

Econ 340
Lecture 17
European Monetary Unification
and the Euro

Announcements

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News

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Outline: European Monetary Unification and the Euro

- What Is It?
- History of the EMU
- Need for Convergence
- Pros and Cons of Unification
 - Why Adjustment Is Hard
 - Winners and Losers under EMU
- Effects on the US
- What Happened?

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What Is It?

- The move to a common currency for a group of countries of Europe
 - Originally 12 countries
 - Now 13, with the addition of Slovenia in 2007
- Purpose: To further the economic integration of Europe that
 - Began with the European Economic Community (we'll see more about that next time)
 - And is today called the European Union (EU)
- The currency is shared by all 13 countries and is not controlled by any one of them
- It is controlled by the European Central Bank (ECB)
- The group of countries is called the Economic and Monetary Union (EMU)
(Also, informally, the Eurozone)

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History of the EMU

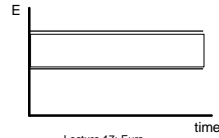
- Before 1973:
 - All these currencies were pegged to the US dollar
- After 1973:
 - The Bretton-Woods system collapsed and major currencies stopped pegging to \$
 - By default, currencies began to float
 - Europe, because of its large trade, found exchange rate movements especially troublesome

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History of the EMU

- After 1973:
 - Europe tried several arrangements to get greater stability
 - Wide-band peg to \$ with narrower peg to each other: “Snake in the tunnel”

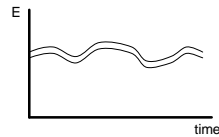


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History of the EMU

- After 1973:
 - Europe tried several arrangements to get greater stability
 - Narrow peg to each other with no peg to \$: “Floating snake”



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History of the EMU

- 1979
 - European Monetary System (EMS) established
 - Features:
 - An Exchange Rate Mechanism (ERM) of exchange rates pegged to each other within $\pm 2.25\%$ bands
 - Provision for adjusting the pegs when needed
 - A basket of currencies forming the European Currency Unit (ECU) that floated with respect to outside currencies
 - Capital controls
 - Did it work?
 - Inflation rates differed, but their differentials gradually fell
 - 11 currency realignments during 1979-87

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History of the EMU

- 1989: First official statement of the goal of moving toward a common currency
- 1991, December: Maastricht Treaty
 - Agreement on greater unification of member countries, forming the “European Union”
 - Also included the terms for adopting the common currency

History of the EMU

- 1992: Crisis
 - Denmark voted NO to the Maastricht Treaty
 - Speculative attacks on currencies forced some to drop out of ERM
- 1993:
 - ERM widened bands to $\pm 15\%$
 - Prospects for EMU looked bleak
 - Denmark ratified Treaty but “opted out” of the euro; UK also opted out
 - Germany was last country to ratify Maastricht Treaty

Need for Convergence

- Difficulties of adopting common currency
 - If countries have different rates of inflation
 - High-inflation countries will lose markets to low-inflation countries
 - Exchange rates won't adjust (a la PPP) to correct
 - If countries have different interest rates
 - Capital will flow to high-interest rate countries seeking higher return
 - Uncertainty about exchange rate won't correct
 - Temptation to run budget deficits when able to borrow from other countries

Need for Convergence

- Difficulties of adopting common currency
 - These suggest that success with a common currency requires countries to have similar
 - Inflation rates
 - Interest rates
 - Budget deficits
 - Government debts
 - Achieving this is called “convergence” and was required in the Maastricht Treaty before a country could adopt the euro

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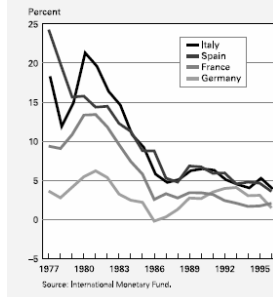
Need for Convergence

- Maastricht Convergence Criteria
 1. National currency in ERM for 2 years
 2. Budget deficit < 3% of GDP
 3. Government debt < 60% of GDP
 4. Inflation < 1.5% above average of lowest 3
 5. Long-term interest rates < 2% above average of lowest 3
- How well were they doing?
 - Following graphs from 1998 article

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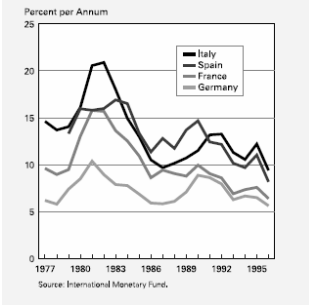
Figure 1
CPI Inflation Rates



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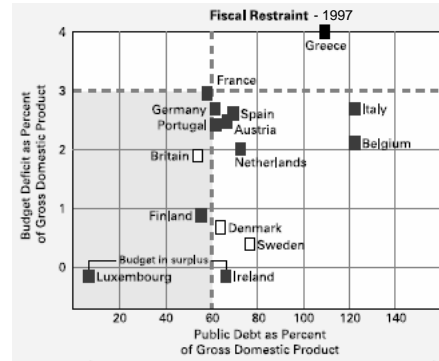
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Figure 2
Government Bond Yields



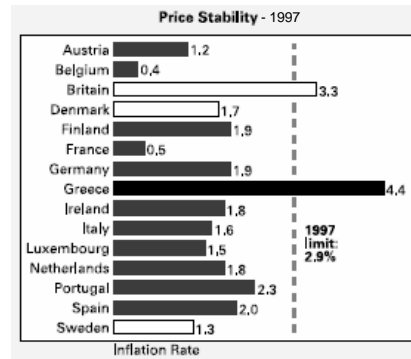
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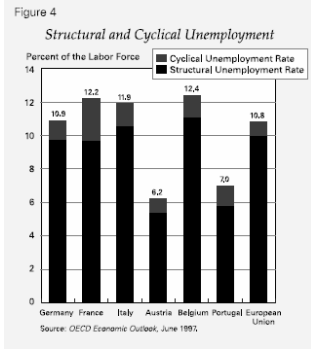
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Maintaining Convergence

- Stability and Growth Pact (SGP)
 - Agreed in 1996 that members of the Eurozone would
 - Keep their budget deficits below 3% of GDP
 - Pay fines if they broke this limit

As we'll see later, this has been a problem!

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Timetable

- May 1998: Membership was set
 - Based on convergence
 - All except
 - UK, Denmark, Sweden – who opted out
 - Greece – who failed to converge (Greece did enter later)
- Jan 1, 1999: Euro launched (except notes/coins)
 - Value of euro = 1 ECU as of midnight Dec 31, 1998 = \$1.18
 - Currencies "irrevocably" linked
 - Single monetary policy: ECB
 - New public debt issued in euros
 - Financial markets started using euro
- Jan 1, 2002: Notes/coins started circulating
- Jul 1, 2002: National notes/coins retired

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Members

- As of 2002, EU had 15 members, of whom 12 adopted the euro

Belgium
Austria
France
Finland
Luxembourg
Italy
Netherlands
Germany
Portugal
Ireland
Greece
Spain

BAFFLING PIGS

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Members

- And 3 did not

Denmark
United Kingdom
Sweden

DUKS

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Pros and Cons of Unification

- Proponents expected
 - Complete the internal market
 - Improved competition & efficiency
 - Arbitrage across national borders
 - New era of prosperity
 - Stable prices
 - Fiscal discipline
 - Lower interest rate
 - ≠ thus higher investment
 - ≠ Stronger growth
 - More jobs

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Pros and Cons of Unification

- Opponents expected
 - Division of the EU (baffling pigs vs. ducks)
 - Loss of sovereignty
 - Little popular support
 - Regulatory & other costs
 - Difficulties of adjustment to asymmetric shocks
(As has happened with German unification and discovery of North Sea Oil)

Pros and Cons of Unification

- Why adjustment is hard
 - Like states in the US, countries in Eurozone have
 - No exchange rate tool
 - No separate monetary policies
 - Very limited fiscal policies (due to SGP)
 - Unlike US states, however
 - Labor is less mobile across countries
 - Wages are less flexible, due to social policies
 - No mechanism for fiscal transfers among countries

Pros and Cons of Unification

- Without adjustment
 - When one country is hit with a shock that others are not (an “asymmetric shock”),
 - Its markets don’t adjust (rigid wages)
 - Its people don’t move
 - It has fewer policies to deal with this
 - Other countries don’t help

Winners and Losers from EMU

- **Winners**
 - Multinational companies: their costs of operating in multiple countries were reduced
 - Europe's biggest banks were expected to gain, through consolidation across borders
 - Consumers, able to comparison-shop across borders
- **Losers**
 - Small firms (e.g. shops, restaurants), for whom changeover was costly, with little benefit

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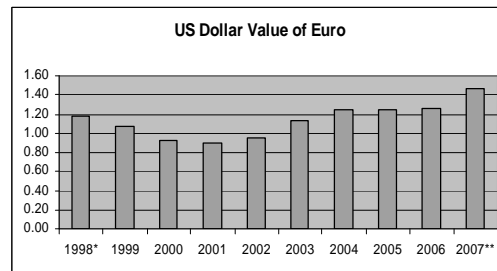
What Happened?

- Euro started (Jan 1, 1999) at 1.18 \$/€
- Now (Nov 9, 2007) it is 1.47 \$/€
- So it has simply risen, right?
- Hardly! Not that simple.

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What Happened?



*1998: Dec 31, **2006: Nov 9

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What Happened?

- Euro fell, after its creation by about 25% to 2001
- Then it rose by 2004 back to slightly above where it started
- Now, this year, it has risen another 17%
- Today, it is almost 25% above where it started
- Why all this change? I don't think we know

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What Happened?

- Has it worked well for Europe?
 - There have been problems
 - Many in Europe think that prices rose when converted to euros
 - Several countries have broken the limit of the SGP
 - Portugal: paid a fine
 - France, Germany
 - » Too big to fine
 - » They revised the SGP

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What Happened?

- The problem of Italy (see Lachman)
 - Has lost 15% of competitiveness over 5 yrs
 - In recession since summer 2005
 - Due to euro membership
 - Can't lower interest rates
 - Constrained in use of fiscal policy
 - Budget deficit already 4% of GDP
 - Needs structural reforms (but hard, politically)
 - There's talk now of it leaving the euro

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What Happened?

- Has it mattered for the US?
 - When the euro fell it made it hard for US to compete
 - Now, with its rise,
 - US benefits as sellers
 - Hurts us as consumers and as tourists
 - There is talk of others switching from dollars to euros
 - So far, not much sign that it is happening

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Next Time

- Preferential Trading Arrangements and the NAFTA
 - What are they?
 - Their effects
 - NAFTA
 - Other

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