TOWARDS A STRONGER EURO: EMU ENLARGEMENT AND EUROIZATION (VS. DOLLARIZATION)

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Abstract.

Since its introduction in 2002, the euro has enjoyed an increasingly important role in international monetary relations. This is due to the fact that the euro is issued by one of the world's leading economic and trading powers. Moreover, the expectation that the euroarea will enjoy low inflation rates in the long term increases confidence in the European currency.

The euro is becoming a competitor to the US dollar as "the international currency". It might even overtake the American currency – as many economists predict – in case of a weak US macroeconomic policy performance, as well as depending on how the euro establishes itself in international financial markets, and – last but not least – on how many (and how rapidly) new EC Members will join the euro, making the euroarea economy larger than the US one.

The main purpose of this paper is to analyze the eurozone enlargement from a legal point of view.

This enlargement can take place either with the consent of the European Community or unilaterally. In fact, the euro can be adopted by a EC Member State, respecting the Maastricht convergence criteria, or by third States through the execution of international monetary treaties (e.g. San Marino, the Vatican, Monaco). Otherwise, the euro can be adopted "unilaterally" by third (non-European) States by conferring it legal tender status with an internal act. This last solution shall be considered legitimate from an international law point of view.

This paper is structured in three sections.

The first section is devoted to the enlargement of the European Monetary Union. Particular attention is given to the legal issues arising from the participation of the new EC Member States in the Exchange Rate Mechanism 2 (ERM2). This analysis is of fundamental importance, because participation in the ERM2 is necessary to meet the exchange rate stability convergence criterion that *non-euro EC Members* should comply with in order to adopt the single currency.

The second section investigates on what legal grounds the Community can negotiate bilateral monetary agreements, with the goal of a consensual introduction of the euro in the counterpart State. This method has mainly been used with *European micro-States*.

The last section aims at evaluating if, under an international law point of view, third States can legitimately "euroize". While the position of the European Community on the euroization of *non-European countries* may be deemed neutral, the Community has actively discouraged the unilateral adoption of the euro by *States of the European region eligible for EC membership*. In fact, prospective accession countries should not unilaterally confer the euro legal tender status bypassing the convergence process foreseen by the EC Treaty.

Eventually, a comparison between the EC policy and the US policy on official euroization/dollarization is offered.

It is not the aim of this paper to discuss why countries should decide to adopt a foreign currency, nor to consider the pros and cons of euroization/dollarization.

1. Introduction.

Since its introduction in 2002, the euro has enjoyed an increasingly important role in international monetary relations.

The following main trends can be identified: the euro spreading on global markets (debt, loan and deposit, and foreign exchange) and in third countries (both officially, as a reserve, as an anchor and intervention currency, and privately, as an effect of currency and asset substitution)[1].

This is due to the fact that the euro is issued by one of the world's leading economic and trading powers. Moreover, the expectation that the euroarea will enjoy low inflation rates in the long term increases confidence in the European currency.

The euro is becoming a competitor to the US dollar as "the international currency". It might even overtake the American currency – as many economists predict – in case of a weak US macroeconomic policy performance, as well as depending on how the euro establishes itself in international financial markets, and – last but not least – on how many (and how rapidly) new EC Members will join the euro, making the euroarea economy larger than the US one.

Monetary governance is one of the most closely guarded national prerogatives. To present day, choosing, creating, evaluating, and controlling the distribution of national legal tender are among the main attributions of a State's sovereign power.

Alongside being a vehicle for international trade and investments, money is also an instrument of power and prestige.

Historically, the issuance of a currency was also a mean to control a newly conquered territory. Legal tender was an instrument for determining the governing power over annexed regions.

One of the most important determining factors of international reserve currency status is the size of the country or region in which the currency is officially used[2].

The widespread use of a foreign currency outside the borders of the State of origin may be driven by private preferences (as it happens in a non-officially dollarized country), or it may be the result of the issuing State monetary policy.

Peculiar to the European Community system is to define a legal framework for the euro adoption both inside and outside EC borders.

The EC Treaty determines criteria and procedures (Art. 121-122 EC) that a new EC Member State has to meet in order to introduce the single currency. This, in fact, is not granted with accession and new Member States are forbidden to confer the euro legal tender status unilaterally.

The EC Treaty also provides for the conclusions of international monetary agreements with third States wishing to adopt the euro (Art. 111.3 EC) (for the time being, this procedure has been mainly implemented by the so-called micro-States).

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[1] See ECB, *Review of the International Role of the Euro*, 2005; GALATI G. and WOOLDRIDGE P.D., *The Euro as a Reserve Currency: A Challenge to the Pre-Eminence of the Us Dollar?*, BIS Working Paper n. 218, October 2006

[2] For a description of the factors that suit a currency for international reserve currency status see FRANKEL J. and CHINN M., *Will the Euro Eventually Surpass the Dollar As Leading International Reserve Currency?*, paper presented at NBER Conference, Newport, RI, 1-2 June 2005 and published in CLARIDA R. (ed.), *G7 Current Account Imbalances: Sustainability and Adjustment*, Chicago, 2006. See also LIM EWE-GHEE, *The Euro's Challenge to the Dollar*, IMF Working Paper WP/06/153, June 2006 and HARTMANN P. and ISSING O., *The International Role of the Euro*, in Journal of Policy Modeling, vol. 24, n. 4, 2002, pp. 315-345.

Therefore, through consensual euroization, the euro could be introduced without necessarily following the EMU path.

Eventually, the Community has exerted its leverage to prevent prospective accession countries from unilaterally adopting the euro, therefore bypassing the convergence process foreseen by the EC Treaty.

The main purpose of this paper is to analyze the eurozone enlargement from a legal point of view. Hereinafter the term eurozone will define the group of countries in which the euro is conferred legal tender status, irrespective of how the euro adoption has been implemented. Therefore, it is comprehensive of the euroarea, which in turn designates only those EC Member States where the euro is the single currency.

2. *EMU Enlargement.*

a) *The Maastricht Convergence Criteria.*

In order to adopt the euro, EC Member States have to respect the so-called *convergence criteria*, as established in Art. 121 EC Treaty and further developed in the Protocol on the Convergence Criteria annexed to the Maastricht Treaty (hereinafter PCC). These criteria relate to the compatibility of national legislations with Articles 108 and 109 EC and with the Statute of the European System of Central Banks (ESCB) and of the European Central Bank (ECB) (the so-called legal convergence). They also relate to the performance in terms of price stability, public finance, long-term interest rates, and exchange rates (economic convergence).

In its definition of rules and procedures for the euro adoption, the European Community aims at limiting adoption to those specific countries which meet a minimum set of economic criteria. No deadline is fixed by the Treaty for the fulfilment of these criteria, though.

Having regard to *legal convergence*, the main focus of the ECB and of the European Commission in their Convergence Reports has been: the independence of national central banks (NCBs) (Art. 108 EC and Art. 7 and 14.2 of the ESCB Statute), the prohibition of monetary financing and privileged access (Art. 101 and 102 EC), and the legal integration of the NCBs into the Eurosystem (particularly, Art. 12.1 and 14.3 ESCB Statute).

Since 1997, when the European Monetary Institute (EMI) established a list of standards for the independence of central banks, this concept has been interpreted as including namely functional, institutional, personal and financial independence, which have to be assessed separately. The ECB has then delivered many opinions on the definition of this requisite.

In particular, the ECB expressed the view that the underlying rationale of central bank independence is to permit the pursuit of the primary objective of price stability. Hence, NCBs of new EC Member States should have price stability as their primary goal of monetary policy, from the date of their accession to the EC to the adoption of the single currency. This principle is based on Art. 2 of the ESCB Statute and on Art. 4 EC Treaty which apply also to Member States with a derogation.

With regard to the achievement of a high degree of *price stability* (Art. 121.1, first indent, EC and Art. 1 PCC), the criterion will be met by a Member State with a sustainable price performance and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5% that of, at most, the three best performing Member States in terms of price stability. Inflation

shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions. Council Regulation (EC) n. 2494/95 of 23 October 1995 defines the harmonized index of consumer prices.

The EC Treaty hence stipulates that in order to satisfy the price stability criterion the reference value will be the average inflation rate of the three best performing Member States plus 1.5 percentage points. The Treaty refers to *Member States*: this means that the benchmark will be calculated on inflation rates experimented not only by euro countries, but also by non-euro EC members. Hence, a prospective euroarea member could be evaluated on the basis of data of a non-euroarea country.

For instance, in the last Convergence Report of December 2006, the ECB calculated the price stability criterion reference value on Poland (1.2%), Finland (1.2%) and Sweden (1.5%), among which only Finland is a euroarea member.

The wording of Art. 121.1, first indent, was decided well before the first group of EC countries adopted the euro. Nowadays, some argue that a new benchmark should be established, referring only to the average euroarea inflation rate (or alternatively the 2% ECB target) plus 1.5%. What matters more, in fact, is the euroarea inflation rate and the stabilization of the euroarea inflation expectations. Unfortunately, the Treaty does not allow this interpretation.

The sustainability of the *government financial position* (Art. 121.1, second indent, EC and Art. 2 PCC) will be apparent from having achieved a government budgetary position without an excessive deficit, as determined in accordance with Article 104.6 EC. This means that the ratio of the planned or actual government deficit to GDP shall not exceed the reference value of 3% of GDP (as defined in the Protocol on the Excessive Deficit Procedure), unless either the ratio has declined substantially and continuously and reached a level close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value. Furthermore, the ratio of government debt to GDP shall not exceed the reference value of 60% of GDP (as defined in the Protocol on the Excessive Deficit Procedure), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

After said fiscal criteria are met and the euro is adopted, the Stability and Growth Pact (SGP) provides the minimum necessary coordination for fiscal and budget policies that otherwise remain a fully national responsibility[3]. The SGP requires Member States not to exceed a general government deficit to GDP ratio of 3 percent and to keep the public debt below 60 percent of GDP. Exceptions to the 3 percent ceiling can be granted in case of severe recession, while violations are subject to sanctions.

The *convergence of interest rates* criterion (Art. 121.1, fourth indent, EC and Art. 4 PCC) means that – observed over a period of one year before the examination – the average nominal long-term interest rate of a Member State has not exceeded by

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[3] The Stability and Growth Pact comprises: the Resolution of the European Council of Amsterdam on the Stability and Growth Pact 17 June 1997 (Official Journal C 236/1 of 02.08.1997); the Council Regulation (EC) n. 1055/2005 of 27 June 2005 amending Regulation (EC) n. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 174/1 of 7.7.2005); Council Regulation (EC) n. 1056/2005 of 27 June 2005 amending Regulation (EC) n. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 174/5 of 7.7.2005).

more than 2% 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 the differences in national definitions.

The calculation of the reference value of this criterion should be performed using the long-term interest rates of the same three EC countries whose parameters were used in the calculation of the price stability criterion.

The same remarks we made to the price stability criterion could apply here. Even if the EC Treaty contains a reference to Member States, it would be preferable to take into account only the interest rates of euroarea members.

A Member State will meet the *exchange rate criterion* (Art. 121.1, third indent and Art. 3 PCC) by respecting the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, without having suffered severe tensions in the previous two years and without having devalued its currency's bilateral central rate against the currency of any other Member State on its own initiative during the same period.

It has to be underlined that both the ECB and the Commission have interpreted this criterion as requiring formal participation in the Exchange Rate Mechanism 2 (ERM2)[4]. Accession countries have accepted this interpretation too.

Therefore, the devaluation of a currency's central rate against the euro is not compatible with the stability provisions set forth in Art. 121 EC: as the central rate may not be lowered, a country which needs to devaluate will have to wait before adopting the single currency.

Hereinafter, particular focus will be given to the above exchange rate convergence criterion.

b) Main Features of the Exchange Rate Mechanism 2 (ERM2).

The ERM2 is the mechanism which regulates the exchange rates between the euro and the currencies of EC Members which have not yet adopted the single currency[5]. As we will see, the ERM2 features cause problems of compatibility with the new Member States' exchange regimes. Moreover, the fact that Art. 121.1 EC Treaty still contains a reference to the old European Monetary System (EMS), replaced by the ERM2 since the 1st of January 1999, might create some problems of interpretation.

The functioning of the ERM2 is governed by many legal instruments:

- the *Resolution of the European Council on the establishment of an exchange rate mechanism in the third stage of economic and monetary union*[6], adopted in Amsterdam, on the 16th of June 1997 (ERM2 Resolution), which outlines the ERM2 principles, objectives and main features;

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[4] See European Commission Convergence Report 2000 and the following, under which however "a period of non-participation before entering the ERM2 can be taken into account". The ECB examines whether the country has participated in ERM2 for a period of at least two years prior to the convergence examination without severe tensions, in particular without devaluing against the euro. In cases of shorter periods of participation, exchange rate developments are described over a two-year reference period as in previous reports (ECB, Convergence Report, December 2006).

[5] See PADOA-SCHIOPPA T., *Trajectories towards the Euro and the Role of ERM II*, in International Finance, vol. 6, n. 1, 2003, pp. 129-44; SMITS R., *The European Central Bank: Institutional Aspects*, The Hague, 1997.

[6] Official Journal C 236/5 of 2.8.1997.

- the *Agreement of 16 March 2006 between the ECB and the national central banks of the Member States outside the euroarea laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union* (as amended on the 21st of December 2006)[7] , which repealed/replaces the previous *Agreement of 1st September 1998* (amended three times);

- the ERM2 implementing *Guideline* and *Agreement*[8].

For each currency of a Member State wishing to participate in the ERM2, a central rate against the euro will be defined following the common procedure specified in the Amsterdam Resolution (at par. 2.3): the decisions on central rates and the standard fluctuation band shall be taken by common accord of the Ministers of the euroarea Member States, the ECB and the Ministers and Central Bank Governors of the non-euroarea Member States participating in the new mechanism, following a joint procedure involving the European Commission, and after consultation of the Economic and Financial Committee. The Ministers and Governors of the Central Banks of the Member States not participating in the exchange rate mechanism will take part, but will not have the right to vote, in the procedure. All parties to the mutual agreement, including the ECB, will have the right to initiate a confidential procedure aimed at reconsidering central rates (Art. 17 ERM2).

Fluctuation margins are fixed at the standard level of ±15% around the central rates. However, on a case-by-case basis, formally agreed fluctuation bands (narrower than the standard one, and backed up in principle by automatic intervention and financing) may be set at the request of the non-euroarea Member State concerned (following the procedure described by Art. 15 ERM2).

The agreement distinguishes between marginal interventions, which are required to prevent a breach of the margins, and intramarginal interventions, which are within the margins and could be required for keeping the exchange rate on target.

The first type of interventions are in principle automatic and unlimited, with very short-term financing available. They can be suspended by the ECB and a participating central bank, however, when these interventions conflict with the objective of price stability. This exit option would prevent the ECB from intervening when a ERM2 participating NCB is pursuing a non-stability-oriented fiscal and monetary policy, causing a strong depreciation of the national currency. In this case, the ECB would be able to legitimately suspend intervention on the grounds of maintaining price stability in the entire euroarea.

Coordinated intramarginal interventions could be agreed upon by the ECB and participating central banks.

Other types of closer exchange rate arrangements of an informal nature may also be established between the ECB and participating non-euroarea NCBs.

In the case of excessive exchange rate fluctuation, the ECB and NCBs will intervene on the markets using euros and the currencies of States non participating in the euroarea.

Non-euroarea NCBs which are not participating in ERM2 shall cooperate with the ECB and the participating NCBs, exchanging information necessary for the proper functioning of the ERM2 (Art. 19 ERM2 Agreement).

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[7] Official Journal C 73/21 of 25.3.2006 and Official Journal C 14/6 of 20.1.2007. This last amendment was adopted in view of the adoption by Slovenia of the single currency on 1 January 2007 and of the accession of Romania and Bulgaria to the EU on the same date.

[8] The ERM2 implementing *Guideline* and *Agreement* have not been published.

c) Matters Concerning the Participation of New Member States in the ERM2.

The European Community has recently undergone one of its major enlargements. On the 1st of May 2004, eight new Central and Eastern European countries, plus Cyprus and Malta, became Members of the European Union[9]. On the 1st of January 2007, the accession of Romania and Bulgaria was also completed[10].

Along with membership, these States have acquired the status of *Member with derogation*, to which Art. 122 EC is applied[11].

Before participating in the ERM2, new Member States have to comply with Art. 124 EC: until the beginning of the third stage of the EMU, each Member State shall treat its exchange rate policy as a matter of common interest. In doing so, they shall take into account the experience they have acquired in cooperation within the framework of the EMS and in developing the ECU, and shall respect any existing powers in this field.

Given the very general character of Art. 124 EC, each new Member State still has the possibility of adopting either a fixed exchange rate, a free floating or a managed floating. However, with a market-determined exchange rate, they would run the risk of excessive fluctuations – which in turn could prevent the determination of a stable rate against the euro.

Member States with a derogation will have to enter the ERM2, but they can freely decide when. They are in fact expected to join the mechanism even if the participation in the ERM2 will basically maintain a voluntary character[12]. Pursuant to the ERM2 Resolution, "a Member State which does not participate from the outset in the exchange rate mechanism may participate at a later date". Accession countries in particular are expected to join the ERM2 and eventually the euro, although not necessarily upon accession[13]. As pointed out during negotiations, though, the adoption of the single currency by the new Members will only be possible if all the convergence criteria are met.

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[9] The Treaty of accession, signed in Athens the 16th of April 2003, entered into force the 1st of May 2004 (OJ L 236/17 of 23.9.2003).

[10] The Treaty of accession, signed in Luxembourg the 25th of April 2005, entered into force the 1st of January 2007 (OJ L 157/11 of 21.6.2005).

[11] Members with derogation status are: EC Member States which in 1998 were not in a position to move to the third phase of the EMU due to the non fullfillment of the convergence criteria ex Art. 121 EC (at that time Greece and Sweden, but Greece entered EMU the 1st January 2001) and new Member States which are not yet in a position to adopt the euro. Bulgaria and Romania have acquired the same status with the entry into force of the Adhesion Treaty. See Art. 4 of the *Act concerning the conditions of 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 and the adjustments to the Treaties on which the European Union is founded* (OJ L 236/33 of 23.9.2003), and Art. 5 of the *Protocol concerning the conditions and arrangements for admission of the Republic of Bulgaria and Romania to the European Union* (OJ L 157/29 of 21.6.2005).

[12] Opt-out States (the United Kingdom and Denmark), instead, are not obliged or committed to move to the third stage of the EMU, but they do have the faculty to adhere to the new exchange rate mechanism. See the Protocol n. 25 on the UK and Protocol n. 26 on Denmark annexed to the Treaty of Maastricht.

[13] See the *Common Statement on Acceding Countries and ERM 2* adopted by ECOFIN, ECB President, NCBs Governors and European Commissioners, in Athens, on 5 April 2003 and the *Policy position of the Governing Council of the ECB on exchange rate issues relating to the acceding countries* published on 18 December 2003.

Even if the ERM2 mechanism is fairly flexible (standard margins being ±15%), it is incompatible with many exchange rate systems of the new Members.

In fact, *free floating arrangements*, *managed floating arrangements*, *crawling bands*, *crawling pegs*[14] *and fixed pegs*, especially on currency other than the euro or on the SDRs, are certainly not compatible with the ERM2 mechanism, which provides for predetermined fluctuation bands and a central rate against the euro.

Currency boards that are not based on the euro are not compatible with participation in ERM2. In euro-based currency board regimes, the absence of fluctuation bands raises the question on whether currency boards may be used in place of ERM2: is a zero band negotiable as a reinforced cooperation within the ERM2 framework (on the basis of Art. 15 ERM2)?

The existence of a minimum degree of fluctuation around the euro central rate is required to define the final conversion rates at which national currencies will be permanently converted into euros. Therefore, the maintenance of a currency board regime can not be deemed a valuable substitute to the biennial participation in the ERM2.

As a consequence, in order to adopt the euro, currency board countries will have to stay in the ERM2 for at least two years, but it remains to be established whether a currency board system may be maintained while also participating in the ERM2.

The ECB was clear on this issue: "*countries that operate a euro-based currency board deemed to be sustainable might not be required to go through a double regime shift, i.e. of floating the currency within ERM2 and then re-pegging it to the euro later. Thus, such countries may participate in ERM2 with a currency board as a unilateral commitment, enhancing the discipline within ERM2. […] Such an arrangement will be assessed on a case-by-case basis and a common accord on the central parity against the euro will have to be reached*"[15].

Therefore, the ECB deems the admission of currency board States to the ERM2 possible but not automatic; the "closer exchange rate cooperation" provided for by Art. 15 ERM2, however, is not applicable to currency board systems.

In fact, the "closer exchange rate cooperation" envisions the possibility of establishing a reduction of the ±15% margin – backed up, in principle, by automatic intervention both by the ECB and by NCBs participating in the ERM2. Hence, any reinforced cooperation within ERM2 must be formally agreed with the ECB. In fact, the ECB is given this power in order to prevent automatic or unlimited intervention obligations on unsustainable reduced margins.

The ECB claimed that a reinforced cooperation on a currency board implying a mutual commitment to intervene on zero margins is unsustainable. Art. 15 ERM2 is deemed applicable only for reinforced cooperation on fluctuation bands not narrower than ±2.25%.

A currency board State will only be admitted to the ERM2 if it commits itself unilaterally: its Central Bank will have to intervene whenever the self-imposed reduced margins are exceeded, while the ECB will only intervene in case of fluctuations exceeding ±15%. Moreover, there shall be a mutual agreement on the fact that the fixed exchange rate prevailing under the currency board will serve as the

[14] Crawling peg arrangements currently in use imply a mechanical, automatic adjustment of the central rate, based on a known standard procedure, at periodically announced intervals, which is not compatible with the procedure provided for by the ERM 2 agreement to reconsider central rates (Art. 2.3 ERM 2).

[15] ECB, *The Eurosystem's Dialogue with EU Accession Countries*, Monthly Bulletin, July 2002, p. 59.

ERM2 central rate for that currency.

The adoption of euro-based currency boards is neither encouraged nor discouraged by the ECB Governing Council.

d) Status of Accession Countries' Participation in the ERM2.

Among accession countries, Estonia, Lithuania and Slovenia entered the ERM2 on the 28th of June 2004, while Cyprus, Latvia and Malta on the 2nd of May 2005, and Slovakia on the 28th of November 2005. Eventually Slovenia adopted the euro on the 1st of January 2007, having met all the convergence criteria[16].

In the case of Cyprus and Slovakia, the fluctuation margins are the standard ones (±15%). Latvia and Malta committed themselves to keep reduced spread margins (respectively, ±1% for the Latvian lat and a fixed 1:1 exchange rate between Maltese lira and euro). The currency board systems of Estonia and Lithuania were deemed sustainable by the ECB within the ERM2 framework, as unilateral commitments.

In the vision of entering ERM2, other new Member States have modified their exchange regimes unilaterally. Hungary, for example, has broadened the managed floating margins from ±2.25% to ±15%, adapting to the requirements of ERM2, and Cyprus did the same before entering ERM2.

Hence, out of twelve new Member States, six are currently participating in the ERM2, while only Slovenia already succeeded in adopting the euro. The Bulgarian lev, the Czech koruna, the Hungarian forint, the Polish zloty, and the Romanian leu do not participate in the ERM2 yet.

Besides, it has to be underlined that the United Kingdom and Denmark have a special status, under which they have the faculty to decide when to adopt the euro (under the condition of meeting the convergence criteria and therefore participating in the ERM2 for at least two years). Denmark, while being an opt-out State, entered the ERM2 in 1999 and activated the closer exchange rate cooperation provided for by Art. 15 ERM2, setting a fluctuation band of ±2.25%.

Finally, among the "old" Member States only Sweden has not adopted the euro yet and is not currently participating in the ERM2.

All the accession countries have submitted to the EC both a prospective date to join the EMU and a strategy in order to reach it.

e) Interpretation of the Exchange Rate Stability Criterion.

Participation in the ERM2 is hence a major step towards the adoption of the single currency. This exchange rate mechanism is however not formally listed among the convergence criteria in the EC Treaty. In fact, Art. 121.1 EC still refers to the exchange rate mechanism connected to the EMS (the ERM), even if this system was repealed by its successor (the ERM2), on the 1st of January 1999 (Art. 121.1 EC refers to "*the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System*").

Given the above, is it sufficient to comply with the standard fluctuation margins set by the ERM2 (±15%) in order to meet the convergence criterion?

It should be noted that, originally, the ERM standard fluctuation bands of the previous ERM were established at ±2.25%, whereas a ±6% band was a derogation

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[16] See the *EU Council Decision of 11 July 2006, in accordance with Article 122(2) of the Treaty, on the adoption by Slovenia of the single currency on 1 January 2007* (published in OJ L 195/25 of 15.7.2006).

from the rule. Moreover, in August 1993 a decision was taken to widen the ERM fluctuation margins to ±15%, and the definition of the "normal fluctuation margins" became less straightforward.

A question therefore arises: are future euro Members required to stay within the ±15% or the ±2.25% band?

Accession countries are the most interested parties in this issue, as the interpretation of Art. 121.1 EC leads to two different scenarios, influencing their policy choices towards the adoption of the euro.

It must be said that even if a primary rule of community law[17] contains an interpretative criterion, the ECB and the European Commission have two slightly different views on the issue.

As early as in 1994, the Council of the European Monetary Institute (EMI) had delivered an opinion on the ERM fluctuation bands[18]. Even recognizing that the wider band had helped to achieve a sustainable degree of exchange rate stability, the EMI Council considered that "member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to the fulfillment of the requirements set out in Article 109j (1) [now Art. 121.1] of the Treaty and the relevant Protocol".

Therefore, in the assessment of the exchange rate criterion for the first group of countries adopting the euro the emphasis was placed on exchange rates being close to central rates[19].

The ECB bases its evaluation of the exchange rate stability criterion not only on the width of the fluctuations, but also by taking into account factors which may determine an increase in value (*ECB Convergence Report 2006*): the ECB assessment of exchange rate stability focuses on the exchange rate being close to the ERM2 central rate while also taking into account factors that may have led to an appreciation, which is in line with the approach taken in the past by the EMI and the ECB[20]. In this respect, the width of the fluctuation band within ERM2 does not impair the assessment of the exchange rate stability criterion.

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[17] Art. 3 Protocol on the convergence criteria referred to in Art. 109j (now Art. 121 EC) annexed to the Treaty of Maastricht.

[18] Opinion of the EMI Council on the ERM fluctuation bands of 7.10.1994.

[19] According to the *EMI Convergence Report of 1998* (p. 8) "Each of the ten ERM currencies mentioned above, with the exception of the Irish pound, has normally traded close to its unchanged central rates against other ERM currencies, and some currencies (the Belgian/Luxembourg franc, the Deutsche Mark, the Dutch guilder and the Austrian schilling) virtually moved as a bloc. On occasion, several currencies traded outside a range close to their central rates. However, the maximum deviation, on the basis of 10 business day moving averages, was limited to 3.5%, abstracting from the development of the Irish pound. In addition, the deviations were only temporary and mainly reflected transient movements of the Spanish peseta and the French franc (in early 1996), the Portuguese escudo (at end-1996/early 1997) as well as the Finnish markka (in early and mid-1997) vis-à-vis other ERM currencies. An examination of exchange rate volatility and short-term interest rate differentials suggests the persistence of relatively calm conditions throughout the reference period. […] Since joining and rejoining the ERM in October and November 1996 respectively, both the Finnish markka and the Italian lira have normally traded close to their unchanged central rates against other ERM currencies. As was the case for other ERM currencies, on occasion the Italian lira and the Finnish markka traded outside a range close to their central rates, but such deviations were limited and temporary".

[20] See EMI, *Convergence Report 1998*, p. 36 and ECB, *Convergence Report 2000,* p. 12; ECB, *Convergence Report 2002*, p. 9; *Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries,* December 18, 2003; ECB, *Convergence Report 2004*, p. 13. It is worthy to note that when the Treaty of Maastricht was

Moreover, the issue of the absence of “severe tensions” is generally addressed: by examining the degree of deviation of exchange rates from the ERM2 central rates against the euro; by using indicators such as short-term interest rate differentials vis-à-vis the euro area and their development; and by considering the role played by foreign exchange interventions.

The European Commission, instead, since evaluating the convergence of Greece and Sweden during the years 1998-2000, gave a restricted interpretation of the norm, making it clear that it considered the margins to be ±2.25% [21]. This interpretation was fiercely criticized as being too strict[22] and the European Commission Convergence Report 2006 no longer contains this explicit assertion.

The institutional contrast outlined above between the ECB and the Commission might generate uncertainty[23]. The ECB position seems more in line with the equal treatment principle by which the exchange rate criterion must be applied in the most possibly consistent manner. ECB’s flexibility was already applied by the EMI in March 1998 when evaluating the convergence of the first group of countries adopting the euro: the EMI, in fact, deemed the exchange rate stability criterion satisfied by all those States whose currency fluctuated within ±2.25% and, temporarily, ±15%.

The interpretation of the exchange rate stability criterion is an obstacle that could have been overcome adopting the Constitutional Treaty. Clearly referring to the mechanism in force at the time, Art. III-92 of the Convention stated that the observance without devaluation - for at least two years - of the normal fluctuation margins set by the *exchange rate mechanism* (without other specifications) would have satisfied the criterion. Said article was amended by the ICG. Art. III-198 of the Constitutional Treaty still contains a reference to the exchange rate mechanism margins of the former European Monetary System.

Finally, concerning the duration of the ERM participation, it is worth noting that the exchange rate criterion has so far been interpreted in a flexible way – as demonstrated by EMI practice.

In 1998, in fact, the European Commission and the EMI assessed the convergence of Italy and Finland even if their currencies had been participating in the ERM for just about 18 months. As the reference period, the EMI considered the time spent by the two countries in the ERM until the assessment, while the Commission chose to analyze the 24 months prior to the assessment. Formally, at the date of the beginning of the third stage of the EMU, the 1st of January 1999, both Member States had been participating in the ERM for more than two years.

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conceived, the ‘normal fluctuation margins’ were ±2.25% around bilateral central parities, whereas a ±6% band was a derogation from the rule. In August 1993, the decision was taken to widen the fluctuation margins to ±15%, and the interpretation of the criterion, in particular of the concept of ‘normal fluctuation margins’, became less straightforward.

[21] *Convergence Report 2000*, COM (2000) 277 def. 3 May 2000, p. 72: “Exchange rate to have been maintained within a fluctuation band of ±2.25% around the currency’s central parity against the median currency in the context of the ERM and against the euro in the context of the ERM2. However, the extent to which a breach of the ±2.25% fluctuation band would correspond to severe tensions would take account of a range of relevant considerations. A distinction is to be made between exchange rate movements above the 2.25% upper margin and movements below the 2.25% lower margin”.

[22] KENEN P. B. and E. E. MEADE, *EU Accession and EMU: Close Together or Far Apart?*, in International Economics Policy Briefs, Institute for International Economics, Washington D. C., October, 2003, p. 2

[23] On this subject see ROHDE JENSE K., *Inside EU, Outside EMU: Institutional and Legal Aspects of the ERM2*, in ECB, *Legal Aspects of the European System of Central Banks: Liber Amicorum Paolo Zamboni Garavelli*, Frankfurt, 2005, pp. 135-146.

3. *Consensual Euroization Through the Execution of International Monetary Agreements.*

The legal framework for the definition of the Community's external relations in economic and monetary matters is provided for by Art. 111 EC, derogating from EC Art. 300.

Art. 111 EC regulates the establishment of an exchange rate system for the euro against non-EC currencies (par. 1), the adoption of general orientations for the euro exchange rate policies against non-EC currencies in the absence of an exchange rate system (par. 2), the procedures to be followed in order to negotiate and conclude an agreement concerning monetary or foreign exchange regime matters with States and international organizations (par. 3), and the procedure to be followed to decide the Community position in the field of international monetary relations (par. 4).

In regard to international monetary agreements *ex* Art. 111.3 EC, the Council - following a recommendation from the Commission, and after consulting the ECB - defines the mandate for the negotiations, and for the conclusion of such agreements, by qualified majority[24]. The negotiations, which can be conducted by one or more Member States on behalf of the Community, are completed with a draft agreement. The Commission and the ECB are always involved in the negotiations. The Council may retain the competence of concluding the agreement or empower a Member State to act on its behalf.

The scope of these agreements covers "monetary or foreign exchange regime matters" which are not dealt with in the other paragraphs of Art. 111 EC. In practice, Art. 111.3 EC has been used for the conclusion of exchange rate agreements (for instance, for the pegging of a third currency to the euro) as well as for the conclusion of monetary agreements (providing for the conferral of legal tender status to the euro in a third State). These agreements could also cover free movement of capital and payments and exchange control rules.

Notwithstanding the fact that the EC Treaty does not explicitly envision the possibility that the Community officially approves the introduction of the euro by a third State, monetary agreements concluded under Art. 111.3 EC are considered suitable also for consensual euroization.

a) Official Euroization of European Micro-States.

Official euroization can be achieved through international monetary agreements with third countries following the procedure of Art. 111.3 EC (consensual euroization). This is the case of the so-called micro-States encompassed within the European Union (Monaco, San Marino, and the Vatican)[25].

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[24] Only euroarea Members can vote in the Council under the provisions of Art. 111 EC.

[25] The case of the French overseas territories of St. Pierre and Miquélon and of the Island of Mayotte, which do not form integral part of the Community, is different. The Council adopted in 1998 a decision acting on the basis of Art. 123.4 EC in order to allow these territories to use the euro (Council Decision 1999/95/EC of 31 December 1998, OJ L 30/29 of 4.2.1999).

The currencies issued by the central banks of the West African Economic Union, of the Economic and Monetary Community of Central Africa, and of the Comores are pegged to the euro. The functioning of the peg exchange rate regime between the CFA francs and the Comorian franc to the French franc was regulated by monetary agreements. In 1998 the Council adopted a decision to allow France to maintain the existing monetary arrangements using the euro as anchor currency (Council Decision 98/683/EC of 23 November 1998). Neither the Community nor the ECB were party to the agreement.

These tiny enclaves were historically linked to at least one of the Member States. Monetary agreements were in force with France (Monaco), and Italy (San Marino and the Vatican) to regulate the use of a foreign currency as legal tender.

With the introduction of the euro, however, monetary relations with these countries had to be redefined in order to ensure the continuity of the existing political and economic ties with the Community.

During the Maastricht negotiations it was agreed that the monetary relations between Italy and San Marino and the Vatican, and between France and the Principality of Monaco, would remain unaffected by the EMU. In Declaration n. 6 annexed to the EC Treaty, the Community undertook to facilitate such negotiations of existing arrangements as it might become necessary due to the introduction of the euro as the single currency. Subject to the conclusion of an agreement with the Community, Monaco, San Marino and the Vatican could be authorized to introduce the euro as their official currency.

In 1998, the Council decided that the new monetary agreements with the above micro-States would have been negotiated by a Member State on behalf of the Community[26]. The Commission and the ECB were fully associated with the negotiations in their respective fields of competence. The ECB consent, in particular, was required for the accession of the micro-States' financial institutions to payment systems within the euroarea.

As a result, in 2000, Italy signed on behalf of the Community the monetary agreements with San Marino[27] and the Vatican[28] on behalf of the Community, and in 2001, France did the same with Monaco[29].

Euroization of the micro-States was made conditional to the satisfaction of specific requirements such as compliance with Community rules on banknotes and coins and cooperation against counterfeiting. The euro was conferred legal tender since the 1st of January 2002.

The financial institutions of Monaco were admitted to the euroarea payment system and eurosystem monetary policy operations because the Monegasque credit institutions used to be treated as they were located in France and fully participated in French payment systems.

The agreement made this access conditional, in particular, to the respect of the same rules as those established in the euroarea for the purposes of monetary policy instruments and procedures and for the purposes of prudential supervision and prevention of systemic risks in payment and securities settlement systems. Consequently, the parties undertook to cooperate in good faith and to ensure that the law applicable in Monaco in the subjects covered by the agreement would at all times be identical, or – where appropriate – equivalent to the law applicable in France.

Firstly, Monaco undertook to apply a number of EC legal acts, especially the ones dealing with monetary functions and operations of the ESCB.

Secondly, Monaco committed to also apply the measures adopted by France to implement Community acts concerning the prudential supervision of credit institutions and the prevention of systemic risks to payment and securities settlement

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The continuation of the same kind of arrangements was allowed by the Community for the Cape Verde escudo which was previously pegged to the Portoguese currency (Council Decision 98/744/EC of 21 December 1998).

[26] Council Decisions 1999/96/EC, 1999/97/EC, 1999/98/EC of 31 December 1998.

[27] Official Journal C 209/1 of 27.7.2001.

[28] Official Journal C 299/1 of 25.10.2001.

[29] Official Journal L 142/59 of 31.5.2002.

systems contained in Annex A to the agreement[30].

Eventually, Monaco agreed to adopt measures equivalent to those adopted by the Member States to apply those Community acts which are listed in Annex B to the agreement. A joint Committee composed of representatives of Monaco, the Commission, the ECB and France was established to examine said equivalence.

By making the EC legal framework related to the activities of credit institutions applicable to Monaco, the Community tries to ensure the respect of a regulatory framework similar to the one applied to euroarea financial institutions, following the principle of level playing field in the financial sector.

Moreover, according to Art. 13 of the agreement, all questions concerning the validity of decisions of Community institutions or bodies - in particular of the ECB - implemented by virtue of the agreement, shall fall within the exclusive jurisdiction of the European Court of Justice.

Financial institutions located in the Republic of San Marino and in the Vatican State may in the future have access to payment and settlement systems within the euroarea under the terms and conditions determined by the Bank of Italy with the agreement of the ECB.

b) Negotiations with Andorra.

The case of Andorra is even more peculiar. Before the introduction of the euro on the territory of this tax-heaven, French and Spanish banknotes and coins were used as a quasi-official currency without having legal tender status. After having scheduled the adoption of the euro for the 1st of January 2002, Andorra formally requested the conclusion of a monetary agreement with the Community.

On the 11th of May 2004, the EC Council adopted a decision on the position to be taken by the Community regarding an agreement on the monetary relations with Andorra[31]. This decision set the parameters for the agreement, making the opening of the negotiations subject to Andorra's meeting of some specific Community standards. In particular, Art. 6 of the decision aims to ensure the establishment of comparable and equitable conditions between financial institutions situated in the euroarea and those located in Andorra.

Andorra is required to adopt all appropriate measures, through equivalent actions or direct transpositions, for the application of all relevant Community banking and financial legislation, and of legislation on the prevention of money laundering, on the prevention of fraud and counterfeiting of non-cash means of payment and on statistical reporting requirements. Therefore, in specific cases, Andorra may be allowed to maintain or amend "equivalent measures". Eventually, under the conditions to be defined in the agreement with the involvement of the ECB, financial institutions located in Andorra might access the payment and settlement systems of the euroarea.

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[30] Recently Annex A has been amended through the Commission Decision 2006/558/EC of 2.08.2006 (OJ L 219/23 of 10.08.2006).

[31] Council Decision 2004/548/EC of 11 May 2004 on the position to be taken by the Community regarding an agreement concerning the monetary relations with the Principality of Andorra (Official Journal L 244/47 of 16.07.2004).

Moreover, the initialization of said agreement was also subject to the prior/previous conclusion of a treaty on the taxation of savings income in the form of interest payments[32] (Art. 8 of the Council Decision).

Following the entry into force of the treaty on taxation of savings income, on the 1st of June 2005[33], the EC Council adopted a decision[34] to open negotiations for a consensual euroization of Andorra, negotiations which are still underway.

The strict conditionality attached to them might explain why the process is taking so long.

4. Unilateral Official Euroization.

The term "dollarization/euroization" usually describes a spontaneous market-driven phenomenon of currency substitution where a foreign currency is preferred to the national one. This phenomenon is generally referred to as dollarization because, until recently, the preferred hard currency has mostly been the US dollar. Nowadays, however, the euro has become a competitor of the US dollar even in case of currency substitution (especially in former Yugoslavia republics)[35].

"Dollarization" refers to the situation of many developing countries which have a history of poor monetary performance and very little economic-policy credibility. A high inflation rate can lead individuals to resort to a foreign currency instead of the national one. Usually the substituting hard currency is the one issued by the main economic partner.

Initially, citizens deposit their money abroad and start investing in bonds and debentures issued in a third State. This may lead to the use of a foreign currency also within the national borders for everyday transactions, both domestic and international. If the law allows it, bank accounts in that currency are opened. Eventually, a foreign currency may become the benchmark to establish the value of commodities, services, the cost of labour and real estate and, in some cases, even prices. However, pensions, taxes, and the salaries of public servants continue to be paid in the national currency being the only one which has legal tender. Such a phenomenon, which could be described as a *de facto* (or unofficial) dollarization, could therefore regard savings, investments and also the issuing of loans and obligations.

A *de facto* "dollarized/euroized" State may either ignore the phenomenon or decide to regulate it officially by means of a legal act. Official dollarization hence occurs when a State formally gives legal tender status to a foreign currency on its territory (exclusively or in co-existence with the national currency).

Official dollarization can take place in four different ways[36]: a) unilaterally, without an agreement with the issuing State (unilateral dollarization)[37]; b) with some

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[32] As it is known, the conclusions of agreements for the taxation of savings income are a condition for the entry into force of the Directive on taxation of savings income.

[33] Agreement between the European Community and the Principality of Andorra providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments - Memorandum of Understanding Official Journal L 359 , 04/12/2004 p. 33-45.

[34] Council Decision (2004/750/CE) of 21 October 2004 on the opening of the negotiations on an agreement concerning monetary relations with the Principality of Andorra, Official Journal L 332 of 06.11.2004 p. 15.

[35] See ECB, *Review of the International Role of the Euro*, January 2005, p. 56 ff..

[36] See M. GRUSON, *Dollarization and Euroization*, in *Current Developments in Monetary and Financial Law*, IMF, Washington D.C., 2003, p. 629 ff..

[37] Ecuador dollarized in 2000 in the midst of a political and economic crisis precipitated by Brazil's

sort of *ex post* acknowledgment by the issuing State (the so-called recognized unilateral dollarization)[38]; c) through the execution of an international bilateral treaty concluded with the issuing State (consensual dollarization)[39]; or d) through a regulation issued under the authority of a UN temporary administration established on the basis of a resolution of the United Nations' Security Council[40]. In this latter case, the aim of introducing a hard currency is to restore monetary public order and the stability of transactions.

a) The Legitimacy of Non-European Countries to Euroize.

After having seen the different methods of achieving official dollarization/euroization, it is worth investigating if the issuing State could find grounds in international law for preventing another State from adopting its own currency.

According to a customary international law rule, every State is under the obligation to respect other States *lex monetae*: it is within the sovereign monetary power of every State to establish the technical and formal features of the national currency, to define its value and the amount of money in circulation, to decide its withdrawal as well as to attribute sole legal tender within its own territory. No one

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devaluation of the real. El Salvador dollarized as well in 2000. Montenegro unilaterally euroized in 2001, while it was still federated with Serbia. On Ecuador see Art. 1, *Ley para la transformacion economica del Ecuador*, 9 March 2000 as well as P. BECKERMAN e A. SOLIMANO, *Crisis and Dollarization in Ecuador: Stability, Growth and Social Equity*, The International Bank for Reconstruction and Development, Washington D.C., 2002. On El Salvador see Art. 5, *Ley de integraciòn monetaria*, 30 November 2000, n. 201. On Montenegro see A. WINKLER, F. MAZZAFERRO, C. NERLICH e C. THIMANN, *Official dollarization/euroization: motives, features and policy implications of current cases*, ECB Occasional Paper Series, n. 11, February 2004.

[38] The *International Monetary Stability Act, a Bill to promote international monetary stability and to share seigniorage with officially dollarized countries* proposal (the so-called Mack Bill), presentati durante il 106mo Congresso dal sen. C. MACK di fronte al Senato (S. 1879 e S. 2101) e dal rep. P. RYAN di fronte alla Camera dei Rappresentanti (H.R. 3493 e H.R. 4818); nonchè l'*International Monetary Stability Act of 2001, a Bill to promote international monetary stability and to share seigniorage with officially dollarized countries*, presentato al 107mo Congresso dal rep. P. RYAN alla Camera dei Rappresentanti (H.R. 2617) has been described as a recognized unilateral dollarization instrument.

[39] Consensual dollarization was achieved in Panama through an exchange of notes between the Secretary of War of the United States and the Special Fiscal Commissioner of Panama. The monetary agreement between the US and Panama, entitled Legal Tender and Fractional Silverage Coinage, entered into force the 20th of June 1904.

The Currency Treaty between the Swiss Confederation and the Principality of Liechtenstein is into force since the 25th of November 1981 (*Währungsvertrag zwischen dem Fürstentum Liechtenstein und der Schweizerischen Eidgenossenschaft,* 19 June 1980).

[40] The United Nations Interim Administration Mission in Kosovo (UNMIK) was established by the UN Security Council Resolution n. 1244/1999. On the introduction of the euro in Kosovo see UNMIK Administrative Direction n. 2001/24, amending Administrative Direction n. 1999/2 implementing UNMIK Regulation n. 1999/4 on the currency permitted to be used in Kosovo.

The *United Nations Transitional Administration in East Timor was established through the* UN Security Council Resolution n. 1272/1999. On the introduction of the US dollar as legal tender see *Special Representative of East Timor Regulation n. 2000/2 on the Use of Currencies in East Timor*, *Special Representative of East Timor Regulation n. 2000/7 on the Establishment of a Legal Tender for East Timor*, successively repealed by *Special Representative of East Timor Regulation n. 2001/14 on the Official Currency and Legal Tender of East Timor* (in particular *Section* 3, entitled *Legal Tender). See also* L. VALDIVIESO, *East Timor Moves to Establish Foundations of Sound Macroeconomic Management*, IMF, Washington D.C., 2000.

else can issue one State's currency and the attributions of *lex monetae* shall be respected worldwide[41].

Given the above definition of monetary sovereignty, according to some Authors a State is free to prohibit the conferral of legal tender status to its own currency abroad[42]. Other States should not interfere with the domestic monetary jurisdiction[43] of the issuing State. "*By giving legal tender status to another country's currency, a country would unlawfully undermine the issuer's capacity to conduct its economic policies, thus interfering in the issuer's internal affairs. For instance, an outflow of currency from the issuer's territory to the foreign user's territory would reduce the money supply in the issuer's territory, which would require the issue of additional liquidity, with the risk of a sudden reflow, which may destabilize the issuer's economy. Both inflows and outflows of the issuer's currency could undermine the issuer's monetary policies*"[44].

However, in the name of monetary sovereignty, it is also possible to affirm that a State is free to choose a currency issued by a third State as its own: unilateral dollarization/euroization is legitimate and does not imply international responsibility – at least until this is done in *bona fides* and the issuing State does not suffer serious consequences.

An analysis of States practice – given also the negligible dimensions of the economies of the currently dollarized countries – may hence lead to the conclusion that the unilateral adoption of a foreign currency is consistent with public international law: the dollarizing country is under no obligation of seeking the consent from the issuing State, which has to tolerate this decision. Consequently, the issuing State has no duty or obligation towards the dollarizing State, and the latter has no right to demand the necessary supply of banknotes, to receive a share of the seigniorage income, or to participate in decision-making with respect to monetary policy. The same is true in case of unilateral euroization.

Nevertheless, political courtesy would make a cooperative approach more desirable and a notification of the intention to dollarize/euroize advisable. Moreover, practical aspects might induce the issuer and the dollarizing/euroizing State to establish some guidelines on the technical steps to be followed after dollarization/euroization has occurred.

Eventually, it shall be emphasized that the position of the European Community

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[41] BURDEAU G., *L'exercice des compétences monétaires par les Etats*, in Académie de droit international de la Haye, Recueil des Cours, 1988, vol. IV, p. 240 ff..

[42] See D. CARREAU, *Monetary Sovereignty in the light of Currency Boards and Similar Arrangements: Some Reflexions*, paper presented at Seminar on Currency Areas - Dollarization, Euroization and Currency Boards, organized by BIS, CEMLA e MOCOMILA a Mexico City, 14-15 February 2002.

[43] "*Domestic jurisdiction can be described as the exclusive authority of the state to prescribe and enforce legal rules governing persons and things in its national territory. Therefore, monetary and fiscal policy of a state falls within the domestic jurisdiction of a state and thus, within its sovereignty. It is undoubtedly the case that the currency of a state is an integral part of its monetary and fiscal policy. Hence, the currency of the anchor country has to be seen as a matter essentially within the domestic jurisdiction of the anchor state*" (M. GRUSON, *Dollarization and Euroization: an International Law Perspective*, paper presented at Seminar on Currency Areas - Dollarization, Euroization and Currency Boards, organized by BIS, CEMLA e MOCOMILA a Mexico City, 14-15 February 2002, p. 15.

[44] GIANVITI F., *Current Legal Aspects of Monetary Sovereignty*, in IMF, Current Developments in Monetary and Financial Law - Vol. 4, Washington D.C., 2006, pp. 3-16; GIANVITI F., *Use of a Foreign Currency Under the Fund's Articles of Agreement*, paper presented at the *IMF Seminar on Current Developments in Monetary and Financial Law*, Washington D.C., 7-17 May 2002, p. 10 ff. http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/index.htm.

and of the ECB on third countries' euroization should be deemed neutral and that historically, the US authorities have not objected when foreign countries have adopted the dollar as their official currency.

b) The Prohibition for EC Member States to Unilaterally Euroize.

As we have seen, the enlargement of the euroarea towards new EC Member States can take place only with the approval of the European Community, provided that the Maastricht convergence criteria are respected. In fact, the requirements for joining the EC (the Copenhagen criteria) are different from the ones established for joining the euroarea (the Maastricht convergence criteria).

The Ecofin Council of 7 November 2000, in its conclusion on exchange rate strategies for accession countries, made it clear that "*any unilateral adoption of the single currency by means of euroization would run counter to the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework. Therefore, unilateral euroization would not be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro*"[45].

The respect of rules and procedures defined in the Treaty will also be a mean to ensure equal treatment between current and future EMU Members as well as a lasting convergence of economic fundamentals within the euroarea.

Under this rationale, during the timeframe between the admission and the entrance into the third stage of the EMU, new Members cannot euroize unilaterally to bypass the process leading to the adoption of the euro. Otherwise, the Council would lose its power to set the conversion rate.

According to some economists[46], however, a State fulfilling the inflation and fiscal sustainability requirements could euroize upon approval by European institutions on the conversion rate and without spending two years in the ERM2.

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[45] 2301st Council Meeting - ECOFIN 12925/00 (Presse 417) of 7 November 2000. See also the ECB's *Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries* of 18 December 2003, p. 1.

[46] BUITER W. H. and C. GRAFE, *Anchor, Float or Abandon Ship: Exchange Rate Regimes for the Accession Countries*, in Banca Nazionale del Lavoro Quarterly Review, 2002, n. 122, p. 22: "the argument why unilateral euroization is not a permissible exchange rate regime under which to qualify for EMU Membership relies mainly on the requirement that the entry exchange rate (or conversion rate) for EMU should be fixed in negotiation between the candidate and existing Member countries (through Ecofin). However, we can see little reason why the existing EMU countries should object to euroization, if the exchange rate at which a country euroizes is fixed in bilateral negotiations between the candidate country and the current EMU Member countries (that is, the euro12 [currently 13] ministers of finance, or perhaps Ecofin, if this is judged to be an issue that should be decided with the involvement of the non-EMU EU Members). The reason why it is against the spirit, and quite possibly also against the letter, of the Treaty for the current accession candidates to euroize unilaterally is precisely that such a unilateral action by the current accession candidates would take place while they are official candidates for EU Membership, negotiating in good faith, and committed to take on board all of the 'acquis', including eventual EMU Membership. This is quite different from what would happen if a country that is not currently a formal candidate for EU Membership, and is not engaged in good-faith negotiations with the EU, were to unilaterally euroize today. If it were subsequently to become an official candidate for EU Membership, it would not make sense to require it to first shed the euro, re-introduce a new national currency for a few years, and then to join the EU and the EMU. This is not, however, the situation faced by the current accession candidates. For them, their best hope is 'consensual' euroization at a negotiated and agreed parity". In favour of a unilateral euroization with an access to the euroarea subject to convergence criteria are KENEN P. B. and E. E. MEADE*, Substance and Semantics in ERM II*, in Central Banking, vol. XIV, n. 4, May 2004, p. 67.

Recently, Von Hagen and Traistaru[47] have compared exchange rate convergence rules to a "purgatory" imposing the risk of unnecessary and potentially large damage on countries about to enter EMU, a punishment that formerly unstable countries have to endure before being admitted to the "paradise" of Monetary Union.

c) The Incompatibility of Unilateral Euroization with an Application to Acquire EC Membership by Countries of the European Region.

The Council, the Commission and the ECB have affirmed that unilateral euroization is not compatible with an application to acquire EC membership.

In particular, the ECOFIN Council declared that during the pre-accession stage, exchange rate strategies should support other economic policies in order to meet the Copenhagen economic criterion and ensure progress on real convergence and macroeconomic stability[48].

From an international law point of view, however, a State of the European region eligible for EC membership – and, not having started negotiations yet, unaffected by the leverage exerted by the Community – has to be considered free to unilaterally confer the euro legal tender status.

For the time being, only Kosovo and Montenegro – not foreseeing a rapid accession to the EC – took this opportunity and adopted the euro as their official currency[49].

Kosovo is a province of the Republic of Serbia which has been administered by the UN Interim Administration Mission[50] (UNMIK) since 1999. Negotiations to determine the final status of Kosovo are still underway, but they will presumably lead to the recognition of some degree of independence.

In 1999, the UNMIK had introduced the German mark as the official currency of Kosovo[51]. In 2001, the German mark was officially replaced by the euro[52], which began circulating in 2002. The Serbian dinar still enjoys the status of parallel official currency, but it is used only within the Serb enclaves of Kosovo.

Montenegro became independent from Serbia on the 3rd of June 2006, once the Parliament formally confirmed the result of the referendum which had been held on the 21st of May[53].

When it was still federated with Serbia in the Federal Republic of Yugoslavia,

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[47] VON HAGEN J. and I. TRAISTARU, *Macroeconomics Adjustment in the New EU Member States*, paper presented at the Third ECB Central Banking Conference on the New Member States: Convergence and Stability, Frankfurt am Main, 22 October 2004.

[48] 2301st Council Meeting - ECOFIN 12925/00 (Presse 417) of 7 November 2000.

[49] Referring to the cases of unilateral euroization in these post-conflict countries of the Balkans the ECB noted that these decisions were taken by the respective authorities (the UNMIK and the government of the Republic, respectively for Kosovo and Montenegro) on their own responsibility. The unilateral nature of these decisions implies that neither legal obligations nor policy constraints would arise for the Eurosystem in the conduct of its policies.

[50] The UNMIK was established by the UN Security Council Resolution 1244 of 10 June 1999.

[51] UNMIK Administrative Directive n. 1999/2 of 4 October 1999 implementing UNMIK Regulation n. 1999/4 of 2 September 1999 on the currency permitted to be used in Kosovo.

[52] The United Nations Interim Administration Mission in Kosovo first legalised foreign currencies circulation and then officially conferred the euro legal tender status (UNMIK Administrative Direction n. 2001/24, amending Administrative Direction n. 1999/2 implementing UNMIK Regulation n. 1999/4 on the currency permitted to be used in Kosovo).

[53] In 1992, after the breakup of Communist Yugoslavia, Montenegro became part of the Serbian-Montenegrin Federal Republic of Yugoslavia. In 2003, the Federal Republic of Yugoslavia was renamed into Serbia and Montenegro and reconstituted as a confederated union.

Montenegro had a different monetary system and autonomously defined its monetary and exchange rate policy. On the 2nd November 1999, Montenegro unilaterally introduced the German mark as a parallel currency, along with the Yugoslav dinar, as a means to protect its economy from the inflationary policies of the National Bank of Yugoslavia[54].

In 2000, the Law on the Central Bank of Montenegro was adopted and in 2002 the euro became sole legal tender in the Republic.

With independence, Montenegro became eligible to acquire EC membership. Recently, the Montenegrin Government has declared that one of its strategic priorities is to accelerate the process towards European integration, endeavoring to fulfill the Copenhagen criteria.

On 8 November 2006, the Commission issued for the first time a dedicated Annual Progress Report on Montenegro together with a new distinct European Partnership for Montenegro[55].

A Stabilization and Association Agreement (SAA) was initialled on the 15th of March 2007 and is now waiting for ratification.

The SAA provides a legal framework for the relations between the EC and Montenegro for the entire period prior to its eventual accession. It aims at the creation of a free trade zone and, under its attached conditionality, Montenegro is required to adopt Community legislation in areas such as customs and trade, competition, money laundering, and the free movement of capital and payments.

On the 22nd of January 2007, the Council adopted a decision on the principles, priorities and conditions that Montenegro should meet in order to move closer to the European Union[56]. The Council singles out some key short-term and medium-term priorities. In particular, Montenegro should achieve a sustained macroeconomic stability by pursuing the necessary fiscal adjustment and consolidation, by implementing the public expenditure management system (notably programme budgeting), and by fully liberalizing capital movements and payments in line with EC principles.

As demonstrated by the SAA and by the 2007 Council decision, the European Community has not yet started to discuss the euroization issue with Montenegro – if not through constant references to macroeconomic stability and economic convergence.

Even if meeting the Maastricht convergence criteria does not constitute a condition for joining the European Community, the unilateral euroization issue will turn out to be a hot topic during negotiations for accession.

The EC would probably exert all its influence to avoid the accession of State which unilaterally adopted the euro. How could in fact the EC legitimate the adoption of the euro by a Member State which does not respect the Maastricht criteria? This kind of euroization could negatively affect the credibility of the euro, not being supported by a real macroeconomic convergence process.

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[54] The Decision of 2 November 1999 was adopted on the basis of Article 94, item 3, of the Constitution of the Republic of Montenegro. See LAMINE B., *Monetary and Exchange Rate Agreements Between the European Community and Third Countries*, European Commission Economic Papers, n. 255, September 2006, p. 43.

[55] Montenegro 2006 Progress Report, COM(2006)649final, Brussels 8.11.2006. While assessing the macroeconomic stability of Montenegro, the Commission notes that Montenegro has continued to use the Euro as legal tender and that the only monetary policy instruments are reserve requirements, as well as the issuing of treasury bills as an indirect possibility to influence interest rates.

[56] 2776th External Relations Council meeting, Brussels, 22 January 2007.

It would also be possible that the country will be allowed to join the EC but it will have to wait before joining the EMU until the convergence criteria are met. Only at that point the new Member State will obtain a seat at the ECB Governing Council and join the ESCB.

Moreover, how can Montenegro fulfill the exchange rate convergence criterion without having its own national currency? As we have seen, Art. 121.1, third indent, still contains a reference to ERM2 participation: will Montenegro have to reintroduce a parallel currency along with the euro, while committing itself to maintain a fixed 1:1 exchange rate to the euro?

Finally, it has to be underlined that, without having at its disposal the exchange rate instrument, it would be more difficult for Montenegro to achieve a sustainable level of convergence with regard to macroeconomic fundamentals.

4. Conclusions: EC Policy Towards Euroization vs. US Policy Towards Dollarization.

While being similar, euroization and dollarization differ in particular in the policy adopted by the issuing international organization or State.

We can describe the EC attitude towards euroization as a policy of rigorous monetary conditionality. While a swift enlargement of the euroarea – as well as of the eurozone – might boost the role of the euro as an international currency, its unilateral adoption by third countries with a weak economic performance could negatively affect price stability and, in turn, the euro's credibility[57]. For these reasons, before consenting to the euro adoption, the EC strictly monitors the level of convergence of Member States and, at the same time, actively discourages unilateral euroization.

On the one hand, in fact, EC Member States can legitimately give the euro legal tender status only after having met the Maastricht convergence criteria, and euroization is precluded to candidate countries prior to their admission to the EC.

On the other hand, third countries may adopt the euro by concluding a monetary agreement with the Community, but they are discouraged – or at least not encouraged – to euroize unilaterally. Moreover, the Community usually makes the conclusion of an agreement on the euro adoption subject to compliance with the "monetary *acquis communautaire*".

In addition, the benefits perceived by EMU Members, by States which euroized through a bilateral agreement, and by unilaterally euroized countries are different[58].

For instance, euro seigniorage exclusively accrues to EMU countries[59], which also achieve a high degree of institutional integration, sitting at the ECB Governing Council and at the meetings of the Eurogroup.

Micro-States benefit from a high economic and financial integration with EC Member States, but are not given voice in monetary policy decision-making. They do not even enjoy observer status at the ECB's Governing Council meetings or in ESCB/Eurosystem committees.

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[57] A. BRATKOWSKI e J. ROSTOWSKI, *The EU Attitude to Unilateral Euroization: Misunderstandings, Real Concerns and Ill-Designed Admission Criteria*, Central for Social and Economic Research, Warsaw, 2001.

[58] The different pros and cons provided by euroization and dollarization are summarized by SALVATORE D., *Euroization, Dollarization, and the International Monetary System*, in ALEXANDER V., MÉLITZ J., VON FURSTENBERG G. M., *Monetary Unions and Hard Pegs*, Oxford, 2004, pp. 27-40.

[59] Seignorage income in EMU is pooled and allocated to the participating NCBs in accordance with their respective paid-up shares in the ECB's capital.

Unilaterally euroized countries do not participate in the sharing of seigniorage revenues, and cannot rely on the ECB as a lender of last resort. In no case the EC has granted dollarized countries direct representation or observer status in the Eurosystem decision-making bodies. Nor is the ECB compelled to consider the economic and financial conditions of euroized countries while defining its monetary policy. Furthermore, a country where euroization takes place before its entry into the EMU will use real resources to obtain the euro banknotes and coins necessary to replace local cash in circulation.

It is evident from the above that the European Community does not offer any kind of incentive to third States wishing to euroize.

The United States policy towards dollarization could be described as of benign neglect[60]. In 2000, after the debate on dollarization was revived by Argentina's expression of interest on the adoption of the dollar as legal tender, a proposal for the sharing of seigniorage with officially dollarizing countries was presented to Congress[61]. The proposed legislation, named the International Monetary Stability Act, expired however at the end of the legislative session. The Act, while being considered a way to encourage dollarization, explicitly provided that the US were under no obligation to act as a lender of last resort, to consider their economic and financial conditions in setting monetary policy, or to supervise their financial institutions. Obviously, no observer seat at the Federal Reserve Board was offered.

The dollarized economy is therefore only a passive partner of the United States, vulnerable both in political and economic terms[62].

Only a serious challenge to the dollar predominance as the international currency could eventually trigger an active encouragement of dollarization from Washington[63]. For the time being, the Bush administration seems to have adopted a policy that does not offer incentives to the dollarizing States, but rather only favors the dollar as the currency in oil transactions.

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[60] See COHEN B., *Dollarization Rest in Peace*, Global and International Studies Program, University of California, Santa Barbara, 2004, Paper 16; COHEN B., *U.S.Policy on Dollarisation: A Political Analysis*, in Geopolitics, vol. 7, n. 1, 2002, pp. 63-84.

[61] See the proposal submitted to the Senate by Sen. Connie Mack of Florida, then chairman of the Joint Economic Committee of the Congress (106th Congress, S. 1879 and S. 2101) and the Bill introduced by rep. P. Ryan in the U.S. House of Representatives (106th Congress, H.R. 3493 e H.R. 4818; 107th Congress H.R. 2617).

[62] The freezing of dollar denominated assets is a tool that the US resorted to very often in the last decades. For instance, in 1988, the US froze all Panamanians assets in US banks and all the payments or other dollars transfers to Panama as part of the Reagan administration's policy to bring General Manuel Noriega to justice. On the concept of currency dependence and the exercise of coercion through monetary power see KIRSHNER J., *Currency and Coercion: The Political Economy of International Monetary Power*, Princeton, 1995.

[63] COHEN B. J., *Enlargement and the International Role of the Euro*, in JOAQUIN ROY and PEDRO GOMIS-PORQUERAS (eds.), *The Euro and the Dollar in a Globalized Economy*, Ashgate, 2007, (forthcoming).

TAB. 1 EXCHANGE RATE REGIMES OF EC ACCESSION COUNTRIES

ACCESSION COUNTRIES	EXCHANGE RATE REGIME FEATURES	REMARKS
Bulgaria	Currency board, pegged to the euro (once to the Deutsche Mark).	Formally introduced on 1 July 1997. National legislation provided that the euro would have replaced the Deutsche Mark in 2002 at the latest.
Cyprus	From May 2, 2005 into the ERM 2 with standard fluctuation band of ±15%.	Previously pegged to the euro, with margins around the euro central rate of ±15% (increased from ±2.25% effective January 1, 2001).
Czech Republic	Managed floating with the euro as reference currency.	The Czech National Bank may intervene in the foreign exchange market in order to smooth large intraday volatility swings of the euro/koruna rate.
Estonia	From June 28, 2004 into the ERM 2 with its currency board arrangement in place as a unilateral commitment.	The currency board, pegged to the Deutsche Mark was introduced in June 1992; repegged to the euro since 1st January 1999.
Hungary	Pegged to the euro with a fluctuation band of ±15%.	Effective May 4, 2001, the width of the fluctuation band was widened to ±15% around the central parity from ±2.25%.
Latvia	From May 2, 2005 into the ERM 2 with a fluctuation band of ±1% as a unilateral commitment.	Pegged to the euro since January 1, 2005 with a narrow fluctuation band of ±1%. From 1994 to 2004 pegged to the SDR with a narrow fluctuation band of ±1%.
Lithuania	From June 28, 2004 into the ERM 2 with its currency board arrangement in place as a unilateral commitment.	The currency board, pegged first to the US dollar and repegged to the euro in February 2002, was introduced in April 1994.
Malta	From May 2, 2005 into the ERM 2 without a fluctuation band as a unilateral commitment.	Previously pegged to a currency basket of three currencies comprising the euro (weight of 70%), the US dollar (10%) and the pound sterling (20%).
Poland	Independently floating exchange rate, with inflation targeting since April 2000.	Previously Poland adopted a crawling peg (until 2000).
Romania	Pegged informally to a currency basket.	Authorities increased the weight of the euro in the informal currency basket to 75%.
Slovakia	From November 28, 2005 into the ERM 2 with standard fluctuation band of ±15%.	Before ERM 2 entry, Slovakia operated a managed floating exchange rate regime with the euro as a reference currency.
Slovenia	Adopted the euro since the 1st of Januay 2007.	From June 28, 2004 into the ERM 2 with standard fluctuation band of ±15%.

Sources: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions, 2006; ECB, Convergence Reports, May and December 2006.

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