of reform of the voting procedures in the Governing Council are all substantial and well-founded. The most troubling point of the reform, which touches on one of the core principles of Euro-system,[158] is the threat to independence of the ECB's decision-making processes from national considerations. From the Article of the new Member States, the most disturbing issue is the use of the relative size of the financial sector as a ranking indicator, since their financial sectors are considerably smaller than the ones of the current Euro-zone States.

III. *CONVERGENCE CRITERIA*

To ensure the sustainable convergence for the single monetary and exchange rate policy, the E.C. Treaty sets four convergence criteria[159] which must be met by each Member State before adoption of the Euro. The convergence criteria consist of: (1) the achievement of a high degree of price stability; (2) the durability of convergence being reflected in the long-term interest-rate levels; (3) the sustainability of the government financial position; and 4) the observance of the normal fluctuation margins.

The Commission and the ECB shall prepare reports for the Council which will examine the compatibility of each Member State's national legislation with the provisions of the E.C. Treaty. Reports will also examine the fulfillment of mentioned economic convergence criteria as well as several other factors, such as "the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labor costs and other price indices."[160]

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158. The NCB Governors sit on the Governing Council "in a personal and independent capacity," not as national representatives. *See* Explanatory Memorandum of the ECB's Recommendation to amend the voting modalities of the Governing Council, O.J. C 29 (2003).

159. Smits identifies five conditions; besides the four economic converge criteria, he also focuses on the "legal convergence criteria" as set out in Article 121 (1) in connection with compatibility of national legislation with EMU provision of the E.C. Treaty, especially regarding the independence of the national central banks and their ability to operate in the ESCB framework. *See* SMITS, *supra* note 6, at 121-23.

160. EUROPEAN CENTRAL BANK, POLICY POSITION OF THE GOVERNING COUNCIL OF THE EUROPEAN CENTRAL BANK ON THE EXCHANGE RATE ISSUES RELATING TO THE ACCEDING COUNTRIES 6, Dec. 18, 2003, *available at* http://www.ecb.int/pub/pdf/policyaccexchangerateen.pdf (last visited Oct. 12, 2004) [hereinafter EUROPEAN CENTRAL BANK, POLICY POSITION].

From the perspective of the new Member States, the most important issues in connection with convergence are whether, when adopting the Euro, they will be subject to the existing convergence criteria, and how the convergence criteria will be applied. Regarding the first question, there seems to not be much space for maneuvering. Although the Protocols[161] that specify in detail the convergence criteria generally set down by Article 121 may be modified by the Council acting unanimously, it is unlikely that the existing convergence criteria would be substantially relaxed for the new Member States. According to former President of the Executive Board of ECB Willem Duisenberg, "the Euro-system should support equal treatment as a key feature of the accession process. This implies that objective and uniform criteria should apply, in turn, to accession, participation in ERM II and adoption of the Euro."[162]

Regarding the issue of the application of convergence criteria to new Member States, it must be stressed that although the four economic convergence criteria seem to be very precise, they contain a number of ambiguities.[163] Since the entrance of the Community into the third stage of EMU, the relevant provisions become even more unclear due to the fact that they were primarily drafted to that end. In the following paragraphs, this Article shall try to indicate the most important issues in this regard.

A. *The Achievement of a High Degree of Price Stability*

The first criterion[164] requires that a Member State has a price performance that is sustainable; an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than one and one-half percentage points that of, at most, the three best performing Member States in terms of price stability.[165]

The most ambiguous part of this provision is the definition

161. *See* Protocol on Convergence Criteria, *supra* note 89; *see also* Protocol No. 18 on EDP.

162. *See* Duisenberg, *supra* note 64, at 14.

163. *See* Kenen, *supra* note 59, at 360.

164. As set out in Article 121(1) and further detailed in Article 1 of the Protocol on Convergence Criteria. *See* Protocol on Convergence Criteria, *supra* note 89, art. 1 & art. 121(1).

165. Regulation 2494/95 is very important for ensuring the accuracy of the inflation statistics necessary for assessing satisfaction of the inflation convergence criterion on harmonization indices of consumer prices *See* O.J L 257/1 (1995).

of the "three best performing Member States in terms of price stability."[166] Since this provision was written before the transition of the Community to the third stage of EMU, it is not clear who is in the pool of the "three best performing Member States,"[167] i.e., is it all Member States, Member States in Euro-zone, Member States outside Euro-zone, or Member States outside Euro-zone without Denmark and the United Kingdom?[168] Neither the E.C. Treaty nor the Protocol on Convergence Criteria makes any reference in this regard. For the new Member States, it would be easiest to achieve the inflation rate criterion if the Member States outside Euro-zone without Denmark and the United Kingdom is the reference group. Nevertheless, it is not very plausible that the ECOFIN Council[169] as the authorized body would adopt such interpretation.[170]

B. *The Durability of Convergence Reflected in the Long Term Interest Rate Level*

The second criterion[171] requires that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. Since this criterion is closely

166. Smits also refers to other ambiguities in the language of this provision. *See* SMITS, *supra* note 13, at 124.

167. The pool in which the "three best Member States" are identified is very important for the new Member States, because it sets the scope for determining the inflation criterion.

168. Since the United Kingdom and Denmark Protocols grant them the ability to opt out, one could argue that they have a special status and therefore do not form part of a reference group.

169. The ECOFIN Council is the Council in its composition as the Ministers for Finance. *See, e.g.*, BERMANN ET AL., *supra* note 107, at 35.

170. It is not surprising, therefore, that the new Member States and various research institutions are using all Member States as a reference group. *See, e.g.*, SLOVENIAN GOVERNMENT AND SLOVENIAN CENTRAL BANK, PROGRAM FOR ERM II ENTRY AND ADOPTION OF EURO 24, Nov. 2003, *available at* http://www.bsi.si/html/eng/publications/Europe/ERM2_BS_Vlada_200311.pdf; 1 DEUTSCHE BANK RESEARCH, E.U. MONITOR, Apr. 2003, *available at* http://www.dbresearch.de/PROD/DBR_INTERNET_EN-PROD/PROD0000000000053172.PDF (last visited Nov. 1, 2004).

171. *See* E.C. Treaty, *supra* note 4, art. 121(1); *see also* Protocol on Convergence Criteria, *supra* note 89, art. 1.

related to the inflation rate criterion, the above discussion on reference group for "three best performing Member States" also entirely applies here.

C. *The Sustainability of the Government Financial Position (Budget Deficit and Public Debt)*

The criterion on sustainability of the government financial position[172] is comprised of two additional criteria. The criterion on the government budgetary position requires that a Member State have a ratio of planned or actual government deficit to GDP that does not exceed 3%, unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or
- the excess of the reference value is only exceptional and temporary and the ratio remains close to the reference value.

The criterion on government debt requires that a Member State has a ratio of government debt to GDP that does not exceed 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

These two criteria were by far the most difficult[173] at the time of the transition to the third stage of EMU and the creation of the single currency (the Euro) in 1999. Due to their importance, it is understandable that the drafters of the relevant E.C. Treaty provisions gave them a certain degree of flexibility and discretion to the relevant decision making bodies. These discretionary powers and their usage by the Commission and the Council in 1998 were the subject of severe criticism by some commentators.[174] Although the criterion on the government budgetary position remains the most difficult criterion to achieve for several new Member States (according to the available data[175] the new Member States should not have problems

172. As set out in Article 121(1) and 104 further detailed in Article 2 of the Protocol on Convergence Criteria and Protocol on EDP. *See* Protocol on Convergence Criteria, *supra* note 89, art. 2.

173. *See* BERMANN ET AL., *supra* note 107, at 1217.

174. *See, e.g.*, Beaumont & Walker, *supra* note 59, at 174-75.

175. EUROPEAN COMMISSION, EUROPEAN ECONOMY, ENLARGEMENT PAPERS NO. 14, EVALUATION OF THE 2002 PRE-ACCESSION ECONOMIC PROGRAMS OF NEW MEMBER STATES 16, Nov. 2002, *available at* http://Europa.eu.int/comm/economy_finance/publications/

with achieving the criterion on government debt), it seems that their application for the new Member States will be much less controversial as for existing members of the Euro-zone. There are several reasons for this situtation:

- the political implications of the decision that Member States will join the final stage of EMU and adopt the Euro were much stronger and crucial in 1998 when the creation of a single currency was at stake than it Will be when the new Member States try to adopt the Euro;
- when EMU is fully functioning, the need for new members will no longer be its first priority. Far more important is the stability and proper functioning of EMU. For monetary union to be workable, the government deficits should be kept at an acceptable level;
- all new Member States except Cyprus and Malta are transitional economies and therefore potentially more unstable than the economies of the current members of the Euro-zone;
- apart from the mentioned discretionary powers of the Commission and the Council, the subject criteria is fairly clear, i.e., government deficit should not exceed three percent of GDP and government debt to GDP should not exceed sixty percent; and
- the senior officials of ECB repeatedly stress the importance of the sustainable real convergence and rigorous application of the nominal convergence criteria. Thus, it is highly unlikely that the discretionary powers would be exercised in the case of the new Member States.

D. *The Exchange Rate Criterion and ERM II*

The final criterion[176] requires the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the EMS for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

It appears that this criterion is the most unclear, but also the

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enlargement_papers/elp14_en.htm (last visited Oct. 12, 2004) [hereinafter EUROPEAN COMMISSION, ENLARGEMENT PAPERS NO. 14].

176. As set out in Article 121(1) and further detailed in Article 3 of the Protocol on Convergence Criteria. *See* E.C. Treaty, *supra* note 4, art. 121(1); *see also* Protocol on Convergence Criteria, *supra* note 89, art. 3.

most important from the Article of the new Member States. Examining the wording of the E.C. Treaty and the Protocol, one can distinguish four fairly precise requirements related to the criterion: (1) the observance of normal fluctuation margins; (2) no severe tension; (3) the observance of time-frame (at least two years); and (4) no devaluation.

At the time the Maastricht Treaty (with provisions on EMU) was drafted, "normal fluctuation margins"[177] were ±2.25%.[178] At the time of the drafting of the Maastricht Treaty, no one could predict the dramatic events of 1992 and 1993 when speculation was rampant. In the efforts to defend the bands, some of the central banks lost large portions of their foreign reserves. In August 1993, in order to put an end to speculation the band was widened.[179] The new band allowed for 15% fluctuation above and below the parity. This situation caused problems with interpretation of the term "normal fluctuation margin." The major contradiction concerning the exchange rate criterion appeared between "the spirit" and the letter of the E.C. Treaty.[180]

On January 1, 1999 the EMS ceased to exist and ERM was replaced by the ERM II.[181] The standard fluctuation margin in

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177. *See* Resolution of the European Council, 6 E.C. BULL. (1978) (on establishment of the European Monetary System and related matters); *see also* BERMANN ET AL., *supra* note 107, at 1209-11.

178. As an exception to the rule, ± 6% fluctuation was allowed for some currencies: the Italian lira till 1990; the British pound; the Spanish peseta; and the Portuguese escudo.

179. *See* SMITS *supra* note 6, at 21.

180. According to Marcin Zogala, the spirit of the criterion was to prove that stable exchange rate could be maintained. The letter of the criterion, however, allowed the exchange rate to fluctuate within a 30%-wide band, which is difficult to identify with exchange rate stability. Moreover, the widening of the band in 1993 was meant to be a temporary measure with the expectation of returning to the narrow margins, which eventually was not the case. As a solution to this dilemma the Commission proposed the system be based on the so-called "median currency." The median currency was selected as the mid-point currency in this ranking. In the median currency approach, ERM currencies were allowed to fluctuate 15% above and below its central parity against other EU Member States, but the stability of exchange rates was assessed in the context of fluctuation margin of plus or minus two and one-quarter percent around the median currency. The Commission used the narrow band as an indicator. The breach of the plus or minus two and one-quarter percent margin was recognized as a possible "severe tension." *See* Marcin Zogala, *The Maastricht Exchange Rate Criterion: What Do We Know, What Do We Need to Know?, in* EASTWARD ENLARGEMENT OF THE EURO-ZONE - IMPACT ON TRADE, FDI AND CAPITAL MARKETS 43-44 (K. Zukrowska & D. Sobczak eds., 2003).

181. *See* Resolution of the European Council, *supra* note 114, O.J. C 236.

ERM II has been set at plus or minus fifteen percent.[182] Hence, in the new system there is no interpretation problem with the "normal" margin. Nonetheless, in the Convergence Reports of 2000 and 2002, the Commission still applied the narrow band as an indicator of severe tensions.[183] It appears therefore that Commission's interpretation of the fulfillment of this criterion requires the exchange rate to have been maintained within the fluctuating margin of plus or minus two and one-quarter percent around the central party (Euro) in ERM II.[184] In other words, to fulfill the exchange-rate convergence criterion, the currency must be part of ERM II yet stay within a range that is narrower than the standard ±15% fluctuation band. So, the maintenance of exchange-rate stability is closely linked to the ERM II, but the two terms are not interchangeable, as it is possible for a country to participate in ERM II and not yet fulfill (or even be heading towards fulfilling) the exchange-rate convergence criterion. The Commission's proposed application[185] of the exchange-rate con-

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182. *See id.*

183. The Commission expressed its standpoint on the fulfillment of the exchange-rate criterion in ERM II in its 2000 Convergence Report, Annex D, Article (D)(4) as follows:

- participation in the ERM II at the time of the assessment is mandatory;
- participation in the ERM/ERM II for at least two years is expected, although exchange rate stability during a period of non-participation before entering ERM/ERM II can be taken into account;
- no downward realignment of the central parity either in the ERM or in the ERM II within the two-year examination period; and
- exchange rate to have been maintained within a fluctuation band of plus or minus two and one-quarter percent around the currency's central parity against the Euro. An assessment of any deviation from the plus or minus two and one-quarter percent fluctuation band would have to take account the reasons for that deviation. A distinction is to be made between exchange rate movements above the two and one-quarter percent upper margin and movements below the two and one-quarter percent lower margin.

See EUROPEAN COMMISSION, 2000 CONVERGENCE REPORT, Annex D, art. (D)(4) (2000); *see also* Zogala, *supra* note 180, at 45.

184. This is also current understanding of Czech National Bank following consultations with competent EU and ECB authorities. *See* CZECH CENTRAL BANK, ERM II AND THE EXCHANGE-RATE CONVERGENCE CRITERION, INFORMATION MATERIAL FOR CZECH GOVERNMENT 3 (2003). Moreover, the issue of absence of "severe tensions" is generally addressed: 1) by examining the degree of deviation of exchange rates from the ERM II central rates against the Euro; 2) by using indicators such as short-term interest rate differentials vis-à-vis the Euro-area and their evolution; and 3) by considering the role played by foreign exchange interventions. *See* EUROPEAN CENTRAL BANK, POLICY POSITION, *supra* note 160, at 6.

185. However, the ECB's position on this issue is much less clear. According to the Member of the Executive Board of ECB, Tommaso Padoa-Schioppa, the width of the

vergence criterion is not based on any official decision of the ECOFIN Council or the European Council. Theoretically, since the Council makes the final decision on when an applicant qualifies for adoption of the Euro, the Council could disregard the Commission's view and confirm an applicant even though it would not fulfill the exchange-rate convergence criterion as interpreted by the Commission. However, such a decision is not very plausible. Because of the potential sensitivity of the Eurosystem to forthcoming post-transitional economies, the Council would have to have a very strong "political" reason to clash with the Commission on such decision. At this time, no political reason is apparent. Statements of the senior officials of relevant EU bodies indicate that no considerable concessions (as was the case in 1998) will be granted to the new Member States.

1. Required Duration of the ERM II Membership

Membership in ERM II is voluntary and is not subject to any criteria. There are no preconditions to be fulfilled to join the ERM II mechanism.[186] The important question is whether formal participation in the ERM II is required along with actual exchange rate stability. Neither the E.C. Treaty nor the Protocol on Convergence Criteria expressly requires formal membership in the ERM II, but requires respect for the normal fluctuation

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fluctuation band within ERM II will not prejudice the assessment of the criterion of exchange rate stability. *See* Tommaso Padoa-Schioppa, Exchange Rate Issues Relating to the Acceding Countries, Speech, Feb. 2, 2004, at 7. Although there is a great demand for being very specific in all respects already at this stage, the added precision would not only run counter to the institutional framework in place, but would also imply undue rigidity, leading to mechanistic assessments that would benefit no one. The reluctance to be more precise or to pre-empt the decision-making, which ultimately involves not only a quantitative but equally so a qualitative assessment, has to be seen in this light. *See id.*

186. According to the policy position of the Governing Council of ECB, the decisions regarding the timing of entry and duration of participation in ERM II should be based on the extent to which participation in the mechanism enhances the prospects of achieving a lasting convergence of economic fundamentals. To determine their optimal strategy regarding ERM II and later Euro adoption, the new Member States (then Member States) will have to consider the specific circumstances of their country, including their overall monetary integration strategy, monetary and exchange rate policy framework and fiscal position. When applying for ERM II the new Member States should, given the risks implied by premature rigidity of the exchange rate, consider the degree of achieved convergence. *See* EUROPEAN CENTRAL BANK, POLICY POSITION, *supra* note 160, at 4.

margins of that mechanism for a two year period.[187] Nevertheless, the formal position of EMI and the Commission was to require that the ERM membership applies.[188] This position became questionable with the decision to allow Finland and Italy to join the third stage of EMU in 1998. The Italian lira rejoined the ERM on November 25, 1996, which results in approximately fifteen months of participation by the end of February 1998. The Finish markka joined the system on October 14, 1996, and by the end of February 1998 had been participating in the ERM for about sixteen months. It is true though that after joining the system, both currencies satisfied the lower two and one-quarter percent margin.[189]

In light of mentioned developments, the Commission in the Convergence Report 2000 stated *ex post facto* that during examination of exchange rate criterion, it took into account the following conditions: (1) participation in the ERM II at the time of the assessment is mandatory; (2) participation in the ERM II for at least two years is expected; and (3) exchange rate stability before entering ERM II can be taken into account. The Commission, however, also clarified that this was the framework used in current examination. In addition, the Governing Council of ECB[190] recently indicated that new Member States must not have devalued their currency's central rate against the Euro on its own initiative within required period. It also indicated that a minimum stay of two years in the mechanism (prior to the convergence assessment that leads to final adoption of the Euro), is expected. The principle of equal treatment would require that

187. The Protocol stipulates that the two-year membership in ERM should be calculated up to "examination," not up to Euro-zone entry. *See* Protocol on Convergence Criteria, *supra* note 89.

188. Zogala, *supra* note 180, at 46.

189. Convergence Reports 1998 were prepared in March so that the two-year period under examination covered March 1996 to February 1998. In the Convergence Reports of the Commission and EMI, however, the period prior to ERM entry was taken into account as well. At the beginning of the two year examination period, both lira and markka were under depreciating pressures. In March 1996, the downward deviation of the lira reached the maximum of 7.6% below its future central rate. In the case of the Finnish markka, its maximum downward deviation below its future central rate reached 6.5% in April 1996. Nevertheless, the conclusion of the Commission was that both Italy and Finland fulfilled exchange rate criterion. *See id.* at 46-47; *see also* Beaumont & Walker, *supra* note 59, at 177.

190. *See* EUROPEAN CENTRAL BANK, POLICY POSITION, *supra* note 160, at 4.

the same rules apply to the new Member States.[191] Nonetheless, as already mentioned, the senior officials of the ECB and the Commission also continue to emphasize the need and importance of the sustainable real convergence.[192] They warn against treating ERM II as simply a waiting room without making any effort to foster the convergence of the real side of the economy.[193] Hence, it is extremely doubtful whether new Member States will be allowed to adopt the Euro after participation of fewer than two years in ERM II.[194]

2. The Formal Procedure to Join ERM II

Participation in ERM II is voluntary for Member States outside the Euro-area. As explained above, however, the "substantive" process for ERM II entry and the subsequent irrevocable fixing of the currencies of the new Member States against the Euro will, begin before the formal procedures to join the ERM II. The key procedural feature of ERM II is the multilateral approach to making decisions on issues linked to its functioning.[195] Such decisions are taken 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. The ministers and governors of the central banks of the non-Euro-area Member States not participating in ERM II take part but do not have the right to vote in the procedure.[196] Such decisions are preceded by a procedure involving the Commission and EFC.[197] For the new Member States, the first step (which is not, however, a direct part of the procedure for participation in ERM II) is accession to the Agreement between the ECB and the NCBs of the non-Euro-area Member States.[198] It is possible to

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191. "The assessment should be based on the principle of equal treatment with the current Member States. Therefore, no additional criteria for the adoption of the Euro by the new Member States will be introduced, while at the same time there will be no relaxation of the criteria laid out in the Treaty, including the criteria concerning the sustainability of nominal convergence." *Id.* at 6.

192. The main deficiency of real convergence is its lack of precision, which gives the additional room for interpretation and is used as a tool to further delay the process of inclusion of the new Member States in Euro-area.

193. *See* Padoa-Schioppa, *supra* note 185, at 5.

194. *Cf.* EUROPEAN CENTRAL BANK, POLICY POSITION, *supra* note 160.

195. *See* Resolution of the European Council, *supra* note 169.

196. *Id.* ¶ 2.3.

197. *See* E.C. Treaty, *supra* note 4, art. 105, O.J. C 325/33.

198. *See* Agreement of September 1, 1998 between the European Central Bank and

sign the agreement and request entry into ERM II at a later date.

The procedure itself consists of several steps.[199] First, the Exchange-Rate Procedure may be initiated by a confidential joint request from a minister and a NCB governor from a country requesting entry into ERM II (as well as from the decision-making bodies), addressed to the ECOFIN minister of the country holding the EU Presidency. At the same time, the EFC member(s) from the initiating country inform the President and the Secretary of the EFC. The Exchange-Rate Procedure takes place at a confidential meeting of the ERM II Committee. When consensus can be reached on the central rate and fluctuation band, confirmation of agreement from the authorities of the home countries is allowed.

Next, the ERM II Committee is called by the EFC President. Its members are the EFC members from national administrations, the EFC members from the non-Euro-area NCBs, two representatives of the ECB, two representatives of the Commission, the President of the alternates, the EFC President and Secretary, and two members of the EFC Secretariat. The meeting is a kind of "pre-screening" of the countries applying to introduce the Euro (the results of the meeting serving as the basis for the "Exchange-rate Procedure"). The Committee discusses and determines whether the macroeconomic framework of the ERM II applicant country is consistent with ERM II entry, notably in connection with the BEPGs and the SGP. The Committee also discusses the appropriate central rate and fluctuation band. The decision-making bodies of the ECB have meetings prior to the Committee meeting on the central rate and fluctuation band.

Third, the ERM II Exchange-rate Meeting is called by the ECOFIN minister of the Member State holding the EU Presidency in following composition: the ministers of the Euro-area Member States; the ministers and the central bank governors of

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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, O.J. C 345/05, at 6-12 (1998).

199. Since "Procedural steps to allow participation in ERM II," (a document prepared by the European Commission for the High Level Meeting in Athens on May 28, 2003), a document laying down the procedure to join EMR II is not publicly accessible, the summary of the subject procedure is based entirely on one Nation's publication. *See* CZECH CENTRAL BANK, ERM II AND THE EXCHANGE-RATE CONVERGENCE CRITERION, INFORMATION MATERIAL FOR CZECH GOVERNMENT 7-8 (2003), *available at* http://www.cnb.cz/en/pdf/ERM_II_vlada_15_07_03_en.pdf (last visited Oct. 12, 2004).

the non-Euro-area Member States; the President of the ECB; representatives of the Commission; and the President and Secretary of the EFC. The ERM II Exchange-Rate Meeting adopts the final central rate and fluctuation band.

The final communiqué, in the name of EU, includes the following elements: (1) the party initiating the procedure and the parties making the decision; (2) the decision; (3) the central rate; (4) the fluctuation band; (5) the announcement on the economic policy of the Member State; and (6) a statement on the discussion of intervention points between the ECB and the NCB.

The time schedule for the whole process is not fixed but depends on the degree of agreement reached between the authorities of the Member State and the bodies of EU. While the procedure for joining ERM II may be initiated at any time by the Member State concerned and is not linked to specific calendar dates, the main features, notably the central rate and the width of the fluctuation band, have to be agreed upon among all parties involved in the mechanism. The entire process can be very quick and take just a few days (as in the case of Austria) or it can last for several months (as in the case of Denmark).

E. *Economic Situations of the New Member States in Light of Convergence Criteria*

As is evident from the following table,[200] currently no new Member State fulfills the economic convergence criteria. In addition, no new Member State has yet achieved full legal compatibility of its legislation with Article 109 of the E.C. Treaty and the Statute of ESCB/ECB.[201]

A look at the present performance in respect of the convergence criteria shows that the criteria still present considerable difficulty for most of the new Member States. This is true particularly for their budget deficits and partially for inflation. The

200. See EUROPEAN COMMISSION, REPORT FROM THE COMMISSION CONVERGENCE REPORT 2004 (2004), *available at* http://europa.eu.int/comm/economy_finance/publications/european_economy/2004/cr2004_en.pdf (last visited Nov. 02, 2004). As noted above, this Article was finished on September 1, 2004. The Commission's Convergence Report 2004 was published on October 20, 2004. *See id.* In order to ensure the accuracy of the available data, the data from the Commission's Convergence Report 2004 was inserted in this table. No other conclusions of the Convergence Report 2004 published by Commission and ECB are analyzed in this Article.

201. *See id.*

	Inflation % in August 2004	Interest rates 10 year yield in August 2004	Fiscal deficit % of GDP in 2003	Public debt % of GDP in 2003	Exchange rates (membership in ERM II)
Reference value	2.4	6.4	-3.0	60.0	2 years
Czech Republic	1.8	4.7	-12.6	37.8	no
Cyprus	2.1	5.2	-6.4	70.9	no
Estonia	2.0	4.6	3.1	5.3	June 28, 2004
Hungary	6.5	8.1	-6.2	59.1	no
Latvia	4.9	5.0	-1.5	14.4	no
Lithuania	0.2	4.7	-1.9	21.4	June 28, 2004
Malta	2.6	4.7	-9.7	71.1	no
Poland	2.5	6.9	-3.9	45.4	no
Slovakia	8.4	5.1	-3.7	42.6	no
Slovenia	4.1	5.2	-2.0	29.4	June 28, 2004

three largest of the new Member States — the Czech Republic, Hungary, and Poland — are troubled with high budget deficits, which in the case of the Czech Republic rose considerably further in 2003.[202] The Czech deficit would have been much higher still in 2002 without the abundant proceeds from privatizations.[203] Among smaller States, Cyprus and Malta also have problems with their budget deficits. On inflation, no less than six of the ten new Member States exceeded the reference value of 2.4%, the highest rates being registered in Slovakia (8.4%) and Hungary (6.5%). Except for Cyprus and Malta, the general government debt in most new Member States was well below the reference level of sixty percent. From larger new Member States, Hungary is closest to this threshold with 59.1%. The more troubling fact regarding Hungary, however, is its strong trend towards the reference level in past years.

IV. *FULFILLMENT OF THE CONVERGENCE CRITERIA IN ACCESSION COUNTRIES — REQUIRED ECONOMIC POLICIES*

A. *Nominal and Real Convergence*

The nominal convergence is the fulfillment of the conver-

202. The budget deficit of the Czech Republic was six and four-tenths percent in 2002 and twelve and nine-tenths percent in 2003. *See* Deutsche Bank Research, EU MONITOR, No. 12, April 2004, 17, *available at* http://www.dbresearch.de/PROD/DBR_INTERNET_EN-PROD/PROD0000000000076914.pdf (last visited Nov. 02, 2004).

203. *See* DEUTSCHE BANK RESEARCH, *supra* note 170.

gence criteria as described in the preceding section. Real convergence is comprised of the structural adjustments and real income improvement that signals the entrant is catching up with EU and Euro-area Member States. No mention is made of real convergence as a criterion for entry into the third stage of EMU and adoption of the Euro.[204] Nor are these criteria quantified in the way that those for nominal convergence are quantified. Nevertheless, the importance of the real convergence criteria can be inferred from the statements of several senior ECB officials, e.g., Willem Duisenberg (former President of the Executive Board of ECB), Christian Noyer (former Vice-President of the Executive Board of ECB), and Tommaso Padoa-Schioppa and Eugenio Solans (Members of the Executive Board of ECB).[205] Real conver-

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204. The Maastricht Treaty (Treaty on European Union) in Article 2 "indirectly mentions a need for economic and social cohesion, which is intended to eliminate disparities between countries and regions," but criteria for real convergence are not specifically laid down. *See* TEU, *supra* note 51, art. 2, O.J. C 224/1; *see also* JOINT PROGRAMME OF THE SLOVENIAN GOVERNMENT AND THE BANK OF SLOVENIA, PROGRAMME FOR ERM II ENTRY AND ADOPTION OF THE EURO 23 (2003) [hereinafter SLOVENIAN ERM II PROGRAM].

205. According to Solans, the accomplishment of the convergence criteria by new Member States must be sustainable. *See* E.C. Treaty, *supra* note 4, art. 121, O.J. C 325/33; *see also* Protocol on Convergence Criteria, *supra* note 89, art. 1; Eugenio Domingo Solans, Speech delivered at the Seventh Central European Covered Bond Conference, Berlin, Oct. 12, 2003 (2003), *available at* http://www.ecb.int/press/key/date/2003/html/sp031013.en.html (last visited Oct. 14, 2004) (Mr. Solans is a Member of the Governing Council and of the Executive Board of the European Central Bank). "The idea of sustainability of nominal convergence goes hand in hand with the concept of real convergence insofar as any excessive real divergence could compromise the sustainability of nominal convergence." Solans, *supra*, at 7. Another officer of the European Central Bank, Christian Noyer, states that "advancing real and nominal convergence with the Euro-area in a parallel manner should take top place on the agenda of the new Member States' policy-makers." Christian Noyer, The ECB and the Accession Process, Speech delivered at the European Federation of Finance House Association (EUROFINAS) Conference, Oct. 15, 2001, at 4 (2001), *available at* http://www.ecb.int/press/key/date/2001/html/sp011015.en.html (last visited Oct. 15, 2004) (Mr. Noyer is the Vice President of the European Central Bank). In addition, Duisenberg stresses that:

> [R]eal convergence mean[s] the broad adjustment through structural reforms and economic development of the economies towards structures prevailing in the EU. This requires, [*inter alia*], the completion of the market economy transition agenda, further privatization in some sectors, and the strengthening of the institutional and legal framework. Real convergence is seen as facilitating economic cohesion among Member States once they have joined EMU, thereby helping to minimise the risk and effects of asymmetric shocks. Hence, in order to enhance the process of real convergence as much as possible, accession countries should ensure that they make progress in the restructuring of their economies and gradually align them with those of the [E]uro area.

gence is seen as facilitating economic cohesion among Member States once they join EMU, thereby helping to minimize the risk and effect of asymmetric shock.[206]

The requirement for real convergence is composed of both income and structural convergence.[207] Income convergence relates mainly to per capita GDP and consumer prices, while structural convergence encompasses reform of the institutional framework within which the economy operates. Real income convergence and structural convergence are closely related. Structural convergence and institutional reform can be viewed as bases for a more favorable business environment and a more efficient allocation of financial resources in the future.[208]

B. *Macroeconomic Policy Orientation*

With accession to EU, the new Member States became subject to the EDP; and are therefore forced to adjust their fiscal policies to its strict requirements. While new Member States other than Malta and Cyprus do not face serious challenges in

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Willem F. Duisenberg, The ECB and the Accession Process, Speech delivered at the Frankfurt European Banking Congress, Nov. 23, 2001, at 2 (2001), *available at* http://www.ecb.int/press/key/date/2001/html/sp011123.en.html (last visited Oct. 17, 2004).

Finally, Padoa-Schioppa advocates:

> [T]hat real and nominal convergence should be pursued in parallel. Real convergence is more than the catching up in income levels; it is the adjustment of the real economies towards structures that allow the new Member States to participate in a monetary union without contributing to, or suffering from, significant asymmetric shocks. The level of per capita income is a useful, but by no means always close, approximation of the relevant concept of real convergence. Income levels in accession countries are still far below those of the EU, to an extent never observed in previous EU enlargements.

Tommaso Padoa-Schioppa, Accession Countries on the Way to the Euro, A central Banker's View, Speech delivered to Conference on Economic Policy Directions in the OECD Countries and Emerging Markets: Analyzing the Experiences, Warsaw, Poland, Mar. 22, 2002, at 3 (2002), *available at* http://www.ecb.int/press/key/date/2002/html/sp020322_1.en.html (last visited Oct. 18, 2004).

206. *See* Duisenberg, *supra* note 205, at 2; *see also* Padoa-Schioppa, *supra* note 205, at 3.

207. *See* Padoa-Schioppa, *supra* note 205, at 2.

208. The introduction of the real convergence as a requirement for adopting the Euro was criticized by certain economists in the new Member States as a tool for additional discretion to delay the process of inclusion of new Member States in the Euro-area. According to Lavrac, the real convergence is not precisely defined, which gives the additional room for interpretation and discretion. *See* Vladimir Lavrac, Institutional Aspects of Dynamics of Inclusion of Accession Countries into EMU, Ezoneplus Working Paper No. 18, (2003), at 16, *available at* http://www.ezoneplus.org/archiv/ezp_wp_18.pdf (last visited Nov. 2, 2004).

adjusting their ratio of government debt,[209] several have severe problems with budget deficits. To meet the convergence criteria, new Member States will have to consolidate and restructure the income and spending sides of their budgets.[210] They will have to pursue a gradual reduction of their budget deficits, and remain conscious of the general situation in the international business cycle. The new Member States' medium-term fiscal policy goal should be to achieve a balanced budget with zero structural deficits. A similar policy on structural deficit is planned for the Euro-zone in the SGP.[211]

With regard to monetary policy and exchange rate strategies,[212] most new Member States have already indicated their intention to join EMU as early as possible after entry into EU.[213] According to Padoa-Schioppa, the difficult task in implementing the monetary and exchange rate strategies on the road toward the Euro is to support the parallel pursuit of real and nominal convergence. He further states that the ECB is not recommending a particular monetary policy strategy to uniformly apply to all new Member States, but only recommends that maintaining price stability remain the ultimate compass of monetary

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209. Nevertheless, most countries expect a gradual reduction of the debt ratio, in line with decreasing deficits. Major exceptions to this trend are the Czech Republic, with a rise of the debt ratio of more than 10 percentage points between 2001 and 2005, and Poland with a rise by seven percentage points. The projected development of public debt particularly in these two countries gives rise to concern about the medium-term debt dynamic and its impact on macroeconomic stability. *See* EUROPEAN COMMISSION, ENLARGEMENT PAPERS NO. 14, *supra* note 175, at 16.

210. The consolidation and restructuring of their budgets will probably represent the most difficult and painful task for most new Member States when trying to fulfill the economic convergence criteria. On the income side they will have to, among other issues, cope with reduction of import duties and VAT due to accession to EU, while on the spending side they will need to reduce the social transfers and cover the initial accession costs. *See id.* at 13-15 (analyzing budget deficits of the new Member States).

211. *See* Resolution of the European Council on the Stability and Growth Pact, *supra* note 116.

212. New Member States have a wide variety of exchange rate regimes, including: independent floating (the Czech Republic and Poland); currency boards (Estonia and Lithuania); managed floating — informally using the Euro as the reference currency — (Slovakia and Slovenia); pegging to a basket of currencies with a greater (Malta) or lesser (Latvia) weighing of the Euro; and, finally, pegging to the Euro within fluctuation bands of ± 15% (Cyprus and Hungary), a practice reminiscent of that used by the ERM II. *See* DEUTSCHE BANK RESEARCH, *supra* note 202, at 33.

213. *See* EUROPEAN COMMISSION, ENLARGEMENT PAPERS NO. 14, *supra* note 175, at 12.

policy.[214] This indicates, though, that an increasing orientation toward the Euro would be in line with further economic and financial integration with the Euro-area.[215]

As small, open economies, most new Member States cannot disregard exchange rate developments when making their monetary policy decisions. The exchange rate is generally a more potent transmission channel of monetary policy decisions than domestic interest rates and plays a crucial role in explaining the pass-through to price developments in most accession countries.[216] Thus, in order to achieve further disinflation and sustainable growth, excessive exchange rate fluctuations need to be avoided.

In practice, a growing number of new Member States already follow exchange rate strategies that are in line with EMR II requirements. Only a few will have to modify their policies to make them compatible with ERM II membership.[217] In addition, the Governing Council in its policy statement[218] indicated that with regard to currency boards, the ECB does not consider them to be a substitute for participation in ERM II. Thus, the Governing Council implies that countries operating a currency board will be required to participate in ERM II for at least two years *before* the convergence assessment that is made prior to a Member State's ability to adopt the Euro. However, Member States that operate a sustainable Euro-based currency board might not be required to go through a double regime shift (i.e., floating the currency within ERM II only to re-peg it to the Euro at a later stage). Such countries may therefore participate in ERM II with a currency board, enhancing the discipline within ERM II.[219]

In addition, and in order to achieve necessary restrictive

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214. *See* Padoa-Schioppa, *supra* note 185, at 4; *see also* EUROPEAN CENTRAL BANK, POLICY POSITION, *supra* note 160, at 1-2.

215. *See* EUROPEAN CENTRAL BANK, ANNUAL REPORT 2001, 109 (2001).

216. *See* Christian Noyer, Challenges Ahead: The Accession Process, Speech delivered at the Foreign and Commonwealth Office, London, United Kingdom, Dec. 12, 2001, at 6 (2001), *available at* http://www.ecb.int/press/key/date/2001/html/sp011112.en.html (last visited Oct. 21, 2004).

217. *See* Padoa-Schioppa, *supra* note 185, at 5.

218. *See* EUROPEAN CENTRAL BANK, POLICY POSITION, *supra* note 160, at 3.

219. However, the ECB has stressed that such an arrangement will be assessed on a case-by-case basis and that a common accord on the central parity against the Euro will have to be reached. *See id.*

monetary and fiscal policies, the new Member States will have to proceed with structural reforms.[220] In this regard, a functioning and stable financial sector is of vital importance. Further privatization and restructuring of the enterprise sector will have to be vigorously implemented. Completion of social security reform and facilitation of labor market flexibility are also necessary to achieve sustainable real convergence.

C. *Procedure to Join the Third Stage of EMU and Estimation of the Time Schedule of the Fulfillment of the Convergence Criteria in the New Member States*

The new Member States that want to adopt the Euro as quickly as possible must aim to fulfill the convergence test at the earliest possible date. For this, they would need to enter the ERM II as soon as they joined EU. An ideal time schedule based on the wording of the convergence criteria could look as follows:

- *May 1, 2004* Date of accession of the new Member States to EU. Simultaneously, possible submission of the request for membership in the ERM II. The earliest possible date of ERM II entry is Monday, May 3, 2004.[221] This is very unlikely due to accession ceremonies. The next possible date is the following Monday, May 10, 2004.[222] This is possible but requires detailed previous discussions between the new Member States and the ECB, Commission and the Council;[223]
- *End of 2005* Since 2005 budget will be the last before examination in 2006, the new Member States have to comply with criteria on budget deficit and public debt by the end of 2005;
- *April 2006* The Convergence Reports should be published in 2006, according to the E.C. Treaty. In order to be assessed in the 2006 Convergence Reports, the new Member State must comply with budgetary, inflationary, interest rate

220. *See* EUROPEAN COMMISSION, ENLARGEMENT PAPERS NO. 14, *supra* note 175, at 18–22.

221. In such a case the decision of joining the ERM II in accordance with the formal procedure as described above should take place during the weekend of May 1-2, 2004.

222. The day of entry to ERM II has so far always been Monday. *See* Zogala, *supra* note 180, at 49.

223. *See* SLOVENIAN ERM II PROGRAM, *supra* note 204, at 57-75 (providing detailed time schedule regarding the technical issues in connection with adoption of Euro).

convergence criteria.[224] If the same timing as in 2002 is applied to the 2006 Convergence Reports, a new Member State will miss by just days the full two-year duration of the ERM II participation required. If the participation in the ERM II proceeds smoothly (without devaluation or "severe tensions"), there should be no reason to deny a finding of fulfillment of the exchange rate criterion;

- *May 9, 2006* If the new Member States enter the ERM II on May 10, 2004, the two-year test period for the exchange-rate criterion ends on May 9, 2006;
- *May - June 2006* Assuming that the participation in ERM II proceeds smoothly, budgetary criterion is fulfilled by the end of 2005, and the inflation and interest rate criteria are fulfilled in April 2006 at the latest, the Commission and the ECB should conclude in their Convergence Reports that a new Member State fulfills the requirements of the E.C. Treaty.[225] Both reports will then be submitted to the Council. Next, the European Commission will prepare a proposal for those Member States whose derogation is to be abrogated. The European Parliament will be consulted and then the Council (in its composition as Heads of States or Governments) will discuss the issues. The last step of the procedure is the meeting of the ECOFIN Council. The Council, acting by a qualified majority, will decide which Member States with derogation fulfill the necessary conditions and whose derogation is to be abrogated. The Council will also decide on the date of EMU entry and the conversion rate. The ECOFIN Council could make its decision before the June 2004 European Council meeting.[226]
- *January 1, 2007*[227] Entry in third stage of EMU and adoption of the Euro as official currency. The central bank gov-

224. Last Convergence Reports published in 2002, were prepared in May and examined the period up to end April 2002. In accordance with Article 122(2), the Member State can also require from the ECB and the Commission to prepare the Convergence Report. *See* E.C. Treaty, *supra* note 4, art. 122(2), O.J. C 325/33.

225. For purposes of clarity of this timeline, there is deliberate negligence of the issue of sustainable real convergence.

226. According to Zogala, this would be "politically correct" and will give the European Council the possibility to officially "welcome the decision of the Council." *See* Zogala, *supra* note 180, at 49.

227. The entry date has so far always been January 1. This was the date of the start of the third stage EMU in 1999 and the date of Greece's entry in 2001. This is reasonable, because the easiest way to deal with the various consequences of the change of the currency is the end of year. However, this is not a prescribed rule, and the Council could set another date, if it considers it appropriate.

> ernor of each new EMU country becomes a member of the Governing Council, the main decision-making body, of the ECB.

This timetable, however, has already proven to be unrealistic. No new Member State entered the ERM II on May 10, 2004. The first new Member States to enter the ERM II were Estonia, Lithuania, and Slovenia on June 27, 2004. Consequently, these three countries, although in the best position among the new Member States to adopt the Euro, are already almost two months behind the above time table. Moreover, the available data show that the possibility that any of the new Member States will fulfill the nominal convergence criteria and achieve sustainable real convergence to the degree required by Commission and ECB is not very high. Therefore, a more realistic scenario is adoption of the Euro by the first new Member States on January 1, 2008 or even 2009.

It appears therefore that the first new Member States to adopt the Euro will come from the group of small countries with managed budget deficits, most probably one of the Baltic countries. If sustainable real convergence is the deciding factor, Slovenia may be the first. Its real convergence is comparatively advanced[228] and it has achieved good results in meeting the inflation rate criterion.[229]

It would be very surprising if one of the three largest of the new Member States — the Czech Republic, Hungary, or Poland — would be among the first new Member States to adopt the Euro. Absent strong political pressures, the most reasonable approach is to begin with a small, open economy. When testing how a transitional economy will function in and influence the operation of EMU, damage control on both sides should definitely be considered.

A cautious approach, as strongly advocated by the senior ECB officials, seems in place. Nevertheless, the adoption of the Euro is not only an extremely important instrument for further integration of the new Member State economies into EU, but also carries a strong emotional value for the citizens of the new Member States. For ordinary people single currency is one of

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228. ALES DELAKORDA, IZPOLNJEVANJE EKONOMSKIH KRITERIJEV CLANSTVA SLOVENIJE V EU IN EMU, BANKA SLOVENIJE, PRIKAZI IN ANALIZE XI 1 (2003) (on file with author).

229. *See* SLOVENIAN ERM II PROGRAM, *supra* note 204, at 24.

the most visible and useful attributes of relatively detached EU structures. A strong Euro could consequently play a significant role in the long-term satisfaction of citizens of the new Member States. It is therefore of vital importance for the future of European integration that new Member States adopt the Euro as soon as possible.