THE EURO ADDOPTION PROCESS – MACROECONOMIC EFFECTS FOR MEMBER STATES

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Keywords Euro, EU, macroeconomic effects

Abstract: In January 2004 eleven members of the European Union (EU) took a new step toward the creation of a single European market. They launched the European Monetary Union and implemented a new cross-border currency, the euro.This event was unprecedented in monetary history. This article deals with the macro-economic effects of euro implementation. First, it considers the trade-creating and trade-destroying effects within the new currency area as well as for non-EMU countries. It then examines the internal economic implications for countries both within and outside of the new euro-currency zone

Trade-Creating Effects

Perhaps the strongest *economic* argument touted for implementing the single currency is the reduction (or elimination) of currency-conversion transaction costs as traders move from one euroland country to another with goods and services for sale. Americans have long enjoyed the advantage of a single currency with its attendant lower transaction costs as residents trade across state borders. Clearly, as transaction costs fall, trade expands and wealth is created. For non-euroland members of the EU, this benefit can be captured to the extent that their nationals (firms, banks, and individuals) decide to carry out their transactions in euros, rather than in their national currencies. Many non-euroland companies have already moved to adopt the euro for their international, or at least their European, operations.

For European investors, the single currency provides another huge advantage as eleven separate national stock markets suddenly switch to trading and valuing in euros rather than in their respective national currencies. This means reduced (or eliminated) currency risk for cross-border investment transactions, which in turn reduces transaction costs and further expands possibilities for trade and wealth creation. Again, non-euroland investors can reap the same benefits to the extent that they are willing to hold euros and transact business in that currency.

Other significant economic benefits of the single currency include lowered information costs as European consumers find themselves able to compare directly prices for goods across borders. The business advantages of euro implementation include the ability of manufacturers to identify readily the most competitive suppliers of needed inputs. And the key feature of euro usage is the creation of an integrated European market with 290 million customers. This market will be larger than the United States, with its 270 million consumers.

Central European countries such as Poland, Hungary, and the Czech Republic appear to be jumping on the euro bandwagon with unexpected zeal. Since twothirds of their international trade takes place with euroland, billing theirEUcustomers in euros will mean substantial savings from currency hedging. Moreover, euro pricing makes the cost advantages of Central European companies more obvious to EU customers. The

political advantages to euro usage are also significant for these economies as they contemplate their own entry into the EU some years ahead. Even Finland, now anEUmember, finds the political effect of the euro compelling as that nation strives to complete its independence from Russia and its Soviet past

Trade-Destroying Effects

Several factors, however, may have trade-destroying effects as a result of the implementation of the single European currency. Some of these concerns may recede after the three-year transition period during which national currencies continue to circulate in parallel with the euro. Such transitional costs include the need for sellers to post dual prices for the three-year period; the need to carry larger cash balances (in both euros and national currency); and the one-time costs of converting some 3.2 million vending machines to the euro. In addition, trade diversion effects may be anticipated as the euro takes hold in Europe. Euro-zone consumers, benefiting from lower goods prices, may purchase fewer goods from outside the currency area. The impact may be especially felt in the financial services sector. For example, the introduction of the euro may spell the end (or decline) of the LIBOR (London Interbank Offered Rate), as euroland banks attempt to replace it with the EURIBOR, what these banks are touting as "a measure for Europe." Such an action may reduce the importance of London as an international financial centre. American commercial banks such as Citicorp and Chase Manhattan and US investment bankers such as Merrill Lynch, Goldman Sachs, Salomon Smith Barney, and Morgan Stanley, have already begun beefing up their Continental European presence with the launch of the euro. These banks are anticipating a doubling or a tripling of the size of European equity markets over the next decade.

This bulking-up of American banks in Europe suggests stronger competition for both continental and London banks. This increased competition also arrives just as European banks contemplate the loss of up to 70% of their foreign exchange transaction fees due to the emergence of the euro.

Uncertainties of Euro Implementation

Aside from trade issues, however, several operational issues affecting national economies and domestic welfare remain to be resolved. Take the matter of the new European Central Bank. How wide is its mandate? Its declared function is to promote price stability. Will it also perform as lender of last resort when the need arises? How will cross-border bank supervision be carried out and which institution will do it? There is also the less compelling question of who will speak for the euro at meetings of the G7 nations?

But more important is, how will euroland authorities deal with financial crises and business cycle downturns? How will individual countries handle countryspecific cyclical downturns when they can no longer resort to monetary expansions or currency devaluation as policy weapons? For instance, what can a single Euroland member country do if it finds itself slipping into recession at the same time that the other ten euroland countries are enjoying an expansionary phase of the business cycle? The country in recession cannot rely on monetary policy or defensive devaluation to solve its problem as these sovereign powers have been surrendered in the cause of Economic and Monetary Union.8 The situation can be especially acute over the next three years, when countries are expected to support their currencies vis-a-vis the euro. Any sign of

weakness will lead to a speculative attack on that currency, perhaps even an exit from the EMU.

Even expansionary fiscal policy is largely precluded as a remedy since EMU member countries have signed onto the Stability and Growth Pact in 1996. This pact imposes severe fines onEMUcountries, which have budget deficits in excess of3% of their GDP. Even without the constraint imposed by the Stability and Growth Pact, attempts to reverse a cyclical downturn by an increase in deficit spending would result in a sharp rise in interest rates as the government borrows to finance the increase in spending. The absence of discretionary monetary policy for the country suffering the downturn means that the government budget constraint imposes substantial restrictions on fiscal policy "solutions." Of course some national policies such as subsidies and public procurement that favour domestic firmsmay continue. But European Union officials are trying to curtail such actions. Besides, there is very little labour mobility within Europe to serve as an economic escape valve. Due to continued linguistic and cultural differences most European workers prefer to remain in their own countries.

The United Kingdom and other nations outside of the euro zone retain the independence of a national monetary policy and of control over their exchange rate. If Britain were to experience a recession, the government has the full panoply of policy tools at its disposal to offset the cyclical downturn. This presumed policy independence is a large part of the explanation for Britain's current desire to remain outside theEMUbloc. But is there a downside to this independence from the Euro? The answer is that a non-euro country can retain its policy independence, but if it chooses monetary policy options substantially at variance with EMU growth rates, the exchange rate will be forced to move to accommodate the difference. For example, suppose Britain finds itself in a recession while the euroland is in the boom phase of the cycle. The Bank of England has the ability to accelerate the rate of growth of the domestic money supply in order to attempt to pull the economy out of the doldrums. However, assuming the resultant growth rate of the money supply in Britain is faster than that chosen for the euro by the ECB, sterling will fall relative to the euro. The freedom to select a national monetary policy implies a trade-off in setting an exchange rate. This outcome may be desired, but it needs to be acknowledged nevertheless.

Also implied by the above analysis is the fact that "policy independence" may be illusory to the extent that UK authorities want to maintain a more-or-less fixed exchange rate vis-a-vis the euro. Britain will have to adjust the growth rate of sterling to match the growth rate of the euro. Otherwise the sterling-euro exchange rate will start to move. Given the larger size of the euro currency zone, the pound will likely be the tail of the dog. The Danes and the Swedes are likely to find this effect even more substantial given their smaller relative sizes and greater dependence on euroland trade than Britain.

Possible economic isolation may also play a role. Should the United Kingdom stay out of the EMU, its attractiveness as an investment destination may be harmed. Britain's success in gaining foreign direct investment has been due, in part to its flexible, productive and reasonably-priced labour force and the available packages of regional aid. Pacific Rim and US firms have sought a UK base from which to tackle the lucrative European markets. Should the United Kingdom not join the EMU, such firmsmay choose to avoid Britain in favour of a continental Euro member. The recent decision by Toyota to favour France over the United Kingdom for a new investment project is a case in point. This outcome suggests the likelihood of an enlarged euro zone

in the future, as non-euro EU members eventually seek to join the club. The price of national monetary sovereignty may be too high, especially if initial implementation of the euro goes smoothly over the next three years.

Will the EMU have an inflationary Bias?

Perhaps the most important concern of macro policy observers is the possibility that relatively left-leaning governments within euroland will push the ECB into the acceleration of monetary growth in order to lower the double-digit unemployment rate of the euro eleven. There are already signs that pressures are building on the ECBto lower interest rates and "target" the exchange rate so as to reduce euroland's 11.1% unemployment rate. As stated earlier, the ECB was established with a stated primary objective of maintaining price stability, but the governments behind the ECB may have a very different set of priorities. This sets up the interesting possibility that euro growth exceeds the growth of sterling, leading to a weakening of the euro vs. the pound. This may foce Britain into an unwanted acceleration of its own monetary growth rate to prevent further strengthening of the pound and negative effects on British exports to euroland. But inflating the pound to keep up with the euro raises the spectre of disequilibrium against the dollar and/or the yen.

Only time will tell if such fears are justified. The introduction of the euro provides opportunities for increased economic growth and welfare. But it raises challenges as well, especially for nations outside of the currency bloc.

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