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# European Monetary Union

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**Abstract:** The following paper represents a summary of the main challenges that Romania is facing regarding the accession to the eurozone. The adoption of the single currency in Romania is a nationwide intensely debated topic. Policy makers have set the year 2020 for the completion of this process, so steps are being taken in order to achieve the economic and monetary conditions needed to join the eurozone. Studying the preparation of the Romanian economy for the integration into the Economic and Monetary Union is of great importance for the economic and political environment as well as the academic one. A major regime change, as the monetary unification, is clearly made when there are strong motivations given by benefits, but such a change involves costs, risks and difficulties.

**Keywords:** Monetary Union; convergence criteria; national target; euro adoption

**JEL Classification:** E42; E52

## 1. Introduction

The government confirmed its intention to adopt the euro in 2020. The official target date leaves open the possibility that euro-adoption could be delayed from until 2020. All Member States of the European Union, except Denmark and the United Kingdom, are required to adopt the euro and join the euro area. To do this, they must meet certain conditions known as “convergence criteria”.

All EU Member States are part of the Economic and Monetary Union, which means they coordinate their economic policies for the benefit of the EU as a whole. However, not all EU Member States are in the euro area – only those having adopted the euro are members of the euro area.

Of the Member States outside the euro area, Denmark and the United Kingdom have 'opt-outs' from joining for reasons of economic sovereignty. These two countries can join in the future if they so wish.

Sweden is not yet in the euro area, as it has not made the necessary changes to its central bank legislation and it does not meet the convergence criterion related to participation in the Exchange Rate Mechanism (ERM II). However, under the Treaty, Sweden is required to adopt the euro. The remaining non-participating Member States acceded to the Union in 2004 and 2007, after the euro was launched. At the time of their accession, they did not meet the conditions for entry to the euro area, therefore their Treaties of Accession allow them time to make the necessary adjustments – they are Member States with a “derogation”, as is Sweden. These Member States have committed to joining

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the euro area as soon as they fulfil the entry conditions. When this is the case, the 'derogation' is 'abrogated' by a decision of the Council, and the Member State concerned adopts the euro. (Baldwin & Wyplosz, 2009)

According to The Yearly Report of National Bank of Romania, the fulfilment of the criteria foreseen in the Maastricht Treaty and the adoption of a sole European currency are a part of the European registration process of Romania. The entrance in the euro area implies the transfer of the development and leadership of monetary policies to the Central European Bank, institution whose actions are enterprised in a unitary manner for the whole euro area, without taking into consideration the national economic particularities. In this context, in the primary period of the sole currency adoption, it takes a fundamental act in order for the national economy to cover the necessary adjustment in the euro area.

According to the Maastricht Treaty, a member state of the European Union benefits of a temporary derogation regarding the euro adoption. But has the obligation to prepare itself for the entrance in the European mechanism and in the exchange rates ERM II, where it will stay for a period of at least two years, after the sole currency can be adopted.

## 2. The Conditions for Romania to Entry to the Euro Area

The process of building Europe is one of progressive integration. The single market for goods, services, capital and labour, launched in 1986, was a major step in this direction. Economic and Monetary Union and the euro take economic integration even further, and to join the euro area Member States must fulfil certain economic and legal conditions.

Adopting the single currency is a crucial step in a Member State's economy. Its exchange rate is irrevocably fixed and monetary policy is transferred to the hands of the European Central Bank, which conducts it independently for the entire euro area. The economic entry conditions are designed to ensure that a Member State's economy is sufficiently prepared for adoption of the single currency and can integrate smoothly into the monetary regime of the euro area without risk of disruption for the Member State or the euro area as a whole. In short, the economic entry criteria are intended to ensure economic convergence – they are known as the 'convergence criteria' (or 'Maastricht criteria') and were agreed by the EU Member States in 1991 as part of the preparations for introduction of the euro.

In addition to meeting the economic convergence criteria, Romania must make changes to national laws and rules, notably governing its national central bank and other monetary issues, in order to make them compatible with the Treaty. In particular, national central banks must be independent, such as the monetary policy decided by the European Central Bank is also independent.

For the adoption of the euro, the national target date in Romania is 01.01.2015. The Member States which were the first to adopt the euro in 1999 had to meet all these conditions. The same entry criteria apply to all countries which have since adopted the euro and all those that will in the future. (Hurduzeu & Constantin 2007)

## 3. The Convergence Criteria

The convergence criteria are formally defined as a set of macroeconomic indicators which measure:

- Price stability, to show inflation is controlled;

- Soundness and sustainability of public finances, through limits on government borrowing and national debt to avoid excessive deficit;
- Exchange-rate stability, through participation in the Exchange Rate Mechanism (ERM II) for at least two years without strong deviations from the ERM II central rate;
- Long-term interest rates, to assess the durability of the convergence achieved by fulfilling the other criteria.

The exchange-rate stability criterion is chosen to demonstrate that a Member State can manage its economy without recourse to excessive currency fluctuations, which mimics the conditions when the Member State joins the euro area and its control of monetary policy passes to the European Central Bank (ECB). It also provides an indication of the appropriate conversion rate that should be applied when the Member State qualifies and its currency is irrevocably fixed.

**Table 1. The five convergence criteria**

| **What is measured:** | Price stability | Sound public finances | Sustainable public finances | Durability of convergence | Exchange rate stability |
|---|---|---|---|---|---|
| **How it is measured:** | Consumer price inflation rate | Government deficit as % of GDP | Government debt as % of GDP | Long-term interest rate | Deviation from a central rate |
| **Convergence criteria:** | Not more than 1.5 percentage points above the rate of the three best performing Member States | Reference value: not more than 3% | Reference value: not more than 60% | Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability | Participation in ERM II for at least 2 years without severe tensions |

According to the Treaty, at least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank assess the progress made by the euro-area candidate countries and publish their conclusions in respective convergence reports.

On the basis of its assessment, the Commission submits a proposal to the Council which, having consulted the European Parliament, and after discussion in the Council, a meeting among the heads of state or government decides whether the country fulfils the necessary conditions and may adopt the euro. If the decision is favourable, the Council abrogates the derogation and, based on a Commission proposal, having consulted the ECB, adopts the conversion rate at which the national currency will be replaced by the euro, which thereby becomes irrevocably fixed. (Iordache, 2009)

Romania ticks three of the five boxes imposed by the convergence criteria for adoption of the euro, also known as the Maastricht criteria. The country does well on the exchange rate evolution, on the budget deficit and on the total public debt, which is of only 38 percent of the Gross Domestic Product, much below the imposed threshold of 60 percent of the Gross Domestic Product, according to Valentin Lazea Romania’s Central Bank chief economist. The private debt, which is also important, is of 70 percent of the country’s Gross Domestic Product, while the Maastricht criteria mention a threshold of 160 percent for the private debt. Romania must work on its inflation, which exceeds the imposed limit by 0.6 percentage points, and the long term interest rates, of 6.67 percent, which are 1.3 percentage points higher than in the Maastricht criteria.

## 4. Advantages and Disadvantages in the Euro Adoption

There are two levels for euro adoption. One is technical, the other one is political. The best moment is when Romania is ready, it is the political answer. Technically, if we also take into account the ERM mechanism, if we take into account the negotiations with the European partners, the opening of these talks, which probably did not happen, will probably lead to another five- six years of waiting from the moment when the talks open.

He showed that the postponement of the euro adoption is more visible now, especially after an announcement "official or semiofficial, but it is no surprise that 2015 was not a realistic term. The euro adoption for Romania is a solution for the economic problems we have and especially for the economic euroisolation problem. The fact that we adopt it now or later is not bad either. The most important thing is to maintain the political objectives to correct the macroeconomic indicators and to enforce some healthy policies, able to support growth and development..

- Romania's situation is similar to Hungary's: Most people support euro adoption and all mainstream political parties back it;

- The recently updated convergence plan sent to Brussels sets the target date for euro entry at 2020. This may be feasible, but it is increasingly likely that the country will have to delay it. The government won political cover from IMF chief Dominique Strauss-Kahn, who said Romania should not insist on a 2020 entry date because the country could use an extra year or two. The European Commission (EC) reacted cautiously to Romania's updated convergence plan and pointed out several inherent risks. First and foremost, the EC criticized the lack of measures to bring down the budget deficit in 2011 and 2012. Romania will have to present deficit-lowering proposals to EU officials by mid-May. Romania also received negative comments for its failure to enact a fiscal responsibility law, which lowers the credibility of the government's pledges to consolidate state finances, the EC opined;

- Inflation remains relatively high, registering 4.56 % in November 2012. But while consumer price increases are expected to cool off, the budget deficit is expected to top 4.3% this year. Given Romania's track record, skepticism is justified when it comes to Romania's ability to reduce its deficit;

- Political factors could also hinder the introduction of the euro. The Romanian government's resolve in bringing down the budget deficit may not be strong enough. Many of the conditions of its IMF loan remain unfulfilled a year after the contract was signed. The government should have made sizeable reductions in the state workforce by now. The administration is also still debating IMF-mandated laws that should have been passed already, including the fiscal responsibility law, pension reform and the unitary wage law. The government has reaffirmed its commitment to passing these painful measures on multiple occasions, but has always failed to follow up.[1]

The euro adoption brings a series of advantages which can be grouped directly and indirectly, but also disadvantages.

The direct advantages are:

- removal of currency risk from the euro;
- reduction of volatility of the exchange rate from the currency of other commercial partners;
- reduction of transaction costs;
- reduction of administrative costs;

[1] European Commission: *Romania and the euro.* Communication from the Commission, Brussels. 2012.

- reduction of capital cost.

The indirect advantages:

- growth of the exterior commerce;
- growth of the direct foreign investments (DFI);
- GDP growth/habitant due to the increase of exterior commerce and DFI;
- increase of competition and transparency;
- increase of the standard of living in the long term.

Disadvantages:

- technical and organizational costs referred to the conversion in euro;
- specific costs in the bank sector and reduction of bank income sources;
- loss of monetary independence policy and the exchange rate;
- risk of asymmetric shocks;
- possibility of a greater inflation on long term.

Regarding the benefits due to the adoption of euro, they are absolutely cert. The most important from them is the one referred to the removal of the exchange rate risk and the stimulation of exterior commerce. (Oprițescu, Manta & Perpelea, 2012)

Analyzing the disadvantages of the euro currency adoption it is found that the Romanian economy is completely different than the euro area. After the adherence to the euro area, Romania cannot use the exchange rate as an adjusting instrument. The exchange rate facilitates the shock absorbance and the impossibility to use the exchange rate as a silencer for the economic shocks imposes a stable, solid, competitive economy. In the contrary the effects which will occur can be dramatic. The major disadvantage of the adherence is the loss of monetary policy, this thing can lead to the appearance of the so called asymmetric shocks.

## 5. Conclusions

Romania may face difficulties in meeting the European Central Bank (ECB) convergence criteria on inflation, fiscal deficits and long-term interest-rate in time to adopt the euro in 2020. To adhere to the euro area, we should concentrate firstly on the increase of competitiveness, on public coherent policies and on an agenda of structural reforms. At enterprise level, the competitiveness is the capacity to maintain yourself on the market through products with equal characteristics or superior ones than the competitive similar products. At nation's level, to be competitive, means taking a series of indicators (occupation, productivity, exterior commerce, financial stability, business environment) over the average and close to the most performing states from the euro area.

The moment of the euro adoption is not only a decision of Romania, through the efforts which need to be taken to achieve that level of development which can allow the adoption of the sole currency. Even if the criteria are the same for all states which want to integrate from the economic and monetary point of view, each country needs to create its own strategy of monetary policy of transaction according to the needs and individual circumstances. (Oprițescu, Manta & Perpelea, 2012)

Likewise, it is to be remarked that the passing to the euro area does not need acceleration in useless way, but the adoption of the sole currency does not need to be treated as a sole purpose. Besides the achievement of nominal convergence goals, the realization in the shortest time of the real convergence represents the goal to which would be indicated to subsume the policies followed by Romanian authorities. It is absolutely cert that Romania has a long way ahead in terms of convergence, especially the real one, but also the nominal convergence. What needs to be insured is, however, the sustainability of the convergence process. Romania also needs to improve its competitiveness before joining European economic and monetary union (EMU). Given the uncertainties facing the euro area, it would be beneficial for the NBR to retain control of the exchange rate, giving it the flexibility to restore competitiveness in the face of asymmetric shocks. As a result of all these factors, we can expect that Romania will postpone adoption of the euro until 2020 at the earliest.

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