

# The euro currency and european union economics essay



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“ The Euro Currency has been a resounding success and is poised to replace the Dollar as the strongest currency in the world. The potential long-term advantages for business make it inevitable that the UK, Sweden & Denmark will have to adopt the European Single Currency shortly or risk damaging their long-term prosperity by staying out”

## **Introduction**

European Union mission in the 21st century is to:

Europe's provide peace, prosperity and stability for its peoples;

overcome the divisions on the continent;

ensure that its people can live in safety;

promote balanced economic and social development;

meet the challenges of globalisation and preserve the diversity of the peoples of Europe;

uphold the values that Europeans share, such as sustainable development and a sound environment, respect for human rights and the social market economy.

## **PEST Chart – Joining European Union**

### **Political**

**Prevent war**

**Government will lose its sovereignty and control over its monetary policies.**

**Forming up as one big economy allows Europe to be competitive with other strong economies such as US, China & Japan.**

### **Economical**

**Bring down trade barriers**

**Economy will be stable due to long term increase in trade**

**Inflation and interest rates can be unified & controlled.**

**But inability to control any undesired inflation rate.**

**Increase of employment and labor supply.**

**Bring down Labor costs.**

**Will be able to improve on employment issues, provide job & trade opportunities**

**Will increase Foreign Direct Investment (FDI)**

### **Social**

**Lost of national Sovereignty will cause unhappiness among the citizens affected.**

**Majority of the people still do not agree on their country joining in the European Union (EU)**

## **EU stresses on the point of social responsibility towards Resource Conservation**

### **Technological**

**Sharing of emerging technologies information.**

**Combined effort/project of research and development activity for European economy**

**Impact of technology transfer.**

**If United Kingdom, Denmark and Sweden were to join the European Single Currency...**

**The Economic & Political advantages for businesses based in these countries**

**Advantages (<http://www.economicshelp.org/europe/benefits-euro.html>)**

1. Transaction costs will be eliminated

This will greatly benefit businesses who trade and tourists within the European Economic and Monetary Union (EMU) area, as there will be no charge for changing of currency, thus boosting the economy. It is estimated that this benefit will be equal to 1% of GDP so will be quite significant.

2. Price transparency

European Union (EU) companies often find it difficult to accurately compare the prices of goods, services and resources across the EU because of the distorting effects of exchange rate differences. So when price is transparent, trading starts to take place.

### 3. No more exchange rate fluctuations. Uncertainty eliminated.

Due to the fluctuating currencies in the EU, many firms become wary when investing in other countries because of the uncertainty. Investment would rise in the EMU area as the currency is universal within the area, therefore the anxiety that was previously apparent is there no more.

### 4. Single currency in single market.

It brings the Europe's economy forward after trading has taken place more effectively and efficiently

### 5. Be able to contend with the American Dollar and Japanese Yen.

A new currency in Europe could be a rival to the two currencies, as it seems EMU seems to be in a good situation that it can survive on its own, with or without the help of Japan and U. S. A.

### 6. Prevent war.

When countries unite & trade effectively together, they don't wage war on each other and if EMU have more undisrupted trade, then there will be peace for Europe too.

### 7. Increased Trade and reduced costs for businesses

Proponents of the move argue that it brings considerable economic trade through the wiping out of exchange rate fluctuations, but as well as this it helps to lower costs to industry because companies will not have to buy foreign exchange for use within the EU. For them, EU represents the

completion of the Single European Market. It is vital if Europe is to compete with the other large trading blocs of the Far East and North America.

## 8. Inflation

The European Central Bank (ECB) which sets interest rates for the whole EMU area will be committed to keeping inflation low; countries with traditionally high inflation will benefit from this. However, this point is debatable as countries outside the EMU have maintained low inflation.

## 9. The Political agenda.

There is also a political agenda to European bank (the European System of Central Banks -ESCB), the removal national control over policy. Individual nation states will lose sovereignty (i. e. the ability to control their own affairs). It will pave the road to move towards ONE economical union.

**Disadvantages (<http://www.economicshelp.org/europe/costs-euro.html>)**

**Cost of replacing currency's and adjusting machines.**

(This is however a one off cost)

## 2. Loss of autonomy over economic policy. Loss of Sovereignty.

By adopting a common interest rate for the EMU area, countries will lose a crucial part of their Monetary policy. Politically, an independent central bank is often argued to be undemocratic in this setting (A Cukierman, 1994).

Although countries are heading towards ONE economic union in Europe but they are definitely not, with regards to political terms.

### 3. Countries economy are at a different stage in the business cycle.

This will be a huge problem, for instance in 2005, Ireland and Spain were growing quite fast and need higher interest rates to control inflation than other countries who need lower interest rates. Therefore with low interest rate Ireland might experience inflation. On the other hand, in 2009, Ireland and Spain were experiencing a deeper recession than the rest of the EMU area. They needed lower interest rates and depreciation, while other countries did not require to.

### 4. The instability of the system

In 1992, UK benefited from leaving the ERM in order to have lower interest rates and come out of recession. This showed that countries economies may not have converged and a single policy could be harmful. As Greece is heavily in debt and had caused EU to be affected, so it seems wise for UK, Sweden & Denmark not to join at the moment

### 5. Government could not devalue the Euro to overcome balance of payments problems.

Countries will lose some independence over Fiscal Policy. This is because of the growth and stability pact.( e. g. no country is allowed to borrow more than 3% of its GDP. Which means that they will have to try and maintain the economy at a similar stage to other countries. E. G. Ireland had high growth and was criticised for increasing spending, (which increases AS), Asymmetric Shocks. If one country experienced an external shock it might need a different response. But this is not possible with a common currency. E. g. In

order to reduce inflation, German reunification required higher interest rates, but this was not in favor for many other EU countries.

6. Monetary Policy will have different effects in different countries.

For example the UK is sensitive to changes in the interest rate because many people have mortgages. And their terms & conditions differ from other countries.

7. The EURO has been quite unstable against the dollar

Whilst Sterling has been quite stable. Joining the EU could therefore increase instability against over currencies

8. The ECB is less transparent in their decision making

For example they do not produce monthly minutes, this makes interest rate changes less predictable and so countries may not be able to do their economy forecast.

## **FIVE ECONOMIC TESTS AS PRECONDITIONS**

**Set out by Chancellor of Exchequer in Oct 1997**

**Used to decide for UK on the membership of Economic and Monetary Union (EMU)**

To adopt Euro currency and interest rate set by European Central Bank (ECB)

**Build on 4 key areas**

Benefit: trade, transparency and stability

Constitutional issues: in nation interest, popular consent, clear and unambiguous

Clear and unambiguous: Treasury's comprehensive and rigorous assessment

Referendum: agreed by British people

## **Five Economic Tests**

Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?

If problems emerge is there sufficient flexibility to deal with them?

Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?

What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?

In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

## **UK Responses in 2003 assessment**

Significant progress on convergence, but the convergence test not met as there are still structural differences with the euro area, such as in the housing market. Therefore, UK are not confident of its business cycles being sufficient compatible with those of the euro area to allow the UK to live comfortably with euro area interest rates on a permanent basis.

Flexibility has shown improvement for UK, but is still not confident that it is sufficient. Greater measures are been set out to meet the EMU requirement.

UK agrees that joining EMU could potentially lower the cost for their companies which boost cross-border investment flows and foreign direct investment (FDI). On the other hand, it is also mentioned that if sustainable and durable convergence is achieved, only then can UK be confident that the investment test is met.

UK agreed that entry EMU can enhance on the competitiveness of the companies while offering some other benefit and the financial services test is met

Increase in jobs and lower cost of living can be achieved through increases in cross-border trade, investment, competition and productivity that EMU could provide. But again, it only sustainable and durable convergence has been achieved then can UK be confident to say that growth, stability and employment test is met.

Overall, UK mentioned that improvement has been seen but it is still not ready the membership of EMU despite the risks and costs in the delay.

According to Stathis Gould (2003) article,

The test seem like a deliberate fudge and political excuse for UK to delay joining the single currency

Loss of control such as interest rate to ECB

EU Membership impose constraint on fiscal policy

Joining euro could pose threat as UK's record of foreign capital recipient is among the best mainly due to relatively light regulation

Problem with the volatility of euro-dollar which is not tackled by ECB

Factor that might really affect the join will be to reform or better leadership in ECB which is criticized for lack of transparency

Another factor will be the increase in competitiveness and opening of labor, product and capital market

According to James Igoe Walsh (2007) study,

Britain's economic cycle not synchronized with euro-zone and bringing

Adopting single currency will harm foreign trade and investment

Close look into the five "excuses" for Britain's reluctance

Divergent business cycles

Convergence – concern of losing the ability they now have to tailor monetary policy

Not really the case – inflation rates have essentially disappeared, as the two economies adopted the same interest rates and monetary integration promote business cycle convergence through greater trade and investment

International trade and investment

British invested more with North America and former colonies in the past, but it is not true now as many firms are also heavily invested in European Union.

Joining the union benefits the large and growing number of firms and investors that trade with and invest in the rest of the Union.

### **Overall,**

UK does have the capability to be in the EMU and by being in the euro member, it can really boost the economy of both their nation and other members

Has been seen as delaying the membership deliberately

Pressure for corporate in UK might also be another factor that influences their decision

Furthermore, with recent issue of Greece, Portugal, and Spain which expose the flaws in Euro Single Currency, it will be even harder to convince UK entry

## **SUCCESSFULNESS OF EURO SINGLE CURRENCY**

### **Main Benefits**

Lower cost of managing cash and raising capital

Eliminate cost on converting currency from one country to another

Broader, deeper and more efficient financial market result in further reduction in cost and access to a bigger capital pool

Less currency risk

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Currency risk and the need to protect own business transactions are eliminated or reduced

Simplify investment planning

Bigger market

Companies will compete in a larger and more integrated market

Population adds up from the member countries to form bigger market

Consumers are more readily to buy across border in euro-zone with no worry of different currencies and exchange-rate

## **Over the years of Single Currency**

With information from Wim F. V Vanthoor (2000) study,

Has high potential in it growth

Created a market population bigger than US when group together

Generated high share of world GDP (Gross Domestic Product)

Created even higher world trade than that of US

Compatible monetary value comparing with US with the aim as to compete with US dollar

Aim not only Economically, but aims at going towards a political union

In Martin Feldstein (2010) article,

Crisis in Greece and the debt problems in Spain and Portugal exposed more flaws

Individual member countries lost control of monetary policy and interest rates in order to respond to national economic conditions

Exchange rate could not respond to the cumulative effects of differences in productivity and global demand trends.

Weakens the market signals of fiscal deficits – Eg. Greece

ECB set monetary policy to the euro-zone as a whole even when it is not relevant to some members

Despite all the problem, euro will likely still survive but the fundamental root problem might still remains

Introduction of euro imply low interest rate to Greece and some other countries which previously has high rate, resulting in temptation for government to borrow. This drives the ratio of government debt to GDP to more than 100% for Greece and Italy.

Until recently, bond markets treated all euro sovereign debts as virtually equal, not raising interest rates on high-debt countries until possibility of default became clear.

## **Euro comparing with other currency**

Against US Dollar

Euro shows it weaken and flaw especially with recent crisis

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As compared with US dollar which also operate on single currency with its fifty states, it lacks in 3 economic conditions

#### Labor mobility

Labor in US moves on to another area easily when one industry weakens in a certain part of the country

Whereas unemployed workers of euro member such as Greece, Portugal, and Spain do not move to faster-growing regions of Europe because of differences in language, history, religion, union membership, etc.

#### Wage flexibility

Substantially slower wage growth in the states that lost industries helped to attract and retain other industries

#### Central fiscal authority

fiscal system collects roughly two-thirds of all taxes at the national level, which can be transferred to the different states if it is falling short in income

### **Euro comparing with other currency**

#### Against UK Sterling Pound

Pound Sterling has become vastly more stable in the past decade and grown in stature as a reserve currency around the world

Ironically it has benefited from being outside the Euro

By not joining EMU, UK have retain their level of sovereignty and has better control and decision on solution to tackle their own economy

## Conclusion

It seems that UK, Sweden and Denmark is going to stay out of the Euro zone for a while as mentioned by Vinocur N. (March 2010)

Removing currency risk and driving integration with the European single market have been the main arguments that have put forward for the three nations to join the euro. But with Greece financial issues, with Ireland, Spain & Portugal following suit, it made Euro

Investec UK economist David Page mentioned that there is no chance that UK is joining the EU in the next 10 years". Conservative opposition front-runner David Cameron has declared that if he wins a general election expected in May, Britain will not join the euro as long as he is prime minister.

Even though In year 2008, Sweden released a poll. It showed support for joining the euro had increased rapidly, with 44% of Swedes now in favour of joining the currency, up from 34. 6% in May, while opposition dropped from 51. 7% to 48% during the same period. ([http://www. guardian. co. uk/business/2008/nov/27/euro-currencies-sweden-denmark](http://www.guardian.co.uk/business/2008/nov/27/euro-currencies-sweden-denmark))

in March 2010 as reported by Nicholas Vinocur on Reuters: Sweden's finance minister Anders Borg mentioned that. " How well it is going in one country decides how well run the whole is, whether or not one has adopted the euro".

Denmark is skeptical on joining the Euro. Danske Bank chief economist Steen Bocian, remains cautious for the next two years, due to Greece incident.