Econ 340
Lecture 17
European Monetary Unification and the Euro

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
• What Happened?
• The Eurozone Crisis

What Is It?
• The move to a common currency for a group of countries of Europe
  – Originally 12 countries
  – Now 19, with addition of Lithuania Jan 1 2015
• Purpose: To further the economic integration of Europe that
  – Began with the European Economic Community (a customs union – see next time)
  – And is today called the European Union (EU)

What Is It?
• The currency is shared by all 19 countries and is not controlled by any one of them
• It is controlled by the European Central Bank (ECB), based in Frankfurt, Germany
• The group of countries is called the Economic and Monetary Union (EMU)
  (Also, informally, the Eurozone)
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 US$  
  – By default, currencies began to float
  – Europe, because of its large internal trade, found exchange rate movements especially troublesome

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

1979
  – European Monetary System (EMS) established
  – Features:
    • An Exchange Rate Mechanism (ERM) of exchange rates pegged to each other within ±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

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

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 ±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
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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 for differences
  - If countries have different interest rates
    - Capital will flow to high-interest rate countries seeking higher return
    - Uncertainty about exchange rate won’t offset this
  - Temptation to run budget deficits when able to borrow from other countries

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

Figure 1: CPI Inflation Rates

Figure 2: Government Bond Yields
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!

Timetable

- May 1998: Membership was set
  - Based on convergence
  - All of the then 15 EU members, except
    - UK, Denmark, Sweden – who opted out
    - Greece – who failed to converge (Greece did enter soon after)
- Jan 1, 1999: Euro was launched (except notes/coins)
  - Value of euro = 1 ECU as of midnight Dec 31, 1998 = $1.18
  - Currencies “irrevocably” linked
  - Single monetary policy: ECB (European Central Bank)
  - 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
The euro notes and coins

- Note what does not appear:
  - People
  - Actual buildings and places
- Purpose was to treat all members equally
- Result was that the currency lacks personality
- People don’t much like it, and they miss their old national currencies.
- See Kulish

Members

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

Belgium  Austria  France
Luxembourg  Italy  Netherlands
Germany  Portugal  Ireland  Greece  Spain

Members

- And 3 did not

Denmark  United Kingdom  Sweden

DUKS

Members

- Since 2002, the Eurozone has become:

BAFFLING PIGS + SCLELMS?

Lithuania (2015)
Latvia (2014)
Slovenia (2007)
Slovakia (2009)

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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
Pros and Cons of Unification

- Opponents expected
  - Division of the EU (baffling pigs vs. duks)
  - Loss of sovereignty
  - Little popular support
  - Regulatory & other costs
  - Difficulties of adjustment to asymmetric shocks

(As had happened before, e.g., with German unification and discovery of North Sea Oil)

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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, in Eurozone
    - 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 (i.e., 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

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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 (Mar 10, 2017) it is 1.07 $/€
• So euro has simply fallen, right?
• Hardly! Not that simple.

What Happened since 1999?

From IMF, International Financial Statistics

What Happened over the Last Year?

From X-Rates.com

What Happened over the Last Month?

From X-Rates.com

What Happened?

• Euro fell, after its creation by about 25% to 2001
• Then it rose by 2004 back to slightly above where it started
• By 2008 it had risen to over $1.50, only to fall in 2009
• From 2004 to 2014, it stayed at or above $1.20
• It then fell to about $1.10, then $1.05 where it has stayed lately
• Some thought it would go below "parity" of $1.00, but it has not.
What Happened?

- Why all this change? I don’t think we know, for the changes that happened over most of this period.
- The fall since 2014 – from over $1.30 in 2013 to just around $1.05 today – is due to
  - Weakness of the Eurozone economies
  - The ECB’s use of “Quantitative Easing” to lower interest rates and stimulate the economy
  - The US Fed’s interest rate increase and signals that it will raise them further
- Note what the market for foreign exchange says about how interest rates affect it.

What Happened?

- Has the euro worked well for Europe?
  - There were problems, even in the early years
    - Many in Europe perceived that prices rose when converted to euros
  - Several countries broke the limit of the SGP
    - Portugal: suffered criticism but was not fined
    - France, Germany
      - Too big even to criticize
      - Instead EU revised the SGP
    - In the last decade, the PIIGS (Portugal, Ireland, Greece, & Spain)
      - Or PIIGS, including Italy

What Happened?

- Has the euro mattered for the US?
  - Not much
    - When the euro fell initially it made it hard for US to compete
    - In 2007-8, with euro’s rise,
      - US benefited as sellers
      - Hurt as consumers and as tourists

What Happened?

- Has the euro mattered for the US?
  - There used to be talk of central banks switching from dollars to euros as reserves
  - So far, not much sign that this is happening

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The Eurozone Crisis

- The crisis consisted of (see Baldwin et al.)
  - News of Greek debt, and concerns about Greece’s ability to manage it
  - Increased interest rates in Greece and other Eurozone countries, threatening debt problems there as well
  - Bailouts by EU, ECB, and IMF
  - Concern that the Eurozone could break up
  - Commitment by ECB’s Draghi to “Do whatever it takes” to save the eurozone.
The Eurozone Crisis: Timing

Source: Baldwin et al., “Rebooting the Eurozone”

Note: The spreads are the difference between national 10-year government bond yields and those of Germany, in percentage points.

What Happened?

• The problem of Eurozone imbalances
  – The common currency fostered current-account imbalances
  – Surplus countries lent to deficit countries
  – Without institutions (banking union, fiscal union) to assist adjustment, loss of confidence could cause “sudden stop” of creditors’ willingness to lend
  – That set the stage for crisis.

What Happened?

• The problem of Greece (started in 2010)
  – Greek government deficits have been over 10% of GDP
    • (compare SGP limit of 3%)
  – Greek debt rose to about 160% of GDP
    • (compare SGP limit of 60%)
  – Markets feared default; speculators attacked both Greek bonds & euro
  – EU (esp Germany) were reluctant to help (& was prohibited by Lisbon Treaty)
  – Greek austerity caused massive protests

Note that Greece is not solved, and crisis may not be over.
What Happened?

• The Euro Zone today
  – In process of negotiating a mechanism to
  • Provide loans to member countries in trouble
  • Put pressure on them for austerity:
    – Cut spending
    – Raise taxes
  • Form “banking union” to safely manage bank failures

What Happened?

• The Euro Zone today
  – Still trying to solve the problem of Greek debt
  – Tradeoff between
  – Bailout money from others to pay it off
    » Favored by weaker EU countries (e.g., France)
  – Cutting value of bonds to private sector holders
    » Called “haircut” (also “bail-in”)
    » Also, “Private-sector involvement” (PSI)
    » Favored by stronger EU countries (e.g., Germany)

What Happened?

• The Euro Zone today
  – Fear that if not solved,
  • Greece would default
  • Speculators would attack other weak countries’ bonds
  • Greece and others will be forced to leave the euro
  – These concerns seemed to have abated in 2014, but then Greece elected a government opposed to the terms of the bailout.

Next Time

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