FOR AGENDA

SM/07/241
Correction 2

July 24, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Euro Area Policies—Selected Issues**

The attached corrections to SM/07/241 (7/10/07) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 5, footnote 3, line 2: for "In Europe, MTSs have" read "In Europe, MTFs have"

Page 6, para. 10, line 5: for "markets, MTSs, or" read "markets, MTFs, or"

Page 9, Table I.1, column 1, row 10: for "Bolsa Italiana" read "Borsa Italiana"

Page 10, para. 16, line 1: for "Bolsa Italiana" read "Borsa Italiana"
para. 16, line 3: for "participation in MTS," read "participation in the MTS Group,"
Table I.2, column 7, row 2: for "Bolsa Italiana" read "Borsa Italiana"
footnote 17: for "MTS is jointly owned by Bolsa Italiana and Euronext. On June 21, 2007, the Italian exchange announced it would exercise its call option right to purchase shares held by Euronext in MTS. The same day, news that the London SE and Bolsa Italiana entered in merger talks led Euronext to consider a counter bid for the Italian exchange."
read "MTS is jointly owned by Borsa Italiana and Euronext. On June 21, 2007, the Italian exchange announced it would exercise its call option right to purchase shares held by Euronext in MTS Group. The same day, the London SE proposed to merge with Borsa Italiana. The transaction was approved by the board of Directors of the Italian exchange on July 18, 2007."

Page 11, footnote 21: for "By January 2007, only the United Kingdom and Romania had transposed *Level* 1 and 2 Directives into their national legislation. 10 more Member

States are expected to complete the transposition process by the end of June 2007, although only one has effectively notified full transposition to the Commission. At least two countries (Spain and Slovenia) do not expect to have done so by the November 2007 deadline."
read "As of July 2007, eight countries had transposed *Level* 1 and 2 Directives into their national legislation. All but one of the Member States and EEA countries are expecting to have completed the transposition process by the November 2007 deadline."

Page 17, para. 26, line 2: for "European Monetary Union and"
read "Economic and Monetary Union (EMU) and"
line 6: for "can participate in European Monetary Union (EMU)."
read "...can participate in EMU."

Page 20, text table: removed footnote 3
text table, column 4
row 4: for "Target date set for January 1, 2012"
read "No official target date has been set. On current budget plans, 2012 would be the earliest feasible date."
row 5: for "No official target date"
read "No official target date has been set. The Convergence Program of December 1, 2006 aims at meeting the Maastricht criteria in 2009."
row 8: for "No official target date"
read "The government is committed to adopting the euro at the earliest possible date, which it now estimates to be 2011, based on current inflation forecasts."
row 9: for "Target range set for 2011-13"
read "According to the information released by the Ministry of Finance, in 2007 the Government would discuss a new target for the changeover to the euro, tentatively in 2011-2013."
row 10: for "Target date is set for January 1, 2010"
read "No official target date has been set. According to the government, Lithuania will aim to join the euro area as soon as possible and the more favorable period for the country to join the euro area starts in 2010."
para. 33: last sentence: for "There was a noticeable decrease in support for euro adoption in the Baltic countries in May 2007 compared to September 2006."
read "The proportion of people in the Baltic countries expecting net benefits from euro adoption fell in May 2007 compared to September 2006."
footnote 37, line 2: for "0.03 percentage" read "0.1 percentage"

Page 21, para. 35, 1st bullet, line 3: for "The current interpretation, revealed in the 2004 Convergence Reports, is that "best performance" means "the lowest non-negative inflation."
read "The 2004 Convergence Reports took "best performance" to mean "the lowest non-negative inflation."
footnote 40: removed and subsequent footnotes renumbered

footnote 42: added last sentence "The ECB examination of exchange rate stability against the euro focuses on the exchange rate being close to the ERMII central rate, while also taking into account factors that may have led to exchange rate appreciation."

Page 22, bullet 2, last sentence: removed
footnote 44: removed and subsequent footnotes renumbered

Questions may be referred to Ms. Tamirisa, RES (ext. 34371) and Mr. Haas, MCD (ext. 34885).

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(or Alternative Trading Systems (ATSs)) are electronic platforms that facilitate the execution of trades by matching clients' orders.[3] "SIs are firms that execute client orders by dealing on their own account outside a regulated market or a MTF on an organized, systematic and frequent basis.[4]

8. **With a view to increasing cross-border provision of financial services and fostering competition, the Directive broadens the reach of the European passport**. The passport principle was first introduced by the ISD. Under the passport framework, a firm licensed to provide financial services in its home country has the right to provide these same services throughout EU countries, without the need for an additional license. MiFID applies the passport to a broader range of financial instruments and significantly extends the list of financial services that can be "passported" across European countries.[5] For instance, operating a Multilateral Trading Facility is explicitly recognized as a passportable activity: from its home country, a MTF can therefore freely provide remote access facilities on the territory of any "host" country. The provision of investment advice is similarly recognized as a stand alone "passportable" activity and so are a broader range of asset management activities. Moreover, with the aim of facilitating the use of the passport and the cross-border provision of services, MiFID established the principle of the exclusive application of home country regulation and rules out the possibility for host country regulators to impose additional requirements on foreign financial services providers. Branches of investment firms, however, are required to comply with host country regulation, in specific areas (e.g., conduct of business, best execution, order execution, etc.) for activities conducted in the host country.[6]

9. **To encourage investors and others to take advantage of the more level playing field, MiFID reinforces and harmonizes investor protection rules, in particular to the benefit of retail investors**. Best execution is a key concept introduced by MiFID. The notion of executing trades in the "best interest of customers" was part of the ISD, but its

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[3] Various forms of ATSs exist, order-driven systems as well as quote-driven, or market-maker, systems, to bulletin boards and crossing systems. In Europe, MTFs have developed primarily in bond markets (e.g., Bondware, MTS and EuroMTS), and to a lesser extent in equity markets (e.g., Instinet, Tradelink). While most are focusing on wholesale market participants, some are accessible to retail investors.

[4] Article 4(1)(7), Directive 2004/39. To be considered systematic internalization, such activity must be carried out according to non-discretionary rules and procedures, have a material commercial role for the firm, and must be available to clients on a regular or continuous basis.

[5] See Annex I.1 for a list of passportable financial services and activities, and financial instruments covered by MiFID.

[6] For activities conducted from a branch located in a host country in another Member State, home country regulation applies. Home/host supervisory arrangements for branches, and in particular the organization of transaction reporting remain among the most contentious interpretative issues.

implementation primarily focused on a narrower notion of best trading price. In contrast, the obligation of best execution refers to a broader range of quantitative (price and fees) and qualitative (speed of execution, likelihood of execution and settlement) factors and requires market intermediaries to seek the best overall execution conditions, considering the characteristics (size, nature) of the order received.[7] MiFID requires investment firms to establish and implement on a consistent basis a verifiable written order execution policy, to which clients have to give consent prior to start business, detailing how orders will be executed and the factors affecting the choice of the trading venues.[8]

10. **Increased market transparency aims at guaranteeing that competition between trading venues does not lead to fragmented market liquidity and contributes to better investor protection**. Pre-trade transparency requirements (i.e., disclosure of current bid and offer prices, depth of trading interests at current prices, best bid and offer prices posted by market makers) apply to share transactions conducted on regulated markets, MTFs, or through SIs. They are particularly important to allow investors and other market participants to have a complete view of market conditions and access trading venues where liquidity is superior. Combined with best execution obligations, pre-trade transparency is expected to ensure that increased competition between trading platforms does not result in liquidity fragmentation. However, pre-trade transparency requirements are less stringent for SIs than for regulated markets and MTSs: for SIs, the requirements apply only to shares that are also admitted for trading on a regulated market, for which a liquid market exists, and only for transactions up to a pre-defined standard market size. Post-trade disclosure obligations direct all market intermediaries to publish the details (i.e., price, volume, time) of share transactions they have undertaken.[9]

11. **Although the objective of MiFID is also to promote a homogeneous "rule book" for the provision of financial services throughout the EU, it does not impose an indiscriminate set of rules to all transactions**. Compared with the ISD, MiFID covers a much broader set of financial instruments, and in particular derivative instruments, including "exotic" structures (see Annex I.1). The requirements of the Directive vary with the

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[7] Note that clearing and settlement costs are explicitly mentioned among execution costs that need to be considered. Mirroring this provision, the Directive stipulates that Member States cannot prevent investment firms, MTFs and regulated markets from using clearing and settlement systems located in other Member Sates.

[8] In addition to best execution requirements, investor protection is organized through strengthened and harmonized client classification rules, marketing communication rules, suitability and appropriateness ("Know Your Customer") principles and reporting requirements.

[9] Although MiFID requires that transaction information be disclosed rapidly ("as far as possible in real time) after the trade is completed, exceptions can be granted by national authorities for large trades and block trades. However, rather than being left at the discretion of national authorities, the definition of what constitutes a large trade and the length of disclosure deferral is harmonized, and based on the average daily turnover in each share.

likely to raise the critical size needed for exchanges to attract and retain liquidity and to generate the resources required to invest in value-adding IT-intensive activities (Table I.1).[16] From that perspective, MiFID is a strong additional incentive for market operators to consolidate or intensify cooperation. While this is especially true for small and medium-sized markets (e.g., OMX strategy in the Nordic-Baltic region, Vienna SE strategy relative to Eastern and Central European stock markets), it is also a valid approach for larger markets (e.g., NYSE-Euronext).

Table I.1. Capitalization of European Stock Markets at year-end 2006

	Capitalization (Euro millions)	Value of Share Trading (Euro millions)	Number of Listed Companies
London SE	2,877,605	5,742,376	3,256
Euronext	2,812,261	3,047,592	1,210
Deutsche Boerse	1,241,963	2,164,848	760
BME Spanish SE	1,003,299	1,529,437	
Swiss Exchange	919,414	1,059,131	348
OMX markets	851,460	1,010,469	791
Borsa Italiana	778,501	1,258,470	311
Oslo Bors	212,284	307,818	229
Athens SE	157,941	85,333	290
Warsaw SE	148,775	55,702	265
Vienna SE	146,197	64,893	113
Irish SE	123,824	64,592	70
Luxembourg SE	60,303	209	260
Budapest SE	31,689	23,441	41
Ljubljana SE	11,513	1,554	100

Source: World Federation of Exchanges

16. **Differences in revenue structures reflect the diversity of business models among European stock markets and point to different strategies in the post-MiFID environment** (Table I.2). Trading fees and the sale of data services, the primary areas exposed to increased competition, are significant sources of revenues for most exchanges (with the exception of Deutsche Boerse), and are especially important for the London Stock Exchange (more than 75 percent of revenues) and to a lesser extent, for the Spanish market and the OMX group (57.2 percent and 53 percent, respectively). While the size of the London market may be seen as a cushion against the immediate impact of heightened fee competition (a situation that will also benefit OMX once its merger with Nasdaq is completed), the same may not be true for the Spanish stock market. Furthermore, the Spanish, German, and Italian markets derive a substantial part of their revenue from their clearing, settlement, and custody activities (they are often termed to follow the "silo model"),

[16] Order optimization, algorithm trading devices, transaction cost analysis, real-time data dissemination are example of technology intensive services that are given increased importance under MiFID.

which are under increased pressure to open up to competition. Borsa Italiana is the only exchange to derive a material share of its revenue from fixed-income trading, through its participation in the MTS Group, the main electronic bond trading platform.[17] As competition rises, it will be increasingly important for market intermediaries to be able to offer technology-intensive value adding functionalities. At the moment, IT is a significant source of revenue only for OMX and, to a much lesser extent, Euronext.[18]

Table I.2. Selected European Stock Markets- Sources of Revenues (end 2006, % of Total)

	London SE	Euronext	Deutsche Boerse	BME Spanish SE	OMX markets	Borsa Italiana
Listing	18.1	5	16.9	9	9.5	10.5
Trading	46.9	28.2		48.1	21.8	29.5
(o/w Fixed Income)		(2.2)		(2.2)		(10.4)
Derivatives	2.7	35.5	32.2	8.4	17.9	7.5
Post-Market activities*		1.3	37.8	21.7		35.7
Data Services	30.3	10.2	8	9.1	13.3	14.4
IT		16.7	5.1	3.7	33.7	0.8
Others	2.1	3			3.8	1.7
Total	100	100	100	100	100	100

* Clearing, Settlement, Custody

Sources: Annual Reports, Author's Calculations

17. **There is a risk that more competition and transparency lead to a fragmentation of market liquidity**. This risk revolves around the extent to which the opening of execution and settlement of transactions, best execution requirements, and transparency rules effectively compensate the potentially centripetal effects of more fragmented market structures on market liquidity. Also, there is a risk that increased transparency requirements will negatively impact the provision of liquidity by market intermediaries. While this is limited in equity markets, it cannot be fully discarded, in particular for second tier equities. Similarly, less constraining pre-trade transparency requirements for Systematic Internalizers may result in the emergence of pockets of opaqueness. Moreover, the ability of the many mechanisms to efficiently aggregate transaction data, a key component of the price formation mechanism, has not been fully tested. Ultimately, the extent to which fragmentation of liquidity presents a risk significantly hinges on the implementation of MiFID at the national levels.

[17] MTS is jointly owned by Borsa Italiana and Euronext. On June 21, 2007, the Italian exchange announced it would exercise its call option right to purchase shares held by Euronext in MTS Group. The same day, the London SE proposed to merge with Borsa Italiana. The transaction was approved by the board of Directors of the Italian exchange on July 18, 2007.

[18] OMX derives more than a third of its revenue from IT, and is a major supplier of financial market technology solutions, including to other stock exchanges.

D. Implementation Challenges

18. **The Market in Financial Instruments Directive is a far reaching and complex web of legislation, and its implementation requires sustained and concerted efforts by public authorities and market participant**s. The challenge of implementing MiFID will not stop when the Directive comes into force. Rather, November 2007 will be the starting point of a new challenge for European supervisors tasked with the responsibility to deliver consistent convergence of supervisory practices over time. This is essential to ensure that more competition comes with more liquid markets.

19. **In the broader sense, MiFID comprises a "Lamfalussy Level 1" Directive, focusing on framework principles, complemented by technical implementation measures (Level 2 Directive and Regulation)**.[19] Following the adoption of these texts, attention has progressively shifted to their transposition into national legislation and their implementation by national regulators. In the Lamfalussy framework, this crucial task is delegated to expert committees composed of national regulators. [20] The Committee of European Securities Regulators (CESR) is responsible for promoting a consistent and homogeneous day to day implementation of MiFID, by issuing guidelines and reviewing national regulatory practices.

20. **The first and most pressing challenge is for national authorities to meet the implementation deadline**. Member states were required to transpose MiFID in their national legislation by the end of January 2007, a deadline effectively fulfilled by only two Member states. To allow market participants to put in place the practical arrangements required to be compliant with the directive and Member States to effectively transpose the directives, the application date of MiFID has been postponed until November 1, 2007.[21] Further delay in the application of the MiFID due to failure to resolve interpretative issues would send the wrong political signal and damage the credibility of the Lamfalussy framework. It would also entail significant opportunity costs and create potentially damaging legal uncertainty for market participants.

[19] The Regulation covers issues where a set of stand-alone, directly applicable implementing measures has been considered both legally possible and technically necessary to guarantee that MiFID can function uniformly in all EU financial markets. In contrast, in the transposition of the (principle-based) implementing directive, Member states have retained a limited ability to adapt MiFID provisions to their national legal system.

[20] See Annex I.2 for a description of the Lamfalussy framework and the Comitology procedure.

[21] As of July 2007, eight countries had transposed *Level* 1 and 2 Directives into their national legislation. All but one of the Member States and EEA countries are expecting to have completed the transposition process by the November 2007 deadline.

21. **Market participants appear unevenly prepared for the November deadline**. Although assessing readiness is difficult, surveys have typically indicated that only a small number of market participants (i.e., the large banks and brokers, and the large stock exchanges) have a clear understanding of the full implications of MiFID for their own activities, and have taken the required actions. A majority of market players, however, often seems unconcerned, due to lack of knowledge or understanding, viewing the whole process largely as a compliance exercise.

22. **The nature and complexity of MiFID makes CESR's task in promoting the convergence of supervisory practices particularly challenging**. Although it is rather detailed and technical on many aspects, MiFID is primarily a set of high-level principles, requiring homogeneous interpretation for consistent implementation. The issues that CESR has to deal with easily become "politically charged" rather than purely technical in nature and are then referred back to the Commission for "arbitrage." For instance, while progress has been made regarding the interpretation of the notion of best execution and its implementation in fixed-income and derivative markets, the supervision and reporting of cross-border securities transactions and the organization of home/host supervisory arrangements for branches remain contentious issues. Ultimately, the logic of MiFID requires that securities supervisors move from a rule-based approach to a principle-based approach, and adapt their relations with market participants accordingly. This is illustrated for example by the implementation of best execution principle: the nature of the requirements (e.g., both an obligation of means and results) and the diversity of situations where the principle applies would make a rule-based approach impracticable. Few supervisors, however, have already adapted their approach to this.[22]

23. **The debate on the implementation of MiFID boils down to the appropriate supervisory arrangements for European securities markets**. The status and the decision-making process followed by CESR (and other Level 3 committees) compound the implementing difficulties caused by the complexity of MiFID. CESR operates within the boundaries of the "delegated mandate" from the Commission and the European Parliament but its members—national regulators/supervisors—are ultimately accountable to their national authorities, which can cause important tensions. The composition of the Committee and its consensual, non-binding approach has facilitated a common understanding of MiFID legislation among national regulators, thereby promoting a first level of regulatory convergence. The task would remain incomplete should these first steps not be followed by day to day convergence of supervisory practices and the development of a common supervisory culture and deeper cooperation among national supervisors.[23]

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[22] Furthermore, a number of countries either did not have up-to-speed securities regulators a few years ago, or lack the resources and the adequate expertise (or lack a truly active securities market).

[23] These concerns are not limited to the implementation of MiFID, but also to other components of the Financial Sector Action Plan. Similarly, they are not specific to CESR, but apply in similar terms to other Level 3 committees.

II. The Euro and the New Member States[29]

A. Introduction

26. **The new member states of European Union are expected to gear their policies toward fulfilling preconditions for joining Economic and Monetary Union (EMU) and adopt the euro when they do**. The European Commission (EC) and the European Central Bank (ECB) are regularly monitoring progress in this area. The entry preconditions are embedded in the Maastricht Treaty and require countries to achieve a high degree of sustainable nominal convergence before they can participate in EMU.[30] The Maastricht criteria have for the past fifteen years served as the cornerstone of a gradual approach to expanding EMU, aiming to ensure its credibility and sustainability. The criteria helped create a shared culture of stability among the "old" members (OMS) and are now expected to play the same policy-anchoring role for the new member states (NMS).[31]

27. **This paper examines the macroeconomic policy challenges the NMS face as they prepare for joining monetary union**.[32] These challenges largely stem from the convergence of incomes and prices in the NMS to euro-area levels, capital inflows and financial deepening, and the resulting inflation and exchange rate developments. Indeed, foreign investors generally perceive the exchange rate risk in the NMS as low and are willing to on-lend capital to the domestic sectors in the NMS in euros and other European currencies.

28. **Against this backdrop, the paper explores the policies the NMS would need to pursue to enter the euro area smoothly and prepare for a good performance in**

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[29] Prepared by Natalia Tamirisa (x34371) with Douglas Laxton (RES), Andy Jobst (MCM), Gavin Gray, Thomas Harjes, and Emil Stavrev (all EUR).

[30] The criteria are set out in Article 121 of the Treaty establishing the European Community and further detailed in a Protocol attached to the Treaty. The Convergence Reports prepared by the ECB and the EC describe how the criteria are applied in specific country cases.

[31] For the purposes of this paper, the OMS comprise Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Within this group, Greece, Ireland, Portugal, and Spain are considered catching-up economies. The NMS are defined as the central and eastern European (CEEC) countries in the 2004 wave of EU enlargement (the Czech Republic, Hungary, Poland, and the Slovak Republic), the Baltic countries in the same wave of enlargement (Estonia, Latvia, and Lithuania) and the two south-east European countries in the 2007 wave (Bulgaria and Romania). Slovenia, which adopted the euro in January 2007, and two island economies, Cyprus and Malta, which are soon to follow, are considered to be the former members of the NMS group. Per capita incomes in these three countries are higher than those in other NMS and/or economic growth is lower, and hence the analysis presented in this paper applies to them to a much lesser extent than to other NMS.

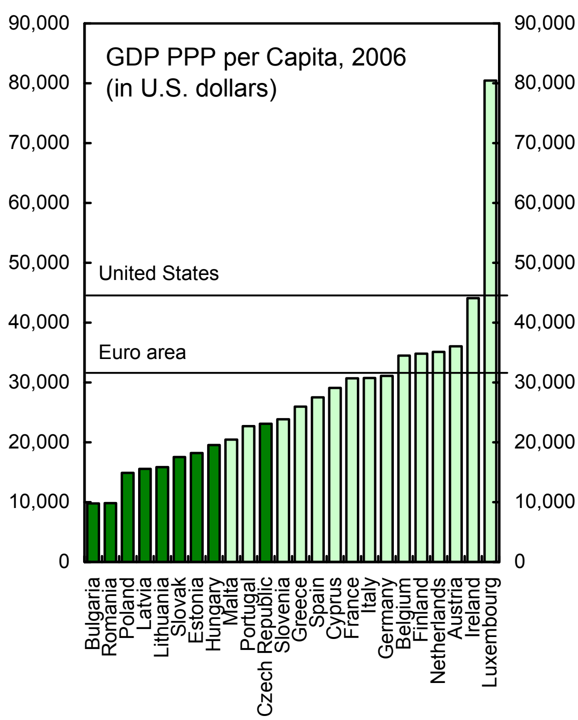
[32] For extensive IMF staff analysis of euro adoption issues, see Schadler and others (2005).

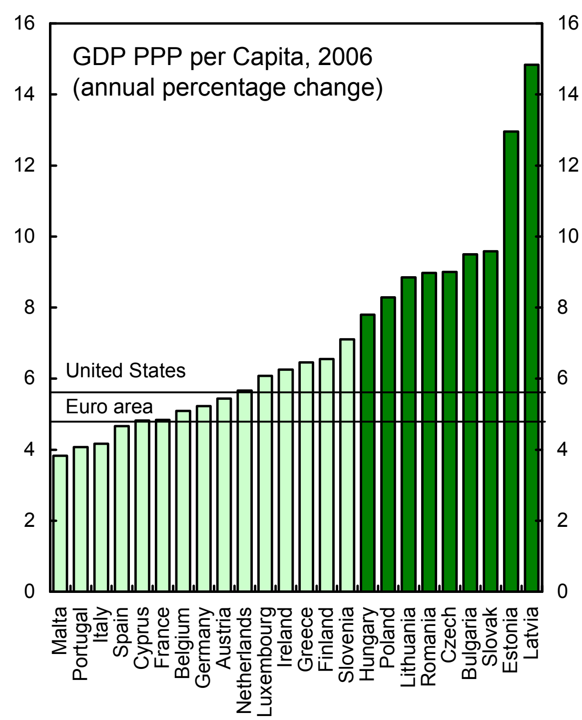
monetary union. Using a dynamic stochastic general equilibrium model, the paper quantifies the degree of policy adjustment the NMS would need to undertake to meet the entry preconditions. The paper also explores structural features of NMS economies, notably their flexibility to adjust to shocks in monetary union.

29. **The paper is organized as follows**. Section II.B provides background information on the NMS. Section II.C summarizes the Maastricht criteria and Section II.D the policy challenges the NMS face in meeting them. Section II.E presents estimates of the policy adjustment needed. Section II.F summarizes the findings and concludes.

B. Background

30. **The NMS are catching-up economies that are in the process of converging to the euro area in real and nominal terms**. Per capita incomes in the NMS are generally lower than in the OMS and are growing fast. Price levels are also lower in the NMS and are converging to the euro-area levels, implying that inflation tends to be higher in the NMS and/or their nominal exchange rates tend to appreciate vis-à-vis the euro. Convergence in nominal interest rates, in part driven by declining risk premia for the NMS, is also proceeding at a rapid pace. Together, these phenomena tend to come with larger current account deficits in the NMS than typical in the OMS.





Source: IMF, World Economic Outlook.

31. **The economic and financial linkages between the NMS and the OMS are strengthening**. In general, the degree of business cycle synchronization between the NMS and the euro area is lower on average than between the OMS and the euro area. However, business cycle correlations between various NMS and the euro area now exceed those for Greece and Portugal. Production structures in the NMS are characterized by a higher share of agriculture and a lower share of services, but are gradually converging to those in the euro area.[33] Inflation correlations and variance shares explained by common euro-area shocks are lower than for the OMS, but the transmission of common euro-area shocks to the NMS does not differ significantly from those to the OMS.[34] About two thirds of NMS trade is with the euro area. The degree of integration of the NMS' equity markets has increased in recent years, especially for the larger NMS such as the Czech Republic, Hungary, and Poland.[35] Local bond prices in the Czech Republic and Poland exhibit fairly high comovement vis-à-vis Germany. With foreign banks, mostly from the euro area, accounting for a significant share of assets in the NMS, the banking systems of the OMS and the NMS are closely integrated.

32. **Most NMS have announced their plans to adopt the euro in the coming years**. This would necessitate changes to their current exchange rate regimes, which range from currency boards to freely floating exchange rates. Membership in monetary union is expected to bring long-term benefits in the form of further integration of NMS and OMS markets for goods, services, labor and capital and faster real and nominal convergence (Box II.1). When the NMS join the euro area, they will lose monetary policy independence and the nominal exchange rate will no longer be able to act as a shock absorber. Staff analysis suggests that this may not entail major losses.[36] Moreover, the elimination of exchange rate risks should at least partly compensate for these costs. The euro area is also expected to benefit from NMS euro adoption through further market integration and improvements in production efficiency.

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[33] Angeloni, Flad and Mongelli (2005). Frankel and Rose (2000) suggest, however, that a currency union can foster endogenous convergence, making countries less susceptible and more adaptable to asymmetric shocks.

[34] Eickmeier and Breitung (2005).

[35] Cappiello and others (2006).

[36] Schadler and others (2005).

Exchange Rate Regimes in the NMS and Euro Adoption Plans

	IMF Classification 1/	Progress in Euro Adoption: ERM II	Progress in Euro Adoption: EMU 2/
Czech Republic	Float	Has not joined yet	No official target date has been set. On current budget plans, 2012 would be the earliest feasible date.
Hungary	Intermediate	Has not joined yet	No official target date has been set. The Convergence Program of December 1, 2006 aims at meeting the Maastricht criteria in 2009.
Poland	Float	Has not joined yet	No official target date.
Slovak Republic	Fixed	Joined on November 28, 2005	Target date is set for January 1, 2009.
Estonia	Fixed	Joined on June 28, 2004	The government is committed to adopting the euro at the earliest possible date, which it now estimates to be 2011, based on current inflation forecasts.
Latvia	Fixed	Joined on May 2, 2005	According to the information released by the Ministry of Finance, in 2007 the Government would discuss a new target for the changeover to the euro, tentatively in 2011-2013.
Lithuania	Fixed	Joined on June 28, 2004	No official target date has been set. According to the government, Lithuania will aim to join the euro area as soon as possible and the more favorable period for the country to join the euro area starts in 2010.
Bulgaria	Fixed	Has not joined yet	Target date is set for January 1, 2010.
Romania	Float	Has not joined yet	Target date is set for January 1, 2014.

Sources: IMF *Annual Report on Exchange Arrangements and Exchange Restrictions* and *International Financial Statistics*; European Commission; European Central Bank; National central banks.
1/ "Fixed" includes currency boards, conventional pegs, and narrow bands. "Intermediate" includes tightly managed floats and broad bands. "Float" includes managed and independent floats.
2/ Latest information available from European Commission and national authorities.

33. **The latest plans represent a delay in euro adoption compared to the original schedules announced in 2004, shortly after the NMS' accession to the EU**. The main reason for the delay was a failure of most NMS to satisfy convergence criteria. Growing skepticism about benefits from euro adoption and reform fatigue also contributed to a weakening of political support for euro adoption in some NMS. The latest Eurobarometer survey (May 2007) indicates that the majority of population in most NMS still supports euro adoption, but the margins are small in the Czech Republic and Estonia. Most citizens in Latvia and Lithuania are against euro adoption. The proportion of people in the Baltic countries expecting net benefits from euro adoption fell in May 2007 compared to September 2006.[37]

C. Maastricht Criteria for EMU Membership

34. **The Maastricht Treaty leaves the timing of EMU entry open**. The NMS are expected to join the euro area if and when they satisfy the entry preconditions. However, unlike Denmark and the United Kingdom, the NMS do not have an indefinite opt-out regarding participation in EMU.[38] The fulfillment of the Maastricht criteria is assessed by the EU Council on the basis of the reports prepared by the EC and the ECB at least once every

[37] Lithuania's application was rejected on the grounds that the country did not meet the inflation criterion (by 0.1 percentage points) and that, crucially, convergence in inflation rates was considered not sustainable.

[38] Sweden does not have an opt-out but is not participating because of domestic political considerations.

two years or at the request of a member state wishing to adopt the euro.[39] Notwithstanding the NMS' commitment to join the euro area, there are no legal limits on how long they can stay outside the euro area, and there are no sanctions for not satisfying the Maastricht criteria. Satisfying them before entering EMU is required. Adopting the euro otherwise, for example, through "euroisation" (i.e., using the euro as a legal tender) would be inconsistent with the spirit of the Maastricht Treaty.

35. **The Maastricht criteria require prospective members to achieve sustainable nominal convergence before entering monetary union**. This involves the following:

- ***Price stability***. The average annual rate of inflation should not exceed by more than 1½ percentage points that of the three best performing EU countries in terms of price stability. The notion of "best performance" is not defined in the Treaty. The 2004 Convergence Reports took "best performance" to mean "the lowest non-negative inflation."[40] Sustainability is also not defined in the Treaty. In practice, the EC examines whether inflation was at or below the Maastricht reference value in the recent past, bearing in mind one-off and temporary effects, and assesses whether such convergence is likely to be sustained over the year following the evaluation. The ECB uses a broadly similar approach. In this context, the EC and the ECB also assess the recent trends and outlook for unit labor costs and the current account balance to gauge if these point to overheating pressures.

- ***Exchange rate stability***. Countries are required to keep their exchange rates within the "normal" fluctuation margins provided for by the exchange rate mechanism of the European Monetary System (ERM-II) without severe tensions for at least two years before the examination and not to devalue their currency during this period.[41] When assessing tensions in the exchange rate, the EC and the ECB examine how far the

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[39] The euro-area authorities indicated that the assessments are guided by the principle of equal treatment of the NMS vis-à-vis the OMS. (The informal Ecofin document adopted on April 5, 2003, as cited in Backé, Thimann and others, 2004).

[40] The euro-area authorities faced a question in 2004 as to whether countries with negative inflation (Lithuania at that time) should be included in the calculation of the reference value for the inflation criterion. See Filáček, Horváth and Skorepa (2006) for a detailed review of how the Maastricht criteria were interpreted in past Convergence Reports.

[41] Requirements concerning participation in the ERM-II and the exchange rate stability criterion jointly imply that the exchange rate is allowed to appreciate within the 15 percent of the ERM-II band but it cannot depreciate by more than 2¼ percent from the central parity (see Schadler and others, 2005, for more details). The ECB examination of exchange rate stability against the euro focuses on the exchange rate being close to the ERMII central rate, while also taking into account factors that may have led to exchange rate appreciation.

exchange rate is from the central parity, the size of the short-term interest rate differential and the size of foreign exchange interventions. Specific limits on the size of interventions or revaluations that would be consistent with the fulfillment of the exchange rate stability criterion have not been specified.

- ***Convergence of long-term interest rates***. The average over the latest 12 months of the nominal long-term interest rate should not exceed by more than two percentage points the average of the three best performing EU member countries in terms of price stability.

- ***Fiscal sustainability***. The fiscal deficits should not exceed 3 percent of GDP, and gross government debt should not exceed 60 percent of GDP.[42] The examination of the fiscal deficit and debt under the excessive deficit procedure outlined in the Maastricht Treaty is designed to take into account whether the fiscal deficit ratio "has declined substantially and continuously and reached a level that comes close to the reference value" or that "the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value." The government debt ratio is allowed to be "sufficiently diminishing and approaching the reference value at a satisfactory pace."

36. **When assessing progress in fulfilling the Maastricht criteria, the euro-area authorities guard against countries' satisfying the criteria in an "opportunistic" manner**. Accordingly, they would consider the roles of unusually favorable external conditions (e.g., declining oil prices), rapid nominal exchange rate appreciation (where applicable), and changes in administrative prices or indirect taxes in lowering inflation. The reason is that the effects of temporary factors or "quick-fix" measures would unwind after entry into EMU.[43]

37. **Although most NMS already comply with at least some of the Maastricht criteria, achieving all of them is proving difficult**. As of December 2006, inflation was below the Maastricht reference value in only two out of the nine NMS: the Czech Republic and Poland. Low inflation in these two countries largely reflected the strength of their domestic currencies (Figure II.1). Fiscal deficits exceeded the 3 percent limit in the CEECs,

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[42] The fiscal criteria are supplemented by the definitions of the excessive deficits and debt, the "no-bail-out" clause (which makes countries responsible for servicing their own debt) and a ban on direct central bank financing and access to favorable financing of public deficits.

[43] Szapary (2001) coined the term "the 'weighing-in' effect" to describe this strategy, comparing it to that of a boxer who refrains from eating and drinking before a weigh-in only to binge afterwards.