# Briefing

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# Adopting the euro

## Convergence criteria and state of play


**SUMMARY**

Adopting the single currency is the third stage of Economic and Monetary Union (EMU). Even though all Member States participate in EMU, not all of them use the euro: the United Kingdom and Denmark have opted out, while Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania and Sweden are yet to adopt it, being formally obliged to do so under the Maastricht Treaty. Before this happens, they need to fulfil the convergence criteria of price stability, soundness and sustainability of public finances, durability of convergence and exchange rate stability. Furthermore, they must align their national legislation with the EU *acquis* on national central banks.

Many argue that during the euro's founding phase the convergence criteria were relaxed in order to enable a wide take-up of the currency. This however is no longer the case, as the Member States which have joined since the euro came into use have had to fulfil the criteria stringently. Bulgaria, the Czech Republic and Sweden fulfil all but one criterion (exchange rate stability) and in fact none of the seven countries have decided to join the relevant currency-pegging mechanism. Furthermore, none except Croatia have made their central bank legislation compatible with the euro area.

Public opinion in these countries is divided: a majority in Romania, Hungary, Croatia and Bulgaria is in favour of adopting the euro, while in the other countries most people would vote against it. However, only 18% of all respondents want the single currency to be introduced as soon as possible. Reportedly, most of the non-euro-area Member States cannot be expected to join the euro before 2020.



**In this briefing:**




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## Single currency and the EU integration process

### Economic and Monetary Union and the euro

The signing of the Treaty of Rome in 1957 was a token of the Member States' wish to create a 'common market', within which people, goods and services would be able to move freely. As integration increased, the argument that this market would need closer economic and monetary cooperation to further develop and thrive gained in strength. The ensuing decision to establish an Economic and Monetary Union (EMU) was formally taken by the European Council[1] in 1991. The EMU was later enshrined in the Treaty on European Union (the Maastricht Treaty), which outlined three stages for its implementation:

- Stage one (starting on 1 July 1990) entailed removing restrictions on movement of capital, free use of the ECU (European Currency Unit, the forerunner of the euro), and increasing economic convergence;
- Stage two (starting on 1 January 1994) included strengthening the coordination of monetary policies and consequently establishing the European Monetary Institute (predecessor of the ECB), enhancing cooperation among central banks, and increasing the independence of national central banks;
- Stage three (starting on 1 January 1999) involved fixing of exchange rates, commencing the Exchange Rate Mechanism II (ERM II), conducting a single monetary policy (under the European System of Central Banks), introducing the Stability and Growth Pact, and **launching the euro**.

The first two stages of EMU have been fully completed, while the third stage is still under way, since it involves the adoption of the single currency by all Member States, which is not yet the case.

### Euro area and the EU Member States

Under EMU, all Member States coordinate their economic and fiscal policies. Some of them have also adopted the euro and have therefore completed the third stage of EMU. Together, these countries constitute the euro area, which was inaugurated in 1999. Its first members were **Austria, Belgium, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Portugal and Spain**. **Greece**[2] joined in 2001.

**Denmark**[3] and the **United Kingdom** joined the EU before EMU was established and chose to remain outside the euro area for reasons of economic sovereignty. They can, but are not obliged to, join the euro.

Under its Treaty of Accession, **Sweden** is obliged – as are all other Member States that have joined the EU since it – to join the euro area. However, the country voted against joining the euro in a national referendum in 2003 and does not yet fulfil all the necessary criteria to do so. The remaining non-euro area Member States joined the EU in successive waves after the euro had been inaugurated and are thus obliged to adopt the single currency. This obligation stems from the fact that the Maastricht Treaty incorporated EMU into the common *acquis* which has to be adopted by all Member States. Because at the time of their accession they did not meet the convergence conditions, their Treaties of Accession gave them time (but no deadline) to make the required adjustments and preparations. These countries (including Sweden) are Member States with a 'derogation'. They have formally committed to joining the euro area as soon as they fulfil the necessary conditions. When this happens, the 'derogation' would be 'abrogated' by a decision of the Council (after consulting the European

Parliament), and the Member State concerned would then adopt the euro. This has been the case with **Slovenia** (2007), **Cyprus and Malta** (2008), **Slovakia** (2009), **Estonia** (2011), **Latvia** (2014) and **Lithuania** (2015).

**Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Sweden** have not set a deadline for adopting the euro, while **Romania** has committed to doing so in 2019. Even though the obligation to join the euro stems from the Treaties,[4] the EU does not force its Member States to make this step.

## The convergence criteria

To enter the third stage of EMU and adopt the euro, a Member State must comply with a set of macroeconomic indicators (known as the **'euro convergence / Maastricht criteria'**).

**Table 1 – The euro convergence criteria**

| **What is measured** | Price stability to show if inflation is under control | Soundness of public finances (avoiding excessive budgetary deficit) | Sustainability of public finances (staying within limits on government borrowing) | Durability of convergence achieved by fulfilling the other criteria | Exchange rate stability |
|---|---|---|---|---|---|
| **How it is measured** | Consumer price inflation rate | Government deficit as % of GDP | Government debt as % of GDP | Long-term interest rates | Deviation from the Exchange Rate Mechanism (ERM II) central rate |
| **Reference value** | Should not be higher than 1.5 percentage points above the rate of the three best performing Member States | Not more than 3% | Not more than 60% | Should not be higher than 2 percentage points above the rate of the three best performing Member States (with highest price stability) | Taking part in the ERM II for at least two years without significant deviations from the ERM II central rate (± 15%) |

Apart from the need to fulfil these criteria, the aspiring euro area Member State must align its national legislation with the EU *acquis* with regard to its national central bank, particularly from the point of view of its independence and the independence of the members of its decision-making bodies, its objectives, and its integration into the European System of Central Banks.

### Monitoring the convergence criteria

Article 140 of the Treaty on the Functioning of the European Union (TFEU) stipulates that, 'At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union'. These convergence reports include an assessment of the compatibility of the national legislation and the achievement of the convergence criteria. Consequently, the European Commission and the European Central Bank submit these reports to the Council in parallel, as both institutions have been given the same mandate. The most recent reports date from June 2014.

Apart from examining issues of legal compatibility, these reports also analyse additional factors such as developments in the balance of payments, risk of macroeconomic imbalances and integration of labour, product and financial markets into the euro area.

**Participation in the Exchange Rate Mechanism II**

Under ERM II, the exchange rate of a non-euro-area Member State is pegged to the euro and is only permitted to fluctuate within a predetermined band (±15%). Countries wishing to adopt the euro may choose to stay within a narrower fluctuation limit (e.g. Latvia opted for a 1% band, and Malta for no fluctuation). When necessary, the central bank of the Member State concerned and the ECB may support the exchange rate so that it remains within the fluctuation band, by buying or selling the currency. There could also be a revaluation of the national currency against the euro (as was the case with the Slovak koruna in 2007 and 2008), but devaluation is not permitted. Member States which adopted the euro after 2001 have taken part in the ERM II for as little as 2.5 years (Slovenia) and as long as 10.5 years (Lithuania).

As regards the obligation to take part in ERM II, the European Council declared in a resolution that: 'Participation in the exchange-rate mechanism will be voluntary for the Member States outside the euro area. Nevertheless, Member States with derogation can be expected to join the mechanism. A Member State which does not participate from the outset in the exchange-rate mechanism may participate at a later date.' Therefore, participation may be interpreted as voluntary but is nevertheless expected. Participation in ERM II is a mandatory pre-condition for those Member States that are obliged to join the euro area while in the process of fulfilling the convergence criteria. Consequently, 'voluntary participation' means primarily the freedom given to each Member State to choose the optimal timing for entering this mechanism. Hence, even though all Member States which adopted the euro after 2004 had taken part in the ERM II before that, none of the Member States with a derogation are taking part in it. Having joined the ERM II on 1 January 1999, the Danish kroner is the only currency now within it, at a central rate of 7.46038 to the euro and a narrow fluctuation band of ±2.25%.[5] The Bulgarian lev has been pegged to the euro since 1999, but the government has not applied for formal participation in ERM II.

**Strict respect for the convergence criteria**

While in 1997 only three Member States (Finland, Luxembourg and Portugal) had achieved all convergence criteria, by May 1998, as many as 11 Member States – Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain – were considered by the Council as having successfully met the necessary conditions. Despite the fact that six of them: Austria, Belgium, Ireland, Italy, the Netherlands and Spain, had not fulfilled the criterion of government debt not exceeding 60% of GDP, all 11 took part in the introduction of the euro in electronic form on 1 January 1999 (euro notes and coins were introduced in 2002). Having failed to meet the 1999 deadline, Greece was allowed to adopt the euro (with conditions) in July 2000. Later, the credibility of the data supplied by Greece has been questioned, with strong claims that it had not really met the convergence criteria.

Many argue that the criteria applied to the first Member States which joined the euro were not strict enough. While the Treaty allows a debt to GDP ratio to exceed 60%, it also specifies that it should 'diminish sufficiently and approach the reference value (60%) at a satisfactory pace' (Article 104c (b) of the Maastricht Treaty). This was not so in the case of Greece, Germany and Austria, whose ratios were increasing. Additionally, even though Belgium's and Italy's deficits were declining, they were much higher than 60% (88% and 105%, respectively), which led some to question the strictness of interpretation of the notion of 'satisfactory pace'. Last, Italy and Finland had not been formal participants in ERM I (predecessor of ERM II) for the required full two years prior to entry. Some also consider that certain Member States were able to meet the deficit convergence criterion due to one-off 'creative accounting' practices (such as selling gold reserves or booking pension funds of state-owned companies as assets), which enabled them to show artificially low budget deficit levels. Some believe that permitting Member States with a high debt or deficit to join the euro was politically justified as it would set them on the right course to improvement, whereas denying a country entrance would risk undermining the whole project.

More recent experience suggests that the requirement for meeting the convergence criteria is being applied with increased stringency. For example, in 2006 Lithuania was denied accession to the euro area after the Commission concluded that its inflation was at 2.7%, just 0.1% above the reference value of 2.6%. Apart from being one of the convergence criteria, the reference value of 3% of deficit to GDP is also used in the Excessive Deficit Procedure. With regard to this procedure, the Commission seems to have more room for interpretation, as it can 'take into account all relevant factors' (Article 126(3) TFEU) when assessing non-respect of the reference value. For example, the Commission decided in 2010 to accept a deficit of 3.5% GDP as close enough not to trigger the procedure.[6] It has done the same for Belgium, Italy and Finland in 2015. It remains to be seen how strictly the convergence criteria will be applied in future accessions.

## Current progress of the non-euro area Member States

Introducing the euro has had certain positive economic effects: it has intensified trade in goods and services, decreased transaction costs, lowered inflation and reduced the costs of debt servicing.[7] Economic research shows that a single currency can be particularly advantageous for small and very small countries. However, euro area countries also face a number of challenges, among which is the fact that they are not allowed to finance debt or respond to economic shocks by appreciating or depreciating their currency (adjusting exchange rates). Instead of monetary policy, they need to apply budgetary and structural policies to manage their economies – which is generally politically tougher and takes longer. The debate on whether the benefits of euro area membership outweigh these challenges or not is far from over. At present, even though some countries with a derogation are close to meeting the convergence criteria, it remains to be seen whether or not there will be enough political and public support for them to join the euro area.

### Fulfilment of the convergence criteria

The annex features a table showing the state of play regarding the fulfilment of the convergence criteria by the Member States with a derogation, as indicated in the 2014 convergence reports of the ECB and the Commission. The table presents the situation as it was in mid-2014 and the data cover both 2013 and 2014.

The table shows that Bulgaria, the Czech Republic and Sweden fulfil all but one criterion, on ERM II. In fact, none of the seven countries with a derogation has decided to join ERM II. Furthermore, none except Croatia has aligned its central bank legislation with the euro area requirements. Croatia however is currently subject to an Excessive Deficit Procedure and therefore does not fulfil the criterion for the government budgetary position as referred to in the Treaty Protocol.[8]

Hungary has government debt well above 60% of GDP (hence it is marked in red), yet in its 2014 report the Commission considered it to have fulfilled the criterion. The ECB however predicts a 'very slow decline' in the debt ratio towards the 60% target. Romania does not fulfil the price stability criterion but is expected to contain inflation in the short term. However, the ECB sees the risk of rising inflation likely to prevail in the medium term.

Furthermore, the ECB has expressed concerns about the mid-term outlook for maintaining price stability in Bulgaria, and about price stability and public debt levels in Croatia, Poland and Hungary. These risks may not materialise, but if they do, the achievement of the relevant convergence criteria in the future may be affected.

**Public opinion in Member States with derogation**

The Commission's Directorate-General for Economic and Financial Affairs conducts annual opinion polls in the EU Member States which are expected to adopt the euro.

**Table 2 – Public opinion on introducing the euro and its consequences (in %)**

| | Opinion on introducing the euro | | Perceived consequences of introducing the euro at national level | | Desired time frame for adopting the euro | |
|---|---|---|---|---|---|---|
| | In favour | Against | Positive | Negative | As soon as possible | As late as possible |
| **Bulgaria** | 55 | 39 | 40 | 53 | 18 | 30 |
| **Croatia** | 53 | 43 | 38 | 53 | 15 | 40 |
| **Czech Republic** | 29 | 70 | 26 | 70 | 8 | 63 |
| **Hungary** | 60 | 35 | 50 | 44 | 21 | 29 |
| **Poland** | 44 | 53 | 39 | 54 | 10 | 47 |
| **Romania** | 68 | 26 | 54 | 39 | 40 | 22 |
| **Sweden** | 32 | 66 | 31 | 62 | 10 | 61 |

Source: Eurobarometer Survey 2015.

People are split almost equally over the question of whether to introduce the euro or not: 49% to 48%. This is a reversal from 2014, when more were for joining the euro: 52% to 45%. A majority of respondents in Romania, Hungary, Croatia and Bulgaria support joining the euro.

Some 41% of all respondents (down 3 percentage points since 2014) expect euro adoption to bring positive consequences to their country. This is still above the all-time low of 38% recorded in November 2011 and September 2005. A majority (53%) think that the introduction of the single currency would have negative consequences for their country.

Some 42% of all respondents want the euro to be introduced as late as possible, 36% would prefer to euro to become their currency 'after a certain time' and 18% want the euro to be introduced as soon as possible. Romania is the only Member State where the majority of people favour introducing the euro as soon as possible (44%).

Some recent non-Eurobarometer polls paint a somewhat more 'euro-sceptical' picture, with for instance as many as 85% of Czechs against adopting the euro and as few as 16% of Poles for it. Independent opinion polls carried out in Sweden consistently show weak public support for adopting the euro, with only 9.6% of Swedes being in favour of such a move in 2012.

## Future prospects

Since none of the countries with a derogation are currently taking part in ERM II, it is certain that there will be no further euro area enlargement in the short term. Only Romania has set the target date of 2019 for joining the euro, while the rest have not yet taken a clear decision on when (and whether or not) to adopt the currency. Many argue that the difficulties some euro area members experienced during the financial crisis have deterred potential members from joining. Furthermore, certain countries with a derogation – such as the Czech Republic, Hungary and Poland – have been using their monetary policy to mitigate economic shocks caused by the crisis.

On the other hand, it has been noticed that in many countries with a derogation the debate on joining the euro area has picked up in 2015. After this revival however, recent uncertainty over Greece seems to have resulted in more reserved stances. For example, the Czech Prime Minister said on 8 April 2015 that his country should set a definite date for euro adoption, only to send the opposite message on 31 May. On the other hand some commentators point out that geopolitical considerations, namely the Ukrainian crisis, are conducive to possible euro adoption in some eastern European Member States seeking political certainty. Nevertheless, the time horizon, as reported by the media, is definitely no earlier than 2020 for Bulgaria, Poland, the Czech Republic, Hungary and Croatia.

Some economic research indeed suggests that premature euro adoption may increase the vulnerability of a country to external shocks. Taking this into account, the former transition economies are possibly prudent to take more time to reform with a view to reducing their vulnerability to external shocks and to establishing conditions under which the loss of fiscal and monetary sovereignty would be more easily manageable.

## Further reading

The new EU countries and Euro adoption, H. Gabrisch & M. Kämpfe, Intereconomics, Volume 48, Issue 3, pp. 180-186, 2013.

Joining the European Monetary Union. Institutional considerations and economic impact on new Member States, O. Bondare, Riga Graduate School of Law Research Papers, No 3, 2011.

Too Much to Lose, or More to Gain? Should Sweden Join the Euro? J. Reade & U. Volz, University of Oxford Department of Economics Discussion Paper Series, 2009.

The euro and economic stability: focus on Central, Eastern and South-Eastern Europe, E. Nowotny, P. Mooslechner, D. Ritzberger-Grünwald, Oesterreichische Nationalbank, 2010.

## Endnote

[1] This followed the 1988 Council decision confirming the progressive realization of the EMU, which led to mandating a committee – chaired by European Commission President, Jacques Delors – tasked with defining the stages leading to this union.

[2] For more details see p. 5.

[3] After the launch of the euro, the Danish Government organised a referendum on Denmark's entry to the third stage of EMU. The referendum took place on 28 September 2000. The turnout was 86% and 53.1% of the voters were against the adoption of the single currency.

[4] As stipulated in Article 119 of the Treaty on the Functioning of the European Union.

[5] With the decrease in value of the euro following the ECB's quantitative easing programme, the Danish kroner has reportedly come under pressure, forcing the country's central bank to adopt negative interest rates and spend billions of euros in intervention to maintain the peg.

[6] This was done in the case of Luxembourg.

[7] For a more in-depth discussion on the subject, please see 'A history of European monetary integration', A. Delivorias, 2015.

[8] Poland shows a surplus in the table because of one-off asset transfer from the second pension pillar. The Council closed the Excessive Deficit Procedure for Poland on 19 June 2015.

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## Annex: Fulfilment of the convergence criteria by the Member States with derogation, as per the ECB's and Commission's 2014 convergence reports

| | Inflation rate | Government deficit as % of GDP | Government debt as % of GDP | Membership in ERM II | Change in interest rates | Long-term interest rate | Compati bility of legislation | Specific comments on mid-term prospects | Excessive deficit procedure |
|---|---|---|---|---|---|---|---|---|---|
| **Reference value** | Max. 1.7% | Max. 3% | Max. 60% | Min. 2 years | Max. ± 15% | Max. 6.2% | | | |
| **Bulgaria** | 0.4% (2013) -0.8% (2014) | 1.5% (2013) 1.9% (2014) | 18.9% (2013) 23.1% (2014) | No | 0.0% (2013) 0.0% (2014) | 3.5% (2013) 3.5% (2014) | No | ECB concerned about inflation rate | |
| **Croatia** | 2.3% (2013) 1.1% (2014) | 4.9% (2014) 3.8% (2014) | 67.1 (2013) 69% (2014) | No | -0.8% (2013) -0.8% (2014) | 4.7% (2013) 4.8% (2014) | Yes | ECB concerned about inflation rate & public debt | Yes: 2016 deadline for correcting |
| **Czech Republic** | 1.4% (2013) 0.9% (2014) | 1.5% (2013) 1.9% (2014) | 46% (2013) 44.4% (2014) | No | -3.3% (2013) -5.6% (2014) | 2.1% (2013) 2.2% (2014) | No | | |
| **Hungary** | 1.7% (2013) 1% (2014) | 2.2% (2013) 2.9% (2014) | 79.2% (2013) 83% (2014) | No | -2.6% (2013) -3.6% (2014) | 5.9% (2013) 5.8% (2014) | No | ECB concerned about inflation rate & public debt | |
| **Poland** | 0.8% (2013) 0.6% (2014) | 4.3% (2013) +5.7% (2014) surplus due to asset transfer | 57% (2013) 49.2% (2014) | No | -0.3%(2013) 0.3% (2014) | 4.0% (2013) 4.2% (2014) | No | ECB concerned about inflation rate & public debt | |
| **Romania** | 3.2% (2013) 2.1% (2014) | 2.3% (2013) 2.2% (2014) | 38.4% (2013) 39.9% (2014) | No | 0.9% (2013) -1.5% (2014) | 5.4% (2013) 5.3% (2014) | No | ECB concerned about inflation rate | |
| **Sweden** | 0.4% (2013) 0.3% (2014) | 1.1% (2013) 1.8% (2014) | 40.6% (2013) 41.6% (2014) | No | 0.6% (2013) -3% (2014) | 2.1% (2013) 2.2% (2014) | No | | |

Criterion fulfilled  Criterion not fulfilled