

The euro in an enlarged European Union

From fragmentation to integration

A single market...

- Since the Treaty of Rome was signed in 1957, a fundamental aim of the European Union has been sustainable economic and social progress, so as to ensure health, wealth and a promising future for Europeans. Closer integration in many policy areas has been vital to achieve this aim. The single market, economic and monetary union (EMU), and enlargement to a Europe of 25 are major stepping stones in this process of integration, which has brought real social and economic benefits and strengthened the EU in the world.

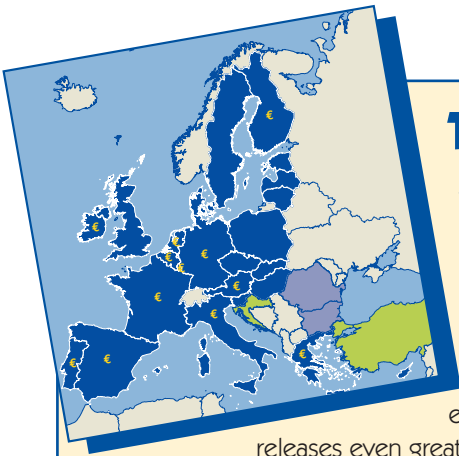
... with a single currency...

- The introduction of the euro is a milestone in the development of the Union and the biggest monetary changeover in history. The euro is the tangible result of EMU. It builds on the success of the single market and contributes greatly to the economic stability needed for more growth. It increases competition and innovation, benefits consumers and releases resources for other areas such as social welfare and education. It also strengthens Europe politically and economically.

... for a closer Union

- However, EMU is not a one-off event – it is work in progress by the euro-area members, who co-operate on economic policy. The new Member States also committed themselves to joining EMU and the euro in their accession treaties. To do so, they need to align their economies carefully with those of existing members. This economic alignment, known as ‘convergence’, is yet another step on the road to closer EU integration.





The bigger the EU, the greater the benefits

Through progressive enlargement the EU has gained the benefits of size. The single market is the main catalyst for realising these benefits. Since it was created, intra-EU trade has increased massively, generating over €900 billion in extra prosperity, creating 2.5 million additional jobs, boosting foreign investment, and making the EU more competitive in international markets. Through its contribution to greater economic efficiency and stability, the euro, a single currency for the single market,

releases even greater benefits:

- Society benefits because price stability and low inflation lead to fewer economic worries for consumers, better long-term planning for industry, and increased social cohesion.
- Member States' economic policies benefit through multilateral surveillance and common fiscal discipline, which prevent gross mistakes.
- Consumers and companies benefit because the strength and availability of the euro increases competition among lenders, thus lowering interest rates. This releases capital for other areas of spending.
- Enterprises benefit because with the euro there are no currency exchange risks. Thus, the euro reduces the cost of doing business across borders and boosts trade.
- Industry as a whole benefits because the free movement of capital within the single market encourages cross-border investment, known as foreign direct investment (FDI). The euro encourages even more FDI.

In 1999, the euro was launched in the 11 founding members of the euro area: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Greece followed in 2001, bringing euro-area membership to 12 countries. On 1 January 2002, euro banknotes and coins were introduced in the largest monetary changeover in history. The euro area currently covers 305 million people of the 451 million in the EU-25, and its size and stability make the euro an attractive international currency. Foreign governments use the euro for borrowing and as a reserve currency, taking advantage of its liquidity, convertibility and stability.

An opportunity for the new Member States

The ten new Member States committed themselves to EMU and the euro as part of their accession treaties. They are now members of EMU 'with a derogation' and will adopt the euro when their national economies meet the convergence criteria. The advantages of the euro will be even more apparent in the new Member States as their economies are in transition and EMU will have a greater catalytic effect on growth:

- The prospect of accession brought much investment (FDI), mostly from the EU. The euro can help sustain these FDI flows by removing transaction costs and exchange rate risks – maintaining the momentum of growth.
- Integration into the euro area can boost both intra-EU and foreign trade, not just by removing transaction costs but also by bringing the stability and credibility of a world economic power to local exporters. Increased trade will boost employment and growth.
- EMU and the euro will lower the cost of borrowing. This makes it easier for local industry to invest in new equipment and build new factories – leading to improved competitiveness and higher-skilled employment.

Convergence with care

The new Member States' economies are growing more quickly than the rest of the EU as they catch up with it. However, problems remain, such as high unemployment and lower productivity. These will lessen with growth – and entry to the euro area will help accelerate the catch-up process. However, before entry, the new Member States must align their economies with the euro area. They must follow policies that lead to convergence in a range of economic indicators – the Maastricht criteria. The Maastricht criteria provide the framework for the Stability and Growth Pact, which guides euro-area members' economic policies today. The Pact helps to maintain a stable and sustainable economy in the euro area. The convergence of new Member States' economies before adopting the euro is crucial for the credibility of their policies and the sustainability of their catching-up process. EMU and the euro will bring many benefits – but the road to the euro area must be navigated with care.



The road to the euro area

Ensuring a stable, sound and sustainable economy: the Maastricht criteria

The EU set the Maastricht criteria as the original conditions for entry into the euro area by the founding members. Keeping to them ensures sufficient alignment for a sustainable and stable euro-area economy. Prospective euro-area members must meet the same criteria, described below and presented in Table 1:

- An inflation rate not exceeding by more than 1.5% that of the three best-performing Member States in terms of **price stability**.
- A general government deficit not exceeding 3% of GDP: an indication of **sound public finances**.
- Public debt of less than 60% of GDP or sufficiently diminishing and approaching this value at a satisfactory pace: a measure of the longer-term **sustainability of public finances**.
- A long-term interest rate not exceeding by more than 2% that of the three best-performing Member States in terms of price stability: an indicator of **durability and credibility**.
- A stable exchange rate, demonstrated by participation without severe tension in the exchange rate mechanism known as ERM-II and by keeping the exchange rate close to the central rate for two years prior to adoption of the euro. This measures the robustness of the economy and the **stability of real convergence** by showing that the government can manage the economy without resorting to currency depreciation.

Table 1 shows how far the new Member States met the Maastricht criteria in 2003¹. These criteria measure 'nominal convergence', which reflects underlying 'real convergence' – the convergence of competitiveness, workforce skills, financial sector integration, industry structures, and a range of other socio-economic factors. A euro-area member must have a sufficient degree of real convergence to be able to withstand economic shocks. Progress towards euro-area membership is not a race. Full participation in EMU and the euro will bring many added benefits – but only for an economy that is well prepared.

Table 1: The Maastricht convergence criteria in the new Member States

What is measured:	Price stability	Sound public finances	Sustainable public finances	Durability of convergence	Stability of convergence
How it is measured:	Consumer price inflation rate	Government deficit as % of GDP	Government debt as % of GDP	Long-term interest rates	Exchange rate stability
Convergence criteria	< 1.5% more than the 3 lowest Member States	Not more than 3%	Not more than 60%	< 2% more than the 3 lowest Member States	Participation in ERM-II for 2 years ²
Czech Republic	1.8%	12.6%	37.8%	4.7%	On ERM-II entry
Estonia	2.0%	-3.1%	5.3%	4.6%	Entry 28/06/04
Cyprus	2.1%	6.4%	70.9%	5.2%	Entry 02/05/05
Latvia	4.9%	1.5%	14.4%	5.0%	Entry 02/05/05
Lithuania	-0.2%	1.9%	21.4%	4.7%	Entry 28/06/04
Hungary	6.5%	6.2%	59.1%	8.1%	On ERM-II entry
Malta	2.6%	9.7%	71.1%	4.7%	Entry 02/05/05
Poland	2.5%	3.9%	45.4%	6.9%	On ERM-II entry
Slovenia	4.1%	2.0%	29.4%	5.2%	Entry 28/06/04
Slovakia	8.4%	3.7%	42.6%	5.1%	On ERM-II entry
Euro-area reference values	< 2.4%	< 3.0%	< 60%	< 6.4%	

Data source: Report from the Commission. Convergence report 2004, COM(2004) 690.

¹ The data in Table 1 are taken from the regular convergence reports, prepared by DG ECFIN every two years or at the request of the Member States concerned.

² See explanation on the exchange rate criteria given above.



As Table 1 shows, in 2003 many new Member States met some of the Maastricht criteria, although this can change from year to year. However, on the road to the euro area, problems and conflicts could arise for the new Member States as they try to expand their economies and meet the Maastricht criteria at the same time:

- Although the new Member States have successfully reduced inflation nearly to the euro-area average, their economies are growing more rapidly than the rest of the EU. This growth is desirable but it can produce inflationary pressures. These pressures must be controlled to maintain economic growth without excessive price inflation.
- Several new Member States do not meet the 3% target on the government deficit. The 3% limit is intended to prevent deficits getting out of control. Of course countries often have to spend more than their income in order to invest, and this is particularly so in the rapidly growing economies of the new Member States – so larger budget deficits are not always bad. However, strong control of budget deficits is a sign of sound finances, which helps attract foreign investment and promote growth. The new Member States must find a balance between investment and prudence to sustain investor confidence.
- The government debt criterion is a longer-term indicator of the sustainability of public finances. The interest on public debt must be paid, so large and growing public debts are expensive and can limit future spending in other areas, such as health and pension obligations.
- To borrow money, governments issue long-term bonds that pay interest. If investors have low confidence in a country's long-term economic prospects, or if there is high inflation, then they will demand a higher interest rate – a risk premium. So the interest rate is one indicator of a country's economic credibility and, for new Member States, of the progress of 'real convergence'.
- As the new Member States' economies catch up, their currencies tend to rise against the euro. On entering ERM-II, each country will fix an exchange rate against the euro and keep it stable within a $\pm 15\%$ band for two years. This means that the Member State can no longer use exchange rates to manage the economy. It will have to use other mechanisms, in particular structural and budgetary policies, to maintain stability and confidence and to demonstrate a robust economy with real convergence, which is ready to enter the euro area.

Convergence and partnership – in the interest of all

The new Member States are catching up with the rest of the European Union. Per capita GDP is much less than the EU average – but it is rising as their economies grow. This is the "real convergence" process. The extensive restructuring achieved during the pre-accession period continues today as the socio-economic structures and institutions become more deeply integrated into the European Union, a necessary process that helps drive growth and real convergence. Each new Member State will follow a different path to the euro, entering only when the criteria are met and the country is able to gain most benefit within the Stability and Growth Pact. EMU and the euro are stepping stones on the path to closer integration, which will release more synergies for social cohesion and wealth creation, both for the new members and for the whole euro area.

For further information:

European Commission, Directorate-General for Economic and Financial Affairs
http://europa.eu.int/comm/economy_finance/index_en.htm

The European Central Bank
<http://www.ecb.int/>

The euro
<http://europa.eu.int/euro>

