

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

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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)

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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)

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History of the EMU

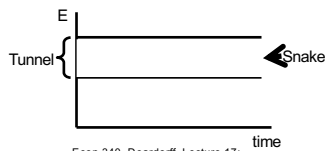
- Before 1973:
 - All these currencies were pegged to the US dollar
- After 1973:
 - The Bretton-Woods system collapsed and major currencies stopped pegging to US\$
 - By default, currencies began to float
 - Europe, because of its large internal trade, found exchange rate movements especially troublesome

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History of the EMU

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

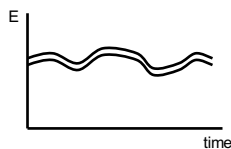


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History of the EMU

- After 1973:
 - Europe tried several arrangements to get greater stability
 - Narrow peg to each other with no peg to \$: "Floating snake"



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History of the EMU

- 1979
 - European Monetary System (EMS) established
 - Features:
 - An Exchange Rate Mechanism (ERM) of exchange rates pegged to each other within $\pm 2.25\%$ 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
 - There were 11 currency realignments during 1979-87

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History of the EMU

- 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

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History of the EMU

- 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 $\pm 15\%$
 - 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

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Need for Convergence

- Difficulties of adopting common currency
 - These suggest that success with a common currency requires countries to have similar
 - Inflation rates
 - Interest rates
 - Budget deficits
 - Government debts
 - Achieving this was called “convergence” and was required in the Maastricht Treaty before a country could adopt the euro

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Need for Convergence

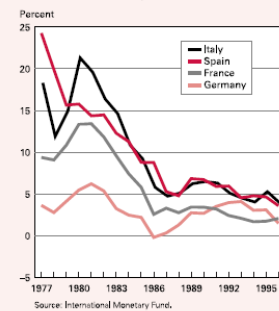
- Maastricht Convergence Criteria
 1. National currency in ERM for 2 years
 2. Budget deficit < 3% of GDP
 3. Government debt < 60% of GDP
 4. Inflation < 1.5% above average of lowest 3
 5. Long-term interest rates < 2% above average of lowest 3
- How well were they doing?
 - Following graphs from 1998 article

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Figure 1

CPI Inflation Rates

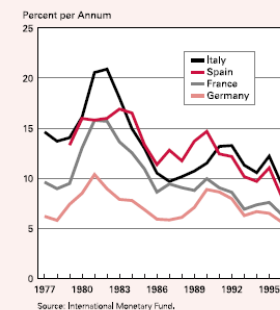


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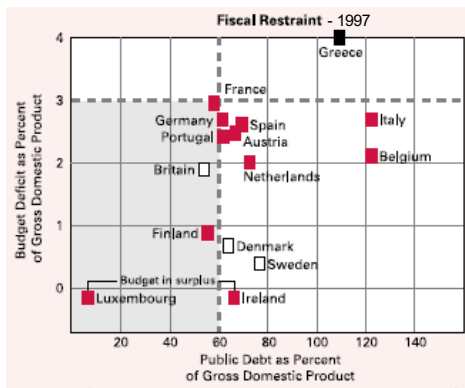
Figure 2

Government Bond Yields



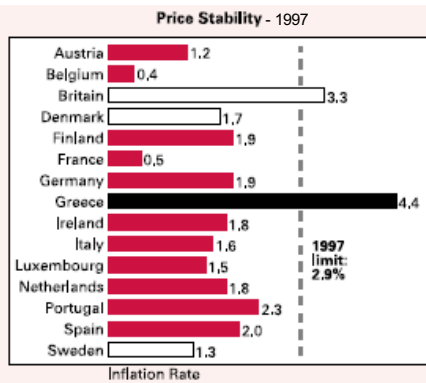
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Maintaining Convergence

- 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!

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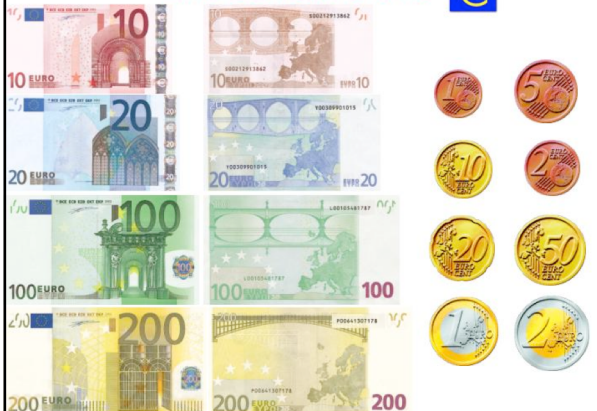
Timetable

- 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

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Euro Coins and Bills €



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

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Members

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

Belgium
Austria
France
Finland
Luxembourg
Italy
Netherlands
Germany
Portugal
Ireland
Greece
Spain

BAFFLING PIGS

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Members

- And 3 did not

Denmark
United Kingdom
Sweden

DUKS

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Members

- Since 2002, the Eurozone has become:

**BAFFLING PIGS +
SCLELMS?**

Slovakia (2009)
Malta (2008)
Lithuania (2015)
Estonia (2011)
Latvia (2014)
Cyprus (2008)
Slovenia (2007)

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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

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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

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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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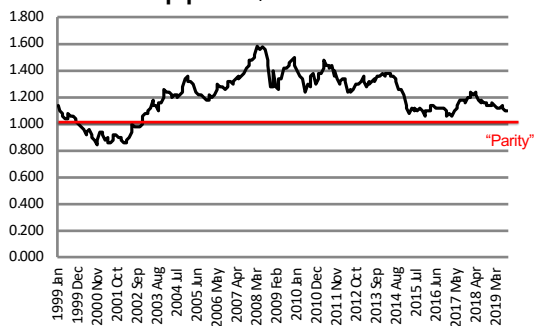
What Happened?

- Euro started (Jan 1, 1999) at 1.18 \$/€
- Now (Nov 6, 2019) it is 1.11 \$/€
- So euro has simply fallen, right?
- Hardly! It's not that simple.

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What Happened since 1999?



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What Happened over the Last Year?

US \$ per €



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What Happened over the Last Month?



From X-Rates.com

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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 stayed until early 2017.
- Some thought it would go below “parity” of \$1.00, but instead it rose to over \$1.20 and is now back down to \$1.11

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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 about \$1.05 two years ago – was 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
- Why did it rise, then fall, over the last two years? Some would say because of Trump

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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 PIGS (Portugal, Ireland, Greece, & Spain)
 - » Or PIIGS, including Italy

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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 benefitted as sellers
 - US was hurt as consumers and as tourists

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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, little sign that this is happening

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The Eurozone Crisis

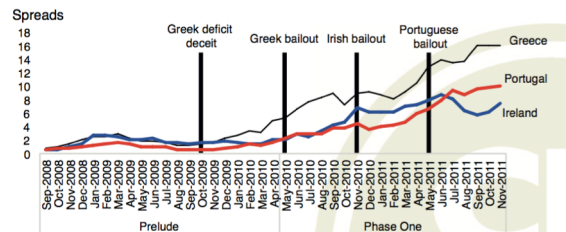
- The crisis consisted of (see Baldwin et al.)
 - News of Greek debt, and concerns about Greece's ability to manage it
 - Increased interest rates in Greece and other Eurozone countries, threatening debt problems there as well
 - Bailouts by EU, ECB, and IMF (the "Troika")
 - Concern that the Eurozone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

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The Eurozone Crisis: Timing

Figure 7 Prelude and Phase One of the Crisis: Contagion in the periphery

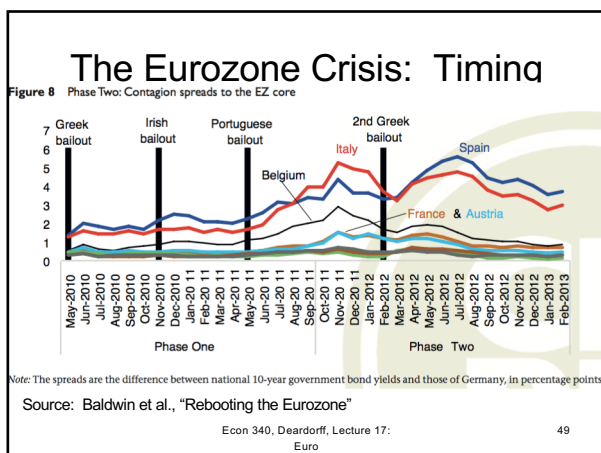


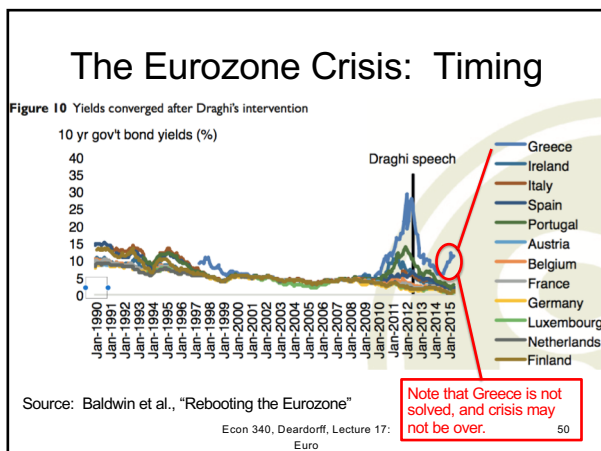
Note: The spreads are the difference between national 10-year government bond yields and those of Germany, in percentage points.

Source: Baldwin et al., "Rebooting the Eurozone"

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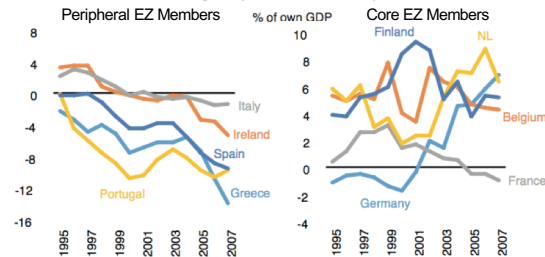
What Happened?

- 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.

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The Eurozone Crisis: Timing

Figure 2 Peripheral EZ members generally ran current account deficits while core members generally ran current account surpluses



Source: Baldwin et al., "Rebooting the Eurozone"

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What Happened?

- The problem of Greece (started in 2010)
 - Greek government deficits had 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

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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

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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 called “Private-sector involvement” (PSI)
 - » Favored by stronger EU countries (e.g., Germany)

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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.
 - Greece is still struggling, now under another new government, and fears of crisis in the Eurozone have lessened but not disappeared

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What Happened?

- The Euro Zone today, per the Smaghi reading
 - Crises are caused by
 - “Doom loop” where banks hold government debt, and doubts about the latter cause bank runs
 - “Perverse loop” (Smaghi’s term) where fear of exit from the euro causes capital outflow that makes exit more likely
 - Smaghi recommends a formal procedure for exiting the euro, and that it be combined with exiting the EU
 - That, he says, would discourage those who want to exit the euro

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Next Time (after exam)

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

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