

The Costs and Benefits of the Euro In European Monetary Union Countries

On January 1, 1999 the euro was put into circulation as a common currency for 11 of the 15 European Union countries, with Greece joining in 2001 (The Euro: Expect., pp. 121). Although the euro went into circulation in 1999, the ideas behind the euro have had been developing since late 1993. The ratification of the Maastricht treaty in November of 1993 signaled the creation of the European Monetary Union (Leblond, pp. 554). The job of the EMU was to ensure price stability, meaning an annual inflation rate of less than 2 percent for the entire euro area (The Euro, the European, pp. 158). The result of that job was the euro. The move to a common currency for all EMU members had both positive and negative consequences. Clearly the benefits outweighed the costs, or the EMU would not have adopted the euro.

The most important benefit associated with switching to a single currency was the elimination of the need to exchange currencies between EMU members (Eudey, pp. 14). By switching to the euro, members of the EMU were expected to save as much as \$30 billion a year (The Euro, the European, pp. 154). Savings were so large due to the reduction in transaction costs associated with the exchange of currency by firms that import or export to or from many countries (Eudey, pp. 14). Along with eliminating the need to exchange currencies, the problems with exchange rate volatility were also eliminated between member nations. That only left fluctuations between the euro, the dollar, the yen, and any other important national currencies from outside the European Monetary Union (The Euro, the European, pp 154). Exchange rate fluctuations were

another form of transaction cost, because they made trading between firms from different countries more risky. If a manufacturer in one country and an importer in another make a deal for the products of the manufacturer, the volatility of the exchange rate can pose a major problem in the trade. If one currency falls in value in relation to the other, then the manufacturer could end up getting far less for his product than he should have, or the importer could pay much more than was originally agreed upon (Eudey, pp. 14-15). The elimination of this risk will help international trade, therefore, giving advantages to all EMU countries.

Two other major benefits of switching to the euro deal with the prevention of competitive devaluations and speculation. A competitive devaluation is when one country devalues its currency in order to export more goods. In response, the trading partners of that country would do the same thing, resulting in a downward spiral regarding currency value, as well as an increase in inflation (Eudey, pp. 15). Since the goal of the EMU was to keep inflation rates low, the switch to a single currency made sense. In terms of speculation, a single currency for the group of nations would eliminate speculation between member nations. Speculation occurred regularly throughout Europe because whenever people thought that a currency was going to drop in value, they would sell all of their holdings in that type of currency. Others would follow and the trend was self matriculating. In order to control speculation European countries had to keep interest rates high. High interest rates hinder economies and that was the result in Europe for a large part of the early nineties (Eudey, pp. 15-16). By eliminating speculation, the economies of member countries would be allowed to grow much more easily than when unnaturally high interest rates were necessary to ward off speculation.

Cutting out speculation and the risk of competitive devaluation, as well as the need to convert from one currency to another, are all benefits that the European Monetary Union counted on when switching to a single currency. The problem is that there were costs that come along with the benefits. The biggest cost of switching to a common currency was that each member nation relinquished its right to change monetary and economic policies in order to respond to economic problems at home (The Euro: Expect., pp. 123). Along the same lines, exchange rates between countries were no longer adjusted by the individual countries to help regional economic slumps get moving (Eudey, pp. 16). On the surface these appear to be major costs, but when looked at closely the idea of giving up individual monetary policy is not a big step for most of the European Monetary Union countries. Since the creation of the EMU most member nations have already removed all trade barriers, making it easy to buy and sell goods across national borders. It has also made it very easy to lend and borrow, which means that EMU countries are already tied together in a semi-unitary monetary policy (Eudey, pp.17).

The main problem that opponents of a one currency EMU focus on is that one country can be in a recession, and have no choice but to wait it out. That country would have to wait it out because changing the monetary policy of the whole EMU would hurt more countries than it would help (The Euro, the European, pp. 157). The theory, however, is that by creating a single currency economy throughout Europe, the economies will be tied together, and the business cycles will slowly come together. If the business cycles of all the countries were in sync, then there would be no fear of one

country being in a recession, while the others were economically stable (The Euro: Expec., pp. 123).

There are other ways of dealing with economic problems in individual countries. Even though a country gives up its right to change monetary policy, it still retains the right to change its fiscal policies. This means that EMU countries will still be able to change how much they tax the people (Eudey, pp. 20). If only one EMU country is having economic problems, then the other countries can raise taxes in order to increase the purchasing power from those countries. The extra money can then be used to help bail out the country that is having problems. There has also been talk of the European Union budget increasing, so they would also be able to help countries in the union that undergo economic problems in the future.

The other downside to the adoption of the euro as a common currency was that labor-market reforms had to be made in order to avoid downward wage stickiness (Eudey, pp. 21). The reason that reforms were needed was because changes in wage rates were the second of two ways that individual countries are still able to change fiscal policy. Ordinarily, wages are not prone to move downward. Stipulations were needed for people to make the possibility of wage cuts available to the governments. In the case, of the EMU the stipulation was that the EMU governments had few other ways to control the economy. If workers were not willing to take a wage cut, then many could end up out of the job, because the economy would go bad if the government did not have control of the economy. There is no clear outline for the labor-market reforms, but one of the main ideas was to increase the ease of worker integration (Eudey, pp. 17-21). Worker integration means that firms need to make it easier for workers from other countries to

work outside of their home country. The inability of workers to move from one country to another is mostly based on language barriers, so that was the first issue that needed to be looked at.

Although there were problems that arose from the creation of the common currency, it was clear that the European Union took those problems into account even before they instituted the euro. The measures taken by the EMU to prevent the problems that could be brought on by the euro showed that they were prepared to stick with the euro. This type of action led other countries from around Europe to apply for entrance into the EMU. One of the countries at the forefront of this movement is Croatia, which is projected to join in 2007 (Vujcic, pp. 160). The idea that more countries were willing to join the system shows that there was not too much fear of the downsides. If countries from outside the EMU are not shying away from joining, that meant that there was probably not much uncertainty on the inside either.

The positives and negatives of the common currency of the EMU are clear. The European Monetary Union stuck to the plan of implementing the euro in 1999, and that showed that they obviously thought that the positives outweighed the negatives. Not only did the members of the EMU elect to put the euro into circulation, there are other countries, including Croatia, that are trying to join the EMU. All of these factors showed that there was a positive attitude about the euro. A positive attitude about any currency is one of the most important factors to its success. Any time that people have lost confidence in a currency, either a major recession ensued, the currency succumbed to extreme inflation, or in some cases hyperinflation. Confidence in the euro bodes well for its success in the future.

References

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