

## **European Monetary Union – The pros and cons**

## **Why was monetary union required?**

In order to create a single market and move towards economic union a single currency was required

For Federalists it is a step on the road to a United States of Europe

It involved replacing all national currencies of the participating country with a single currency – the Euro

The Euro has become the sole operational currency of the Euro area – often referred to as the Eurozone

There are now 16 states in the Eurozone and every country that has joined the EU since 1993 are obliged to become members of the zone

UK and Denmark secured opt outs from joining

Apart from the creation of the Euro there are a number of elements to EMU:

## **1. Independent central bank – The European Central Bank - ECB**

Like any central bank this has a number of well established functions:

Monitoring and regulation of interest rates in the economy by varying the money supply to the commercial banks

Monitoring and manipulating the money supply aggregates – unlike the Fed and BOE the ECB pays attention to the money supply in the Euro area

Managing exchange rates – the Euro floats against other major currencies and the ECB is responsible for external dealings with the Euro

Lender of last resort for the European banking system – quantitative easing

Criticised as over secretive - minutes of meetings are not published

Inflation target asymmetrical

## 2. Growth and Stability Pact

In order to obtain low debt ratios and low inflation the pact limited governments budget deficits to 3% of GDP

The thinking behind this was that some country's with a history of fiscal mismanagement might try to thwart the policies of the ECB

For example:

- ❖ Assume the ECB increases the ROI as inflation in the € area is rising
- ❖ The effect of this will be to reduce aggregate demand in the area – deflation
- ❖ Without the pact a country could frustrate this policy by increasing government expenditure to increase aggregate demand

Originally breaking the pact was supposed to trigger fines of up to 0.5% of GDP

But Germany the instigator of the pact broke the barrier along with France, Portugal, Spain

Some countries have found this too restricting and while the Pact remains in force several types of government expenditure have been excluded which allows governments to increase aggregate demand

The pact was suspended during the global turndown in 2008 but the EC is taking a tough line with Greece that has a deficit of at least 12% of GDP

## **The potential benefits of a single currency:**

### **Reduced transaction costs**

Transactions costs refer to the cost of changing from one currency to another

A single currency will eliminate the cost of foreign exchange transactions for firms

The European Commission suggests that elimination of transaction costs could boost the GDP of the countries concerned by an average of 0.4%.

### **Reduced exchange rate uncertainty**

Exchange rate uncertainty is reduced between members which could increase trade between EU countries - intra-EMU trade

May also ↑ FDI as exchange rate uncertainty can be an important deterrent to investment by firms trading over international borders

Single currency will also remove the possibility of devaluation, which countries have used in the past and has increased inflationary pressure

### **Increased intra-EMU competition**

Price transparency due to a single currency will make price comparison across countries easier so consumers can buy in the cheapest markets

May force higher cost firms to reduce their prices

The success of this is also dependent on action by the EU competition commissioner

### **Increased inward direct investment**

FDI is likely to be encouraged by a move to a single currency, since it will result in an increased potential market size

If a country remains outside, investment may be reduced as there is no knowing what will happen to the relationship between their exchange rate and the Euro rate

Changes in the rate would change the profitability of plants situated in their country

## **Lower interest rates**

The benefit of a single monetary policy run by an independent central bank is that government failure will be removed from interest rate decisions

Eurozone will be able to make a credible commitment to low inflation and put in place the necessary policies to keep it low

The benefits of lower ROI should be a more rapidly expanding economy

## **The potential costs of a Single currency:**

### **Loss of an independent monetary policy**

Adapting to a single currency entails the countries concerned passing control of monetary policy to the European Central Bank

ECB would set interest rates and other aspects of policy to achieve objectives for the single currency area as a whole rather than for any one country within the EMU

This has several implications:

## **Loss of power to choose a different short term inflation/unemployment trade off**

In the long run there is no trade off between inflation and unemployment

In the short run governments can choose an interest rate which reduces inflation slowly, giving time for the unemployed to find jobs i.e. trading off on the short run Phillips curve

Countries that join the single currency will lose the ability to make different choices between inflation and unemployment in the short run

## **Inability to react to country specific economic shocks**

An economic shock - ↓ in demand for the product of a major industry due to cheaper competition is likely to lead to high levels of unemployment in order to reduce costs and prices

European labour markets are not flexible and labour mobility is low unlike in the US

With a floating exchange rate the country would be able to adjust monetary policy so that the value of its currency fell and it remained competitive

ECB unlikely to react unless all countries within the single currency area are affected similarly

Country hit by such a shock will ↑ government expenditure and break the stability pact as a PSBR limited to 3% of GDP may be too constricting to allow countries to respond to such shocks

## **'Real' misalignment**

Possible that the economic structures and degree of development of some of the countries in Europe are not sufficiently close to be able to maintain a single currency between them

Result might be unacceptable levels of unemployment or real income decline in some countries

## **Asymmetric policy sensitivity**

ROI adopted by ECB might have different effects in different countries

In UK, a relatively high proportion of borrowing for mortgages is at floating rates but in Germany is at fixed rates

UK will be more sensitive than Germany, to a ROI change and could be far more affected by the central bank tightening monetary policy

## **Too deflationary**

ECB has adopted a target inflation rate of 2% or lower, which may be too deflationary and lead to higher levels of unemployment

Contrast with BOE which is +/- 1%

If BOE expects inflation to be below 2% it reduces the ROI

The ECB is much slower to reduce rates than increase them

This monetary policy + growth and stability pact may lead to slow rates of economic growth

Experience so far suggests that the ECB is slower to react to falling growth rates than the BOE or the Federal Reserve

## **Economic convergence**

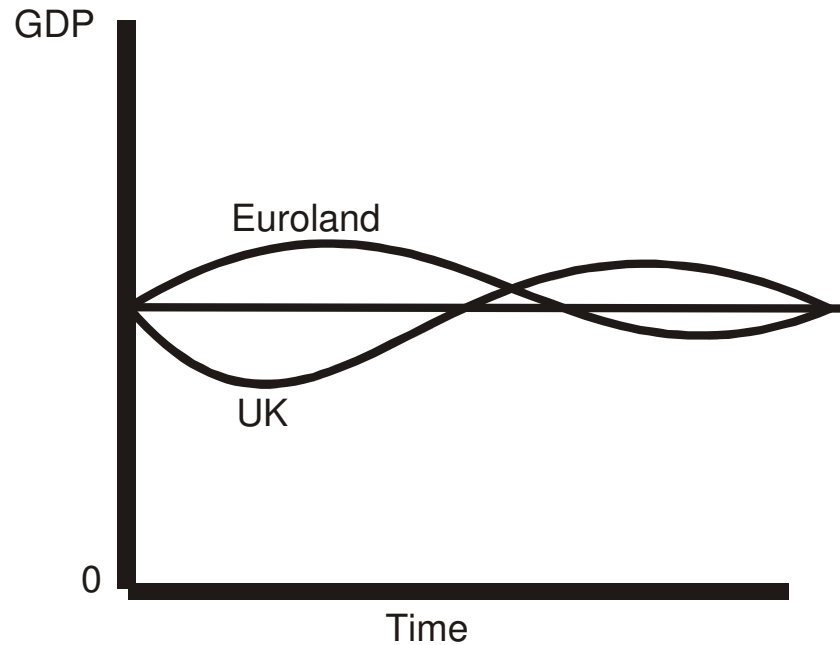
This situation will occur if the country's economic cycle is aligned with Europe's

May not occur for the UK?

May be due to the structure of the economy e.g. Britain has more non EU trade, more home loans made at variable interest rates than its partners, and is the only oil exporter

These factors make it hard for Britain's economic cycle to match Europe's, and hard for its interest rates to be the same - one size will not fit all!

## Economic convergence



Straight line shows desired economic convergence

The trade cycles are shown as horizontally opposed

UK in recession while Euroland in boom - different monetary policies are appropriate

## **UK's position**

The UK government has said that Britain should join EMU if the single currency is successful and the economic case for joining is clear and unambiguous

A Treasury paper, sets out five specific economic tests that Britain would have to pass before joining EMU:

the degree of alignment of British and continental business cycles;

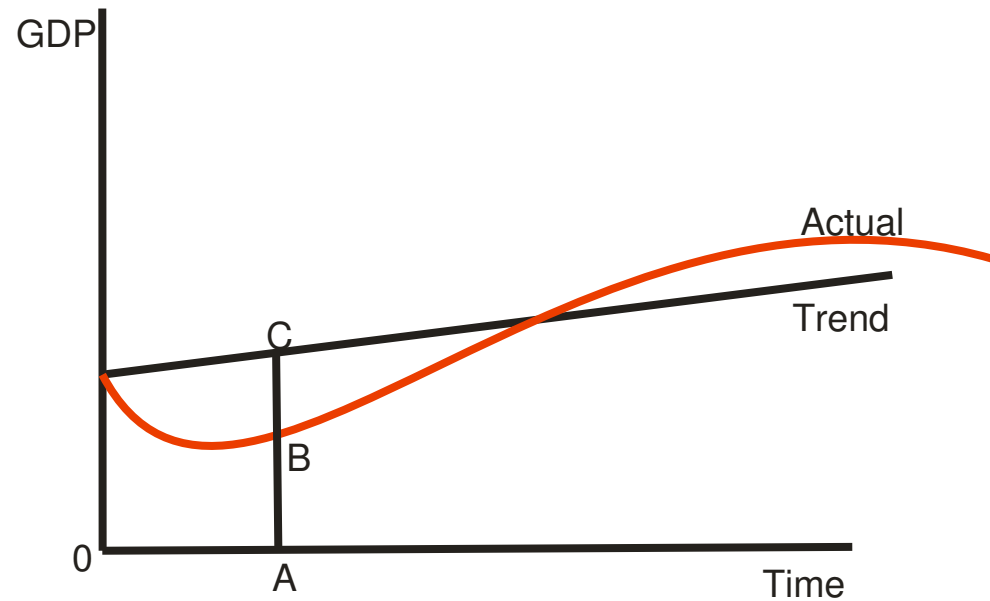
the flexibility of European markets to cope with economic shocks;

the effect of monetary union on investment in Britain;

its effect on the financial-services industry;

its implications for British employment and growth

## An economy in recession



Apart from the present unusual times a single economy in recession has limited options

Assume at A the economy is in recession with a negative output gap of CB

Possible policy initiatives:

Reduce ROI

Impossible as ECB controls ROI

Depreciate the currency to increase exports and reduce imports

Impossible as ECB controls the Euro

Expansionary fiscal policy - running a budget deficit

Restrained by the parameters of the Growth and stability pact

Without access to such policies the only remedy is to deflate the economy – reducing costs down to a level where the countries goods are competitive

This is likely to entail rising levels of unemployment and cuts in real income