

## POSITIVE AND NEGATIVE SIDES OF ERM II

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The panel discussion on ERM II at the East-West Conference in Vienna lasted for two hours. So that all the dozen participants would be able to briefly present their views the organisers asked them to focus on answering the following two questions:

- **What do you think are the principal positive and negative sides of participating in ERM II?**
- **What is your strategy regarding the duration of the ERM II participation period?**

I gave the following short overview of Estonia's position:

Estonia has been applying a fixed exchange rate regime for more than 10 years, which is why the policy change associated with ERM II is not likely to be very significant. **For Estonia the problem associated with ERM II lies first and foremost in the fact that technical measures do not secure exchange rate stability better than the currency board system.** At the same time, it might be difficult to explain to the economic agents how ERM II would enhance the exchange rate stability of the kroon, which is why a reverse effect might be possible – the transformation might be misinterpreted as a possible step towards policy change. This might increase insecurity under certain conditions, and preventing that from happening is a key issue in the process of joining ERM II.

It has been highlighted in further arguments that ERM II might, under certain conditions, discipline the government, making it analyse the macroeconomic impact of the fiscal policy better. Even though such an impact might indeed materialise, it still remains a dubious claim since budgetary policy discipline has to arise from domestic factors.

However, if ERM II boosts the overall credibility of the exchange rate policy, joining the mechanism will in every respect be useful to us, too. Hence Estonia's viewpoint is that it would be reasonable to join ERM2 as well as become a full member of the EMU as soon as possible.

Negative aspects related to joining ERM II might emerge, should it encourage money markets' interest towards taking speculative positions or should membership in ERM II unintentionally send out signals to the economic policy makers that it is no longer necessary to continue with structural reforms in order to maintain credibility. At the moment I do not regard either of the threats very likely.

**The time of joining ERM II should not have a major impact on eliminating possible imbalances since these threats have to be handled in any case.** Besides positive

developments (much faster economic growth than in the industrial countries of Europe, halting inflation rate) Estonian economy has during 2003 also shown some phenomena causing close attention. Here I mainly mean extensive external imbalance. But if the underlying reasons are analysed, it is clear that these phenomena are above all related to the process of successful convergence, whose possible adverse side effects should be taken into account when carrying out economic policy, but which are for transition countries a normal component of the process of catching up with other countries. Also one-off phenomena have played a role, including the political shock from joining the European Union, as well as a few major investment deals.

All in all, these risks require a consistent economic and monetary policy, but backed with appropriate supportive policies these do not have any direct association with the need to delay ERM II entry. Above all, attention has to be paid to maintaining the flexibility of the markets and see to it that the budgetary and financial sector policy would secure the buffers necessary in the economy.