Box 8

ENTRY OF THE CURRENCIES OF CYPRUS, LATVIA AND MALTA INTO THE EXCHANGE RATE MECHANISM II (ERM II)

Following requests by the Cypriot, Latvian and Maltese authorities, the ministers of the euro area Member States of the European Union, the President of the European Central Bank and the ministers and the central bank governors of Denmark, Estonia, Lithuania, Slovenia and of each of the countries requesting ERM II entry decided on 29 April 2005, by mutual agreement, following a common procedure involving the European Commission and after consultation of the Economic and Financial Committee, to include the currencies of Cyprus, Latvia and Malta in the exchange rate mechanism II (see communiqués of the European Union of the same date).

The central rates have been set for the Cyprus pound at CYP/EUR 0.585274, for the Latvian lats at LVL/EUR 0.702804 and for the Maltese lira at MTL/EUR 0.429300. For all three currencies the standard fluctuation band of ±15% will be observed around these central rates. Accordingly, the compulsory intervention rates for these currencies have been established with effect from 2 May 2005 as set out in Table A below. The euro central rate and compulsory intervention rates for the Danish krone, the Estonian kroon, the Lithuanian litas and the Slovenian tolar remain unchanged. For Denmark only, a fluctuation band of ±2.25% applies.

Table A Euro central rates and compulsory intervention rates for the currencies of the Member States participating in ERM II, in force as of 2 May 2005 (EUR 1 =)

	Upper rate	Central rate	Lower rate
Danish krone (DKK)	7.62824	7.46038	7.29252
Estonian kroon (EEK)	17.9936	15.6466	13.2996
Cyprus pound (CYP)	0.673065	0.585274	0.497483
Latvian lats (LVL)	0.808225	0.702804	0.597383
Lithuanian litas (LTL)	3.97072	3.45280	2.93488
Maltese lira (MTL)	0.493695	0.429300	0.364905
Slovenian tolar (SIT)	275.586	239.640	203.694

Prior to ERM II entry, both the Cyprus pound and the Latvian lats were already unilaterally pegged to the euro. While a fluctuation band of ±15% applied in the case of Cyprus, Latvia retained a ±1% fluctuation band when the lats was re-pegged from the special drawing right (SDR) to the euro on 1 January 2005. In line with the preceding exchange rate regime, the Latvian authorities have declared that they will unilaterally maintain the exchange rate of the lats at the central rate against the euro with a fluctuation band of ±1%.

Prior to ERM II participation, the Maltese lira was pegged to a basket including the euro, the pound sterling and the US dollar with no fluctuation band. Upon entry into the mechanism, the Maltese lira was re-pegged to the euro from the basket arrangement. Moreover, the Maltese authorities have declared that they will unilaterally maintain the exchange rate of the Maltese lira at the central rate against the euro.

As regards the currencies which entered ERM II in June 2004, it is worthwhile to recall that it was accepted that Estonia and Lithuania could join the mechanism with their existing currency board arrangements in place. These announcements, as well as those of the Latvian and Maltese authorities, constitute unilateral commitments, thus placing no additional obligations on the ECB.

The agreements on the participation of the Cyprus pound, the Latvian lats and the Maltese lira are based on firm commitments by the authorities in these countries in various economic policy areas. The authorities, together with the responsible EU bodies, will closely monitor macroeconomic developments in these countries. Table B provides an overview of the main macroeconomic and financial market indicators for Cyprus, Latvia and Malta.

The agreement on the participation of the Cyprus pound in ERM II is based on a firm commitment by the Cypriot authorities to pursue sound fiscal policies, including lowering the high debt level, which are essential for preserving macroeconomic stability and ensuring the sustainability of the convergence process. The Cypriot government's medium-term fiscal consolidation strategy requires a high degree of budgetary discipline and needs to continue to be implemented decisively through measures of a permanent nature. The authorities will continue to ensure effective financial supervision. Continued vigilance will be needed to ensure that wage developments remain in line with productivity growth. Further structural reform efforts aimed at enhancing the economy's flexibility and adaptability, including progress with the de-indexation of wage mechanisms, will contribute to strengthening domestic adjustment mechanisms and support the overall competitiveness of the economy.

The agreement on the participation of the Latvian lats in ERM II is based on a firm commitment by the Latvian authorities to achieve a sustainable reduction in inflation. The authorities recognise that strengthening the fiscal stance will be instrumental to this end, while it would also contribute to an orderly and substantial reduction of the current account deficit. To help reduce the external imbalance and contain it at a sustainable level, the authorities will take measures to restrain domestic demand and will remain vigilant concerning risks of excessive domestic credit growth. Continued effective financial supervision will assist the authorities in promoting prudent credit policies and limiting credit risk in the banking system. The authorities will also promote wage developments that are supportive to reducing inflationary pressures. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and safeguard the overall competitiveness of the economy.

The agreement on the participation of the Maltese lira in ERM II is based on a firm commitment by the Maltese authorities to pursue sound fiscal policies, including containing current government expenditure and lowering the high debt level, which are essential for preserving macroeconomic stability, containing the current account deficit and ensuring the sustainability of the convergence process. The Maltese government's medium-term consolidation strategy requires a high degree of budgetary discipline and needs to be implemented decisively. Strict monitoring of budget execution will be required, aimed at a timely detection and correction of slippages. Continued vigilance will be needed to ensure that wage developments remain in line with productivity growth. The authorities will continue to ensure effective financial supervision. Further structural reforms, aimed at supporting productivity growth and enhancing the economy's flexibility and adaptability, will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and safeguard the overall competitiveness of the economy.

Table B Main economic indicators for Cyprus, Latvia and Malta

(annual percentage changes, unless otherwise indicated)

	Cyprus		Latvia		Malta	
	2001-2003	2004	2001-2003	2004	2001-2003	2004
Real economic growth	2.7	3.7	7.3	8.5	-0.4	1.5
HICP inflation	2.9	1.9	2.5	6.2	2.3	2.7
Growth of credit to the private sector	7.9	5.0	41.6	42.9	3.9	12.7
Current account balance (% of GDP)	-3.7	-5.8	-7.6	-12.4	-3.3	-7.1
Fiscal deficit (% of GDP)	-4.4	-4.2	-2.1	-0.8	-7.6	-5.2
Government debt (% of GDP)	65.6	71.9	14.5	14.4	65.6	75.0
Long-term interest rate	6.0	5.8	6.0	4.9	5.7	4.7
Short-term interest rate	4.7	4.7	5.0	4.2	4.1	2.9
Exchange rate (per EUR)	0.5784	0.5818	0.5939	0.6652	0.4127	0.4280

Sources: ECB, Eurostat and European Commission.
Note: Data refer to annual averages.