

Evaluation of the european union's single currency: euro



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Ensuring stable and long-lasting economic development for the whole of Europe was one of the main reasons for the European integration process in the 1950s. The economic structure of the European Union (EU) based on the principles of the single market – the free flow of goods, services, capital and labour, i. e. on the reduction of the barrier restricting free flow. The natural complement of these economic relations seemed to be the monetary union. Werner's report adopted in 1971 stated the theoretical principles for the creation of the single European currency, but the economic crisis and the collapse of the rigid exchange system have postponed these bold ideas for many years. The turning point was the Delors' Report published in April 1989. It sets the path to achieving full monetary union and replacing national currencies with one single European currency.

The monetary union has become a part of the Treaty on European Union. The Treaty, which was the essential part of the EU, was signed in Maastricht on 7 February 1992 and entered into force on 1 November 1993 (Maestre, 2017).

Eventually, the Euro in the virtual form was introduced in 1999, and three years later, the first coins and banknotes for public use entered (CurrencyFair, 2015).

The introduction of the single currency was the next stage of building the economic fundamentals of a united continent. Italian lira, French franc, Austrian schilling and Deutsche mark – the national currencies of the EU Member States – blocked the further progress of integration. In the intent, for example, trade between Germany and France should take place on a regular

and risk-free trade basis. In fact, it turned out that the operation was complicated by the currency risk.

A company exporting a product or service to France did not pay customs duties, as both countries are members of the EU, but they were constantly exposed to the risk of fluctuations of the German and French currency exchange changing rate. The sudden increase in the value of a Deutsche mark resulted, a decrease in the income of German exporters. The introduction of the euro in both countries eliminates this type of danger by removing barriers to trade.

Currently, Euro is used in 19 of the 28 members of the EU: Austria, Belgium, Finland, France, Greece, Spain, the Netherlands, Ireland, Luxembourg, Germany, Portugal, Italy, Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia, Lithuania. Despite this, the Euro is also used in countries that are not the EU members, but the introduction of the Euro was beneficial to their economy. That include Monaco, San Mario, the Vatican, Andorra, Montenegro and Kosovo. Two countries, such as Denmark and the United Kingdom, for agreement on the “ opt-out” treaty, although they are the EU members did not accept the Euro currency. Other Eu countries: Poland, Bulgaria, the Czech Republic, Romania, Sweden and Hungary will adopt the single currency when it is beneficial for their economy and development (European Commission, 2018). The introduction of the Euro to all countries at the same time would cause a crisis because countries with the less developed economy would collapse without being able to defend themselves.

The main advantages of the European currency are:

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No currency risk in trade within the Economic and Monetary Union - national currencies would be eliminated; thus, the economic exchange takes place in euro. Enterprises no longer bear the risk resulting, for example, from a sudden weakening of the franc rate against the lira. There is, a risk in the case of trade with countries outside the eurozone, who are members of the European Union and other countries - the rate of the euro to pound, dollar or yen can change precisely as the franc exchange rate against the lira.

No exchange costs of currency exchange - removing the national currencies also means the total absence of exchange costs for national currencies.

Which would be beneficial for example for companies, they do not need to pay extra money for the exchange transaction to banks.

A more efficient single market - a single currency combined with the single market would enable more businesses to operate on a broader European scale. They could achieve greater efficiency even through easier access to sales markets, increased production and scale effect. By increasing competition, improves the quality of economic management.

Transparency of prices and costs - the common currency would enable on the one hand consumers to compare prices more efficiently, and on the other, reduce costs through access to cheaper suppliers.

On one side, the single consumer would not go for tomatoes to another country. However, a supermarket chain can find cheaper wholesale suppliers easier and more efficiently. For such a recipient, ordering several hundred tons of vegetables from Portugal is a similar process as to order them from Italy or Spain. Retail could - at least in theory - reducing their costs by using <https://assignbuster.com/evaluation-of-the-european-unions-single-currency-euro/>

cheaper suppliers without reducing sales prices. In turn e. g., TV manufacturers already have a global network of suppliers, and the introduction of the euro should not substantially reduce operating costs.

On the other hand, consumers have easy access to online stores in another EU country, offering identical goods at lower prices. The same can be applied to the car industry - the difference in the price of an identical car between individual EU countries (Ec. europa. eu, 2011).

The euro will help reduce these differences to the benefit of the consumer.

The euro would allow an easier search for work in the whole area of the Economic and Monetary Union. The future employee would be able to easily compare the level of their future earnings and choose the country or region in which their skills are most valued.

The euro will increase the mobility of the workforce, which will facilitate finding a job and contribute to increasing employment.

The mobility of the workforce is however only one side of the equation; the other is the mobility of capital. As mentioned above, the introduction of the monetary union removes the exchange rate risk between currencies of various currency areas on which the new currency becomes a legal tender.

It naturally facilitates capital flows, making them cheaper (no commissions for currency exchange) and less risky (exchange rate risk).

Free capital flows across the European Union are the fundamentals of a genuinely integrated European financial system. The report prepared at the

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request of the European Commission identifies, in addition to the above, the following benefits:

Increased competition between stock exchanges – this means lower transaction fees and increase the pressure on technological progress. This will allow cheaper transactions for investors and easier access to capital for enterprises.

Increased competition between financial intermediaries – will reduce the margin on financial transactions, which will benefit primarily consumers, who will pay, for example, a lower handling fee when taking out a loan.

Lower costs are resulting from economies of scale – financial intermediaries can operate on a more extensive European market, which allow them to reduce costs.

Banks will face competition from the financial markets as capital providers for investments – this will allow lowering interest rates on loans.

Increased market depth – it will give businesses and individuals more comfortable access to credits.

With the current state of development of the banking and investment services sector and the speed of information flow, the effective capital allocation should be, theoretically, much easier than ever before.

Thanks to technology, the flow of capital is much easier than the flow of labour. Certainly, the European Union's capital markets are much more integrated than the labour markets.

Thanks to the free flow of capital, one of the essential of which is the euro, enterprises have easier access to capital, both through the issuance of shares on the stock exchange and bank loans. This, of course, has had a measurable impact on the rate of economic growth.

The introduction of the euro enables investors to make better investment decisions. They can more easily compare labour costs, loan interest rates or consumer preferences and create truly European companies (European Commission, 2018)

The Euro performance balance in the first decade:

As a result of political compromises between France and Germany, the eurozone was designed as a monetary union without a supporting unitary state (Shore, 2006)

This agreement was created between the several Member States, and it included sharing monetary sovereignty with the condition that they would not abuse the system through fiscal extravagance. The base of functions in the euro area is the European Central Bank (ECB), whose primary objective is to guarantee inflation below 2% per annum. Also, euro area banded financing the government debt, and the euro exchange rate in relation to the rest of the world remains fluid. From 2012 the purchase of government bonds shorter than three years was considered eligible, but the ECB was only oriented towards the inflation target, which led to deflationary tendencies (The Economist, 2015).

The European Central Bank has been deliberately designed to conduct a monetary policy similar to the Bundesbank (Central Bank of Germany), i. e. focusing solely on reducing inflation. Previously, EU Member States had significant differences in inflation rates and periodic devaluations thus financial institutions expected from these countries higher interest for the risk taken.

Countries such as Italy, Spain or Portugal paid significantly higher interest rates than Germany, Netherlands, Austria or France. This changed with joining the eurozone, as financial market entities began to believe that the Maastricht treaty, together with a common currency, initiated the era of low inflation, without devaluation and bankruptcy of governments.

The adoption of the euro helped eliminate the spread of the interest rates of 10-year government bonds for different countries in relation to the interest rates on German bonds. That was an excellent advantage for Greece and Italy. In the case of Italy, before joining the euro, the spread was around 600 basis points which are 6%, thus in relation to the public debt - 120%, the debt costs were 7.2% higher than the possible costs for Germany. After joining the eurozone, the spread of Italy in relation to Germany decreased to 20-30 basis points - 0.2-0.3%. This showed significant savings to Italy, which could have been used to reduce debt but were used to increase spending (Bagnai, 2016).

Due to the availability of financing public expenditure - which were previously given just to high credibility and trusted financial institutions for example in Germany - countries such as Greece has been tempted to spend

more than they should, e. g. social benefits including generous retirement for selected groups without actuarial contributions or extend free or heavily subsidized public services. (Bulow and Rogorr, 2015). As a result, public debt has become one of the main causes of economic stagnation in many euro area countries.

States with high public debt can be divided into three groups. The first is made up of Belgium and Italy, which already at the time of joining the euro area were characterised by a high level of public debt and it remains at a similar level. Concerning these countries can be said that they have learned to “ live with a high level of debt”. The second group are countries which, although before the crisis of 2008-2009, were characterized by a relatively low level of debt, but due to the collapse of prices on the real estate market, they took over the banks that were expecting to collapse and as a result, public debt grew rapidly (Ireland, Spain). The third group is made up of countries which, due to errors in economic policy, fell into a long-lasting economic slowdown resulting in high costs of servicing and increasing public debt (Portugal). A separate category, in this case, is Greece, which, despite given assistance, is still a country that is unable to reduce its debts. Greece has become a case in which the stability of the eurozone has been tested, not because of its economic importance (Greece’s GDP accounts is approx. 2% of the total income of euro area countries), but because of the symbolic importance of subsequent actions towards this country (successively: mismanagement and misreporting of economic performance, reduction of debt by private creditors, the prospect of a possible exit from the eurozone undermining the credibility of the euro zone’s sustainability). The Greek

crisis began in 2009 when earlier forecasts for the 2009 budget deficit said 3.7% of GDP, collided with the discovery of a real deficit of 15.4%. The liquidity crisis had become a crisis of profitability when public debt in November 2009 reached 126.8% of GDP.

Help from the EU came in 2012 in the form of redeeming part of the debt but was too late, because the French and German governments had not previously wanted to burden their banks, which were the main creditors of Greece. Greece plunged into a long-term crisis, and in 2014 its GDP was 23% lower than in 2008, with an unemployment rate of 26.5%. Although Greece has returned to a growth path, according to IMF forecasts, its public debt will be still 170% of GDP in 2020, and in 2060 would reach 270% of GDP (Donnan and Brunsden, 2017).

The liquidity crisis is becoming a solvency crisis due to the mechanism of panic: the appearance of doubts about the solvency of a country increases the interest rate on that country's debt and, as a result, increases the likelihood of insolvency. The debt liquidity crisis, which under normal circumstances would not pose a threat to bankruptcy (solvency), becomes a solvency crisis.

According to theoretical assumptions, common currency reduces barriers to capital flows from one country to another. This is a potentially beneficial, as it allows increasing the availability of investment funds in countries that offer higher rates of return and enables better adjustment of the savings/consumption ratio in subsequent periods. However, the coexistence in the same currency area of countries with high savings ratio and surplus in

current account balance with low savings and deficit in current account countries may contribute to the creation of speculative bubbles in some markets and countries' capital.

An example of this phenomenon was the construction boom in Spain, which lasted from 1999 to 2007. At that time, 268 billion euros (mainly from Germany) came to Spain (Cunat and Garicano, 2009). This resulted in an increase in property prices and a substantial increase in wages in the construction sector. When the real estate bubble burst, a banking and economic crisis emerged, resulting in painful adjustments in the wake of falling wages and rising unemployment.

From experience over 18 years of the functioning of the euro, it should also be stated that too much public and private debt in such countries as Greece or Spain was financed with foreign funds (even if they were funds from other euro area countries). What is more, a significant part of these loans was directed to low-productivity sectors (to the public sector or the services, including construction). Moreover, in these countries (mainly Greece), banks invested excessively in the securities for their governments, which created a strong negative interdependence in which the solvency of governments affects the profitability of banks, and the bankruptcy of banks may lead to an increase in the level of public debt.

Internal imbalances in the euro area have their source in the strength of the German economy - the surpluses generated by this country have a second (negative) side in the form of pressure on the weaker economies. The German economy surpluses would allow this country to conduct more

expansionary fiscal policy, but Germany's governments resist such suggestions, trying to maintain a rigorous course in fiscal policy.

Good economic results of Germany show that the current rules for the functioning of the euro area serve countries that prefer low inflation (low inflation, as well as deflation, are beneficial for lenders). In the case of Germany, economic strength is additionally supported by wage discipline (low growth in nominal wages, accompanied by quite strong productivity growth), budgetary rigidity and reluctance to increase spending – even if it could help other euro area economies – and a strong surplus of exports, which is the result of the technical sophistication of enterprises and the innovativeness of their products.

The economic performance of Germany is strongly contrasted with Italy's economic performance. At the heart of Germany's economic success is increasing productivity. Italy is characterised by its low growth. While between 1995 and 2011 the annual increase in labour productivity in the United States was 2.3%, in France 1.4% in Germany, 1.5%, in Italy only 0.4%. The Italian economy has proved unable to absorb and use new information and telecommunications technologies. It is characterised by a low level of human capital and small size of the average enterprise. As a result, Italy was closed in specialisation in international sectors with low growth dynamics, and low value added (Oecd. org, 2017).

The paradoxical nature of the political consequences of the euro project motifs is well illustrated by the following quotation from a work of Martin Wolf: “ The euro turned out to be a disaster. No other word fits better. The

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project aimed to strengthen solidarity, increase prosperity and weaken German economic domination in Europe, and brought exactly the opposite effects: it is undermined solidarity, destroyed wealth and strengthened German domination, at least for now (Wolf, 2014). Designers thought that by creating a monetary union, the nations of the eurozone would approach each other. The crisis, on the other hand, divided them into disdainful creditors and overpowering debtors (Wolf 2014).

After more than seventeen years of operation, you can see the benefits that the common currency brings, and the costs it creates. We also know that the benefits and costs can be intertwined in the time sequences. After the period of benefits resulting from reduced debt servicing costs, for some countries, the highest cost (as it seems in the case of Italy) has become the lack of currency devaluation. Obtaining this possibility would require, at least temporarily, exit the eurozone, but the implementation of this option would lead to a strong economic crisis (fear of depreciation of deposits would cause panic and withdrawal of deposits from the banks of countries whose citizens would suppose that it is likely to exit the eurozone). The solution of the eurozone would also lead to sharp legal disputes over the conversion of the currency in which the debt is to be denominated, and an increase in the cost of servicing debts incurred by domestic enterprises abroad would threaten them with bankruptcy.

After the reforms introduced so far, both in the mode of operation (less emphasis on price stability) and in the scope of the framework securing the stability of the financial system, the common currency seems to be better adapted to the conditions of diversified economies. Due to the ambiguity of <https://assignbuster.com/evaluation-of-the-european-unions-single-currency-euro/>

benefits from the functioning of the single currency, joining the euro remains a political choice primarily. The power of the euro was predicted by one of the initiators of the euro many years ago, former German chancellor Helmut Schmidt, saying: “ The strength of the euro is that no one can leave the eurozone without inflicting severe damage to its state and its economy” (Chancellor, 2009).

The eurozone has become a community of fear of the consequences of disintegration. A community of opportunities could be made if it was based on the sense of the identity of the European people connected by cultural, linguistic, religious and racial ties. These ties are at the heart of solidarity, which involves a willingness to share and share the costs of risk. The construction of a federal Europe requires just such a basis, without it, the euro will remain suboptimal and prone to sudden collapse.

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