Money and Exchange Rates

The European Union (EU) was created to foster greater trade and interdependence between the countries of Europe and has continually tried to break down barriers to trade between the member states. However, barriers to trade are many and varied. They include tariffs and subsidies, but they also include rules and regulations, transportation costs and currency transaction costs. The European Union, like its previous incarnations, has strived since its formation to break down these barriers. The Single European Act was an important stage in the process – harmonizing regulations across the union, and paving the way for a single currency, which was introduced on January 1, 1999. On that date eleven of the fifteen countries in the EU entered into Economic and Monetary Union (EMU) and adopted a single currency, the euro, to replace their national currencies: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. Greece joined the single currency in January 2001. The euro notes and coins were introduced and national currencies were withdrawn from circulation in January 2002. Slovenia joined in January 2007; Malta and Cyprus in January 2008.

Why a Single Currency?

A single currency facilitates trade by boosting transparency, stability and competition. But a single currency can only work in specific economic and political environments. This brief will make the case for a single currency, and discuss why it is a natural step between countries that want to increase trade when those countries are at a similar stage of development and are closely linked politically. This text will also highlight the risks of entering into a currency union. Lastly, it will examine the reasons and rationale for the United Kingdom's decision to opt-out from membership of the Euro Area.

A single currency means more than just sharing the same notes and coins as other countries and people. It means locking in an exchange rate with other countries in the currency union at the time of joining. The value of a currency changes over time, as exchange rates between different currencies are notoriously volatile. If the UK and US decided to form a currency union, would you lock in a £1 for $1.40 or $2.00, or somewhere in between? For firms, this decision could affect nominal profitability by 50%, while for consumers it will affect the price of imports. It also means adopting a common rate of exchange with countries outside of the European Union – so the dollar now trades against the Euro, rather than against the previous twelve European currencies. This is particularly important for member countries that trade intensively with non-Euro Area members. And a single currency means pooling sovereignty over the national

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interest rate, with the decision now taken in the interest of the union as a whole rather than at the nation state level.

Adopting the euro involves a loss of independence over monetary policy-making. Yet there are reasons to think that it will lead to better economic policy, stronger growth, trade and investment. The notion of subsidiarity indicates that decisions should be taken at the most appropriate level. Sovereignty is only good or useful if it gives us powers that we want or need. If North Carolina had its own currency and the power to set its own rate of exchange with the other 49 states of the U.S., it would increase the state's sovereignty. But the government of North Carolina would not want it, because its economy is too small and because it is too dependent on both imports from and exports to the rest of the United States. The decision to pool sovereignty was made by the twelve founding members of the single European currency for similar reasons. And yet it is a step that the countries opting out have decided is not currently in their interest.

There are three key arguments in favor of a single currency between interdependent countries. A single currency can reduce *transaction costs,* it can increase *stability*, and it can improve *economic policy.* These arguments will each be discussed in turn before turning to some of the problems associated with a single currency.

Benefits of a Single Currency

Transaction Costs

Having a single currency means having a single and transparent set of prices across countries, which means that consumers and businesses can shop around for the best deal. Consumers choose between different cars from different dealers. Correspondingly, a wholesaler can choose whether to commission goods from a variety of manufacturers. Firms and households are looking for value for money as well as quality in what they buy. A single market in the European Union should mean increased choice, as direct trade barriers such as tariffs and subsidies are broken down and as indirect barriers disappear with the harmonization of rules, standards and regulations. However, with separate currencies there are transaction costs associated with shopping around for the best deal.

It is easy to shop around for a good deal if you can see clearly how prices differ, but if goods and services are priced in different currencies it is not always obvious to consumers what the best deal is. There is a cost in processing all this information, which has to be weighed up against time constraints and the estimated cost saving that might be gained. There is also a cost of changing currencies (the difference between the buy and sell prices for foreign currencies represents the profit made by currency dealers, and can cancel out a cheaper foreign price).

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A single currency enables consumers to observe directly the difference in price between a wide range of goods and services. It therefore cuts transaction costs by making price differences more transparent, so reducing the cost of processing information. It also cuts transaction costs as consumers and firms do not have to change money.

Stability

Businesses and households need to plan for the future. Decisions need to be made about investment, which depend on expectations about the future. Although never certain, a single currency can provide increased stability. The main trading partner of every European country is the rest of the Union. Locking in exchange rates means that one source of uncertainty, namely the value of the currency against the other members of the Euro Area, is made certain. For small, open economies, for example Belgium, Austria and Portugal, this is particularly important. It is also extremely important for manufacturing firms that tend to be very export-orientated and who often use suppliers in a range of countries. Additionally, as the service industries become more outward looking, and while new IT enables greater trade in services, this stability will increasingly benefit them too. Although large firms are able to hedge risks, so that they minimize losses from currency fluctuations, these transactions are costly and are greatly reduced with the replacement of twelve currencies with just one. Moreover, small firms stand to gain markedly from a single currency as they tend to hedge less.

As an example of the gains from stability of a single currency, think of a car manufacturer, who has many suppliers. If a German car manufacturer buys exhaust pipes from an Italian firm, and has a contract to do this for five years at a price quoted in Italian lira, then fluctuations in the Deutschemark-lira exchange rate will affect the "real" price paid by the German manufacturer. A fixed exchange rate cuts out this instability and uncertainty. This will increase investment by reducing uncertainty and will increase trade by taking some of the risk out of cross-border deals. An increase in investment will make firms and nation states more competitive, and increased trade will enable countries to better specialize according to comparative advantage, increasing the welfare of all countries.

Economic Policy

The new member states of the European Union are keen to join the Euro Area as soon as possible. The reason for their enthusiasm despite the sovereignty that they will forfeit reflects the greater credibility of the euro compared to their own currencies. The European Central Bank (ECB), which set the base interest rate for the Euro Area, is regarded as a tough inflation-fighter and a professional institution with the expertise to effectively manage monetary policy. Inflation and the expectations of future inflation in the Euro Area are low and contained. This was not the case for many of the individual members of the Euro Area before they started to pursue the tough policies required to join EMU. Forfeiting control of the nation's exchange rate and interest rate to the ECB can bring better monetary and exchange rate policy to member states; it can also increase

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confidence of better policy. Many European countries have suffered in the past from high inflation and volatile exchange and interest rates. Membership of the single currency ties the country to a tough, inflation fighting central bank.

Membership of the single currency has implications beyond monetary policy and affects the conduct of fiscal policy as well. The Stability and Growth Pact (SGP), which member states have to sign up to, sets limits on government borrowing and debt. Such limits would have been necessary under any circumstances. As well as high inflation and volatile interest and exchange rates many European countries had high government borrowing and potentially unsustainable debt levels when they agreed to form the euro. In this sense, the single currency brings together a range of efforts to develop sound macro-economic policies, thus increasing the credibility of policy making of the member states themselves.

Even if the Euro Area is a better institution for policy making, it is worth noting that a country need not necessarily change policy at all to receive benefits from membership of the single currency area. Perception and a sound framework for good economic policy bring dividends as well as good policies themselves.

Problems

The benefits of a single currency in Europe are real. A single currency is a natural step in the process of removing the barriers to trade in Europe, and a single currency provides a stable environment for investment and trade between closely linked economies.

"One Size Fits All" Interest Rate

Yet in many Euro Area countries – notably, Germany and Italy, growth has been slow and unsteady since the introduction of the euro. On the other hand, some countries have been booming – notably Ireland. Differential growth rates are of course inevitable; no one would expect every state in the US to grow at the same rate every year. But it is possible that the "one size fits all" interest rate for the Euro Area economies, combined with a fixed rate of exchange between the member states and a set of accepted fiscal rules, can limit the scope of policy efforts to deal with economic circumstances.

Even so it is unlikely that interest rates would be lower in Germany than they are currently in the euro area as a whole – or that they would have been even when Germany's inflation was low and growth was anemic. Similarly, there is little chance that the Deutschemark would have depreciated against other currencies in Europe or that fiscal policy would have been relaxed further. These policy options are not available within a single currency regime; but that does not mean they would have been terribly useful outside of the regime either. Hence while it is true that membership in this single currency has restricted the options available to policymakers, it is less clear that this lack of flexibility can hurt when member states' economic needs diverge.

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Structural Reforms and New Institutions

In any event, the euro is still a new currency, and the institutional arrangements governing the Euro Area are still developing. Some of the problems experienced will be ironed out; others need more structural solutions. For example, the ECB, as a new institution, has been concerned with building up a reputation for toughness in tackling inflation, much as the Bundesbank did in the post-war period. The original ECB target of inflation of less than 2% and money growth of 4.5% has evolved. There is now more emphasis on inflation rather than money growth, and the reference for inflation has been set at between 0 and 2% with the view that the ECB is essentially targeting a rate of just under 2%. This has helped firms and households better understand the Bank's reaction function, and has enabled the ECB to pursue a slightly more expansionary policy than originally feared. At the same time the SGP has been relaxed to reflect the particular circumstances of some member states, and countries have been able to run looser fiscal policies than originally envisaged.

The stories of the "big" European countries are reported more than that of the smaller member states. In reality, although below historical growth rates, the Euro Area has grown at a reasonable rate since 1999, and inflation has been low and stable. The debt levels of member states have fallen, and government borrowing has been lower than historical averages. Moreover, the euro should not be used as an excuse for some of the problems experienced by particular members. Germany is still struggling in the post re-unification era, and many countries need to address barriers to work that have kept unemployment stubbornly high and growth lower than its potential. The policies to address such problems are not lower interest rates. Rather, these countries need microeconomic reforms that will require a national and European dialogue about what sort of Europe, welfare state and labor market citizens want. Although the failure to find solutions to these problems lies to some extent at the door of the European Union, it is not straightforwardly a problem with the euro.

The UK's Opt-out

The UK position is that membership is desirable in principle but that the UK should not enter the euro until the economic circumstances are right. There are five tests used to assess whether membership is in the UK's interest:

- Is there sufficient convergence between the UK and the Euro Area economies so that a single interest rate would be suitable on a permanent basis?
- Is there sufficient flexibility in the system to allow countries to respond to shocks?
- Would membership better enable firms to make long-term decisions regarding investment?
- What impact would membership have on the UK's financial services industry?
- In summary, will membership promote higher growth, stability and a lasting increase in jobs?

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The current assessment is that these tests have not been met. If and when they are judged to be satisfied, the final decision on membership will be made by referendum. That said, it is likely that the EU's newest members in the East of Europe will be part of EMU before the UK. The current UK prime minister, Gordon Brown, showed little enthusiasm for the single currency during his decade as Chancellor of the Exchequer and he shows even less now. Meanwhile, UK entry into the eurozone has become the third rail in British politics – much like social security reform in the United States. Even pro-European politicians are unwilling to touch upon the issue for fear of igniting a firestorm of anti-European sentiment that could engulf the wide range of other UK projects with the European Union as well.

Summary

The creation of a single currency in Europe was a natural step for the free trade area that has developed in Europe since the birth of the union fifty years ago. After a tricky start, when the euro lost value against the US Dollar for three years, the euro has since appreciated sharply as the credibility of the framework has grown. The member states met strict criteria on inflation, interest rates, exchange rates, government debt and borrowing before they were admitted into the Euro Area, and EMU has provided a solid foundation for economic policy making in Europe. Yet there are considerable differences between the member states, and a single interest rate for the twelve member countries has created problems, especially as fiscal activism is constrained as well. Despite these problems the euro is here to stay. The Euro Area institutions are evolving as they are tested by economic and political realities. The UK will likely be out of the Euro Area for the foreseeable future, but the new members of the EU are keen to join up to the single currency – reflecting the credibility of the Euro Area and its institutions.

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