

ADVANTAGES AND DISADVANTAGES OF THE EUROPEAN MONETARY UNION

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ABSTRACT

The aim of this paper is to review the European Monetary Union's history and development and to describe its advantages and disadvantages. I chose this topic because the EMU is one of the highest levels of integration forms and still unique in history. The member states adopted a single currency, the Euro, a single monetary policy, and coordinated their macroeconomic policies. Due to this high integration, the Euro may yet become a rival for the U.S. dollar. The size of the EMU's geographical area is vast and still expanding. As it spreads, the Euro becomes a more and more relevant currency for international trade, causing a big change in the world's economy. Aside from projecting the Euro's spread, I analyze the special convergence criteria that must be observed by its member states, demonstrating why these criteria are inadequate and why they are so difficult to observe for some countries. It is important to understand the issues facing the Euro and the countries that use or are considering using it as more and more economists discuss the advantages and disadvantages of the European Monetary Union. Many arguments exist for the EMU and many exist against it. Since Hungary, my home country is an EU member state and we intend to join the EMU--although the accession date was postponed several times because our economic indicators did not meet the criteria of the EMU--it is important for us to be knowledgeable about the current situation.

Keywords: European Monetary Union, currency, monetary policy

INTRODUCTION

The European Monetary Union is an agreement among the participating member states of the European Union to adopt single currency, single monetary policy and coordinated macroeconomic policies. The single means that the participating countries can not pursue monetary policy at the national level. The European Central Bank is responsible for the monetary policy of the participating countries. This institute is responsible for the monitoring of the money supply and for setting a key interest rate instead of the national central bank. The member states have to follow similar macroeconomic policies therefore the EMU can function well.

Earlier there were attempts to create similar union in the history (e.g. Roman Empire). As follows I made a review from the main period of the EMU establishment.

History of the EMU

Bretton Woods

The Bretton Woods system controlled merchant and financial relations among the world's major industrial states.

44 nations participated at the United Nations Monetary and Financial Conference. These countries wanted to rebuild the international economic system.

The participant countries signed the Bretton Woods Agreement in July 1944 and established the International Bank for Reconstruction and Development (IBRD) (one of the World Bank Group institutions) and the International Monetary Fund (IMF). These Institutions regulated the international monetary system.

These organizations became operative in 1946. In the Bretton Woods system each country has to adopt a monetary policy that means the currencies of the countries were fixed to the gold. The currency band could fluctuate plus or minus one percent. The system collapsed in 1971, when the United States decided to abolish the fixed link between the dollar and the official price of gold, which ensured global monetary stability after World War Two. This put an end to the system of fixed exchange rates.

EMS & ERM

Some west European countries established their own exchange rate mechanism (between 1972 and 1977), this was called “snake”, because the graph of the exchange rate fluctuation looked like a snake. These countries decided to prevent exchange fluctuations of more than 2.25% between the European currencies by means of concerted intervention on currency markets.

This led to the creation of the European Monetary system (became operative in 1979), which employed an exchange rate mechanism (ERM). Function of the ERM was to obligate participating countries to hold exchange rates fluctuation of their currency within an acceptable band. Exchange rate of each currency had to link to the reference currency, which called (ECU) and this was a heart of the EMS.

The ECU was a “basket” made up of the currencies of the member states. The ECU calculated from an average of the participating countries’ national currencies.

The system was adjustable because the band of the currency fluctuation was plus, minus 2.25% for the participating countries, but Italian lira was an exception, because the fluctuation margin of lira was 6%. The UK was not part of the ERM, but its currency was part of the ECU. The Central bank of the participating countries had to intervene, if the currency wanted to move outside the acceptable band. The central banks can keep the currency in band by buying or selling it.

Creation of the EMU

The EMR was successful, mainly between 1983 and 1987 because the participating countries become more stable. As the result of exchange rate co-operations, the German currency (the Deutschmark) became “anchor currency”, because it had been such a strong currency, that the ERM countries took German monetary policies. More EC central banks followed the decision of the German central bank.

Germany and France collaborated in economic and monetary integration, before the EC meeting. Leaders of these countries initiated the creation of the European Monetary Union (EMU). The establishing of the EMU helped for example the single European Act (SEA), which facilitated the completion of the single market, furthermore the council agreed to the liberalization of capital markets. In 1988 the Hanover Council meeting was held, where Jacques Delors the president of the European Commission proposed a three-stage plan to Economic and Monetary Union. The committee was made up of central bank presidents, EC commissioners and a few experts. Delors' report was a basis for the creation of EMU.

The Treaty of Rome discussed the creation of the EMU (in Dec. 1990) and the procedure was closed by the Treaty of Maastricht (in Dec. 1991), which included the Delors report and the convergence criteria.

The first stage, which began on 1 July 1990, included free movement of capital within the member states, coordination of economic policies furthermore cooperation between the central banks.

The second stage, which began on 1 Jan. 1994, included convergence of the economic and monetary policies of the member states, and the establishing of the European Monetary Institute (EMI) in Frankfurt. The EMI was made up of the governors of the central banks of EU countries. The third stage, which began on 1 Jan. 1999, included creation of the European Central Bank (the ECB took over the EMI), and a fixed exchange rate and the introduction of Euro. Eleven countries adopted the Euro on 1 Jan. 1999. (Austria, Belgium, Finland, France, Germany Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain).

Later Greece joined, on 1 Jan. 2001. The Euro circulated together with the national currencies for some months then became legal tender. (McCormick, 2002)

DISCUSSION

Optimal Currency Area theory

On the basis of the Mundell-theory, a country's accession to the Euro area can be successful if they have flexible labor and capital flow, they have coordinated economic cycles, and they mostly export to the Euro-area.

In the EMU's case, of the OCA criteria, the free capital flow is most successfully met. Labor flow, however, is not really flexible in the EU because of language barriers, Asymmetric shock effect is becoming more and more visible in the EU countries (*Király*, 2007). The absence of a fiscal policy that supports the EMU's monetary policy and the absence of a coordinated tax policy result in further difficulties.

The theory of the OCA is criticized by several experts because the criteria can only be met after joining the EMU. Emphasis is on the convergence in the monetary integration (*Wiener*, 2003).

Convergence criteria

According to the Maastricht Treaty, every country in the Euro zone (with the exception of Denmark and Great Britain) have to make convergence report which

is a forecast from the conformation of the convergence criteria, beyond that it is include also other economic indicators like unemployment rate, pay, productivity.

The aim of the convergence process is to converge the economic indicators of different countries. There are two types of convergences: nominal (e.g. inflation, interest rate) and real convergence (e.g. GDP).

The convergence criteria are as follows:

- *Price stability*: The inflation rate should not be more than 1.5% points higher than the average of the three best performing member states, prior to the EMU accession.
- *Government finances*: The annual government deficit must be below 3% of GDP and the government debt may not exceed 60% of the GDP, two years prior to the accession.
- *Exchange rate stability*: The member states have to hold exchange rate fluctuation within an acceptable band (+- 2.25%) for two years before joining the EMU. The exchange rate convergence is not the subject of this study since there are only a few countries in the ERM 2, which does not provide enough data to work with.
- *Long-term interest rate*: the nominal long-term interest rate must not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability in the year prior to the accession. (*Európai Központi Bank, 2010; Kende and Szűcs, 2005*)

Compliance of the convergence criteria in the European Monetary Union and in the candidate countries between 2004 and 2010

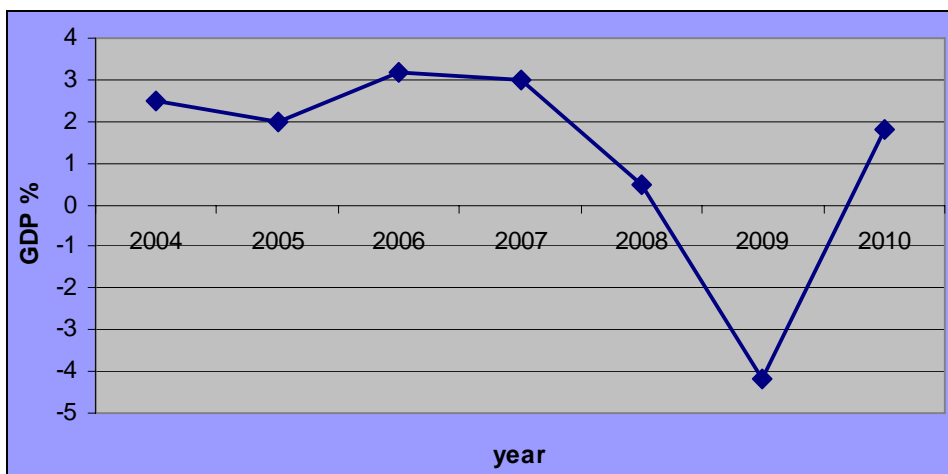
The effects of the 2007 crisis can clearly be seen in the changing of the convergence criteria. The era preceding the crisis was characterized by a stable economic environment. Contrary to this, an exceptionally large financial imbalance was created, partly due to the irresponsible government finances, which created an even deeper economical imbalance among the countries of the world. The global imbalance was a good starting ground for all of this. (The USA showed a considerable balance of payment deficit while the South-East Asian and oil-exporting countries realized sufficient) As an effect of the crisis the EU countries had a significant decrease in the GDP. (*Figure 1: EU27 -4.2%*). The global economic recession result in decaying finances position, increasing interest rate, which also reflect in the increasing countries risk. (*Antal, 2010*)

In the followings I am analyzing how the candidates (with the exception of Denmark and Great Britain) and the countries of Euro area (EU 16) could comply with the convergence criteria between 2004 and 2010 and to what extent the crisis affected the convergence criteria.

On the other hand I did not analyze Denmark and Greet Britain, because they do not make a convergence report, furthermore the economic indicators are better than in the candidates countries, therefore they would be revise the averages of the candidate countries, which would be worsen the result of this study.

Figure 1

Tendency of GDP percentages in Euro Area (27) between 2004 and 2010



Source: Based on *Eurostat*, 2011

Price stability

As a result of the negative global shock and economic recession in 2009 and 2010, the inflation was exceptionally low in the EU zone.

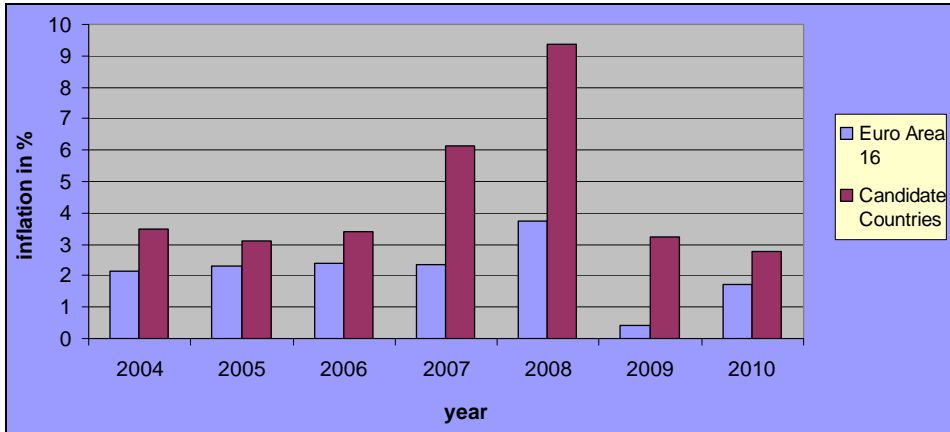
Therefore, the reference value of the price-stability criteria was 1.13%, in 2009 and 1.63% in 2010 (own calculation by data of *Eurostat*, 2011) In Ireland, the negative inflation rate was very high in both years, (-1.7% and -1.6%). In order to avoid distortion, I did not include it in the calculations to determine the reference value.

This way the three best performing countries in 2010 were Latvia (-1.2%), Slovakia (0.7%) and The Netherlands (0.9%). It can clearly be seen from the graph (*Figure 2*) that there was a considerable increase in the price of the oil and food in 2008. The inflation increased relevantly in the candidate countries. It was 15.3% in Latvia in 2008 and it was more than 10% in several countries (*Eurostat*, 2011). Then, with the significant decrease in the price of raw materials in 2009, several EU states realized a negative inflation.

Only three of the candidates and six of the sixteen Euro-area countries complied with the requirements in 2010. Greece had the highest inflation with 4.7% in the Euro-zone and Romania had an inflation of 6.2%, outside it. It can be seen that the highest inflation differences between the Euro-area and the candidate countries became acute during the recession (*Figure 3*). At that time the flow of foreign capital decreased, the loaning conditions became stricter, foreign demand also decreased, the price of raw materials at the world market increased. These factors together further increased inflation. In 2009 the emission, the export and food prices decreased, resulting in a drastic decrease of the inflation. (According to *Eurostat*, 2011 data in the Euro zone: 1.7%, in candidate countries: 2.7%).

Figure 2

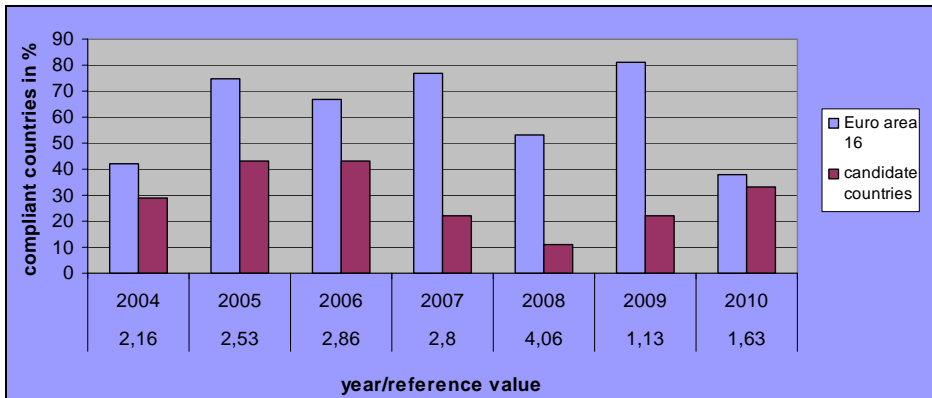
Tendency of the inflation rate in the Euro area and in the candidate countries between 2004 and 2010



Source: Based on *Eurostat*, 2011

Figure 3

Compliance of the price stability criteria by the reference value between 2004 and 2010



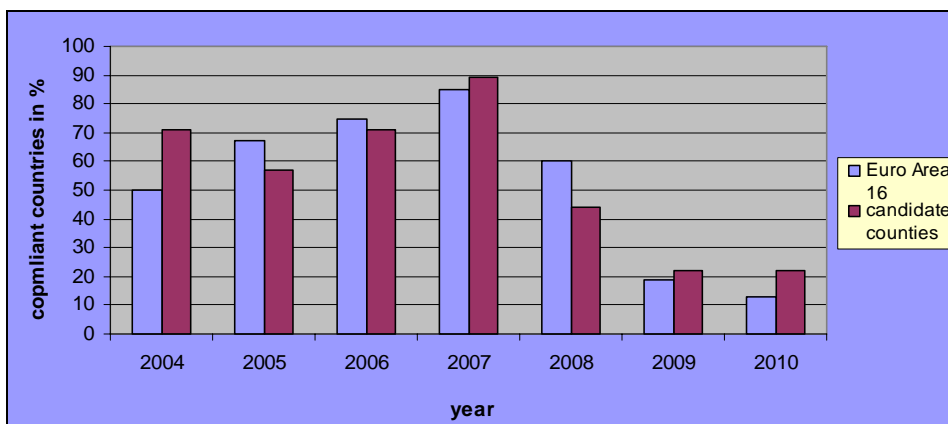
Source: Based on *Eurostat*, 2011

Finances position

The economic crisis definitely worsened the finances in most of the countries in 2009. There was a survey in nine of the EMU candidates and only two countries, Sweden and Estonia stayed under the reference value in 2009. Of the EMU states, only three of the sixteen complied with the criteria (Luxemburg, Finland and Germany). Even Germany could not comply in 2010. (*Figure 4*)

Figure 4

Compliance of the annual government deficit in the Euro area



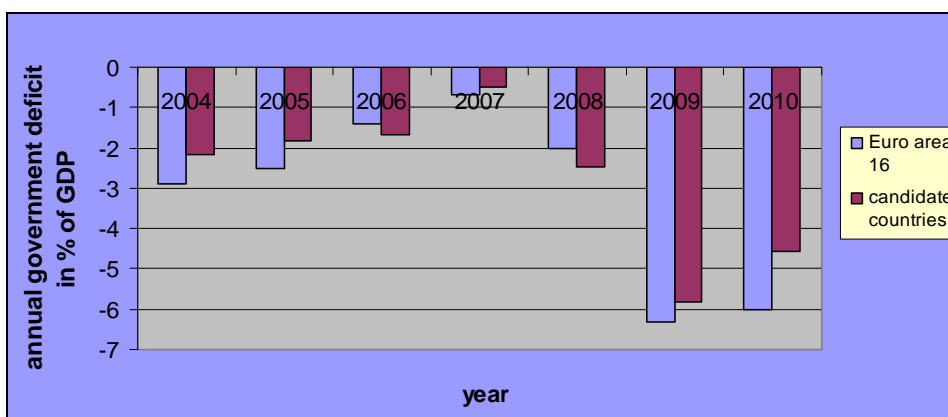
Source: Based on Eurostat, 2011

As it is shown in the chart, on average, the EMU states realized a bigger government deficit than the non-Euro area states (Figure 5).

Some countries resulted in an unsustainably high debt, because of the capital flow to the less developed countries, endangering the monetary union itself. The EMU states' divergence can be seen in the position of state finances. The average is mostly ruined by the high government deficit of Ireland (-32.4%), Greece (-10.5), Spain (-9.2) and Portugal (-9.1%) (Eurostat, 2011). Presumably the reason for this is that the risk premiums in the euro area were significantly lower than in the non-euro zone, because of the single currency. All of these resulted in growing debt and external imbalance.

Figure 5

Tendency of government deficit in the EMU and in the candidate countries

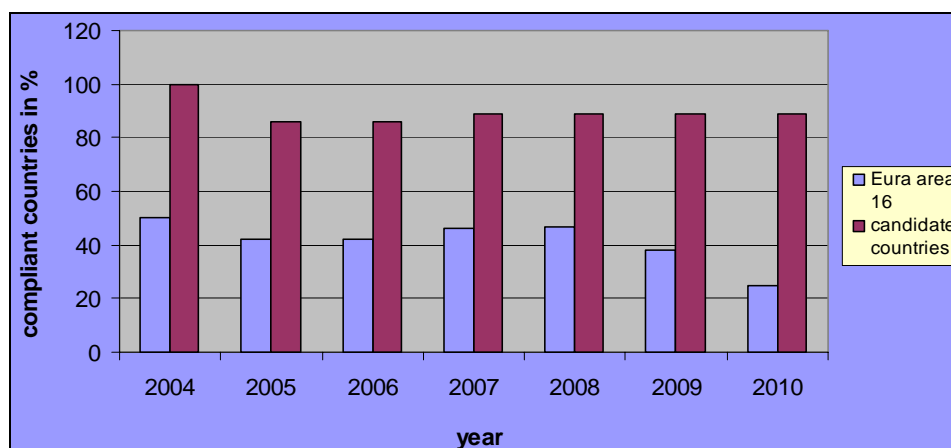


Source: Based on Eurostat, 2011

As regard government debt, only Hungary of the candidates showed a higher percentage (78.4% in 2009) than the reference value (*Figure 6*). Although the other countries were under the threshold, its volume increased. During the study period the candidates performed better than the Euro-zone countries.

Figure 6

Compliance of the government debt in the Euro area and in the candidate countries between 2004 and 2010



Source: Based on *Eurostat*, 2011

Greece of the Euro-zone is struggling with a considerable government debt, showing 127.1% in 2009, which figure increased to 142.8% in 2010. The extent of the state debt in Italy was 119%, in Belgium it was 96.8%, and in Ireland it was 96.2%, which considerably worsens the Euro-zone's average. (*Eurostat*, 2011) (*Figure 7*).

Long-term interest rate

The long-term interest rates significantly increased in the candidate countries in 2009. Because of the decaying economy indicators, the risk premium increased, which can also be seen in the increase of interest rates. The interest rates did not drastically increase in the Euro-area (*Figure 8*).

The convergence criterion was met by almost each of the countries, except Greece, where the long-term interest rate was 9.09% in 2010. Of the candidates, only the Czech and Swedish average long-term interest rates were lower than the reference value in 2009 (*Figure 9*). Lithuania showed the highest interest rate with 12.36%.

It can be concluded that in the EMU the interest rates did not significantly increase, contrary to the decaying finances position, showing market trust in the stability of the area.

Advantages and disadvantages of the European Monetary Union

Exchange rate risks, conversion and transactional costs disappear in the Euro-area countries, which triggers a higher-rate of real GDP increase in the countries which

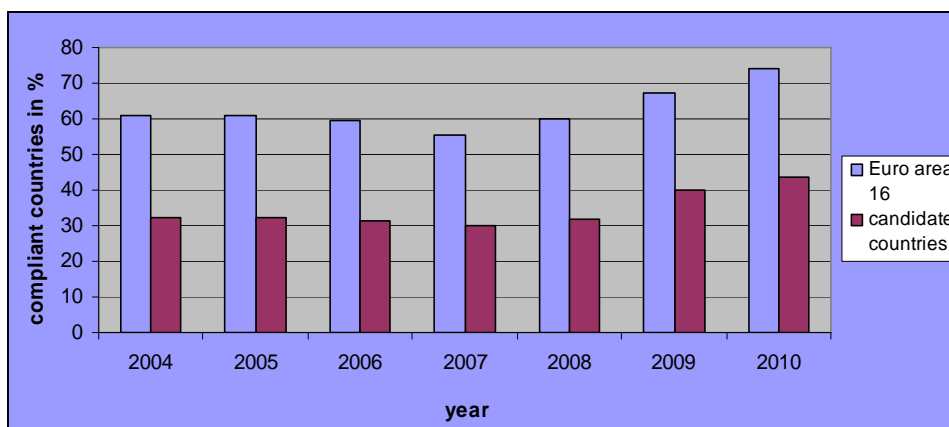
mostly export to the Euro-area. (For example 75-80% of Hungary's export goes to the EU.) The risk assessment of the given country improves with the EMU accession, since as a member state there is a low risk of government bankruptcy, in the opinion of the market performers. Funds become cheaper, stimulating investments. It is also favorable for budget financing. Inflation is decreasing in the long run because of the monetary politics based on common price stability, and the interest rates are becoming lower. All of these create a more favorable economic environment for the investors, which may result in the flow of functioning capital. Due to the single currency prices become easy to compare, which increase the competition. The Euro is a stable currency that provides protection against possible speculations. The Euro is the symbol of collective sovereignty practice and integration. (Taksán et al., 2010)

Of course the EMU have some disadvantages as well. One of the most well-known disadvantages is the loss of national sovereignty, because of the single monetary policy and controlled fiscal policy. The member states can not follow their own monetary policies, they can not devalue their national currency to encourage export, and finances position.

The European Central Bank is responsible for the single monetary policy, which is applied to every member states. Some countries have other economic accomplishment, therefore those economic policies which are prefer for this countries are not adequate for the others. The single monetary policy is not adequate for every country, because each country has a different economic cycle and the economic shocks come in different periods. With the EMU accession, the monetary and fiscal instruments of member states are considerably narrow, therefore the handling of shock is more difficult. (Losonczi, 2005; Taksán, 2010)

Figure 7

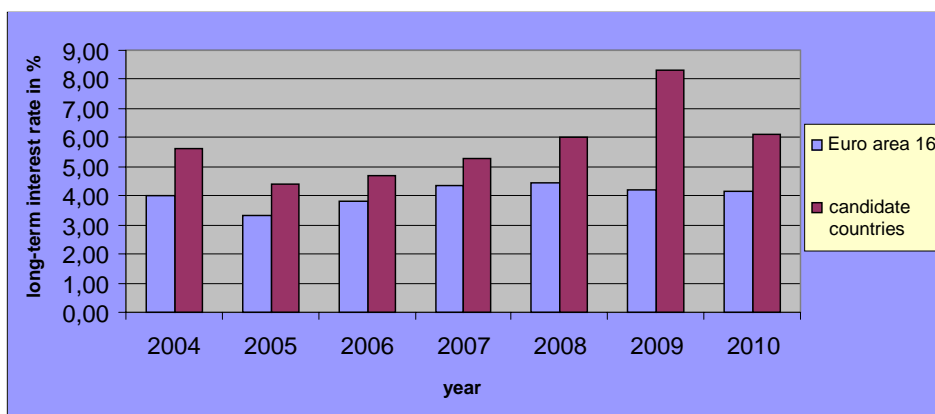
Tendency of the government debt in the Euro area and in the candidate countries between 2004 and 2010



Source: Based on Eurostat, 2011

Figure 8

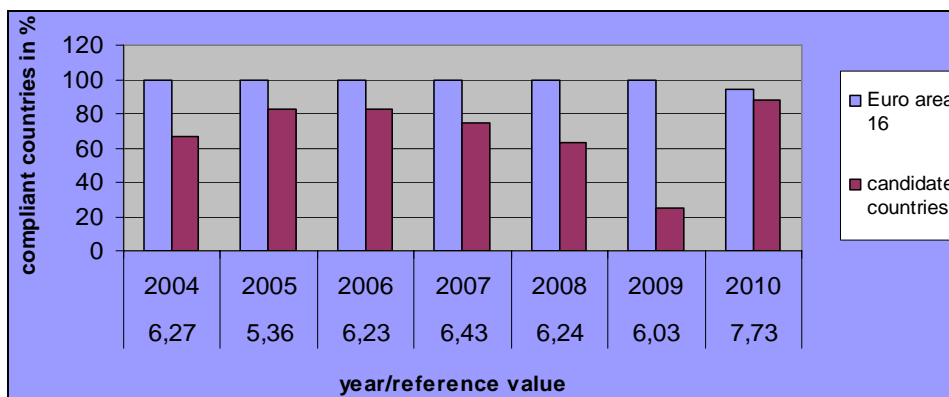
Tendency of the long term interest rate between 2004 and 2010



Source: Based on *Eurostat*, 2011

Figure 9

Compliance of the long-term interest rate between 2004 and 2010



Source: Based on *Eurostat*, 2011

Some countries did not join to the EMU. These are: Sweden, Denmark, and United Kingdom. Sweden and Denmark are very skeptical against the EMU. They are very proud of their own policy, society and economy.

In a referendum in 2000, the Danish voted against joining the EMU, and Sweden decided to stay outside of the Euro-zone. These countries are keeping their own sovereignty and thinking that they will lose this by joining to the EMU.

United Kingdom has an even more EMU skeptical population. They have got several reasons.

The first of these important reasons is the different business cycle. The UK's business cycle and the financial structure of her business are different from the

European countries. On the other hand the prestige of the national currency is very strong. The pound is a national symbol. The British are very proud of their nation and their own economy and they could not accept the loss of national sovereignty.

At the same time the United Kingdom has got a stronger and more competitive economy, than some member states, and they suppose that the accession will not result economic advantages for their country. There are many investors in the United Kingdom because low tax rates and ideal economic environment. The public services, infrastructure, and the pension system of the UK are not so developed, therefore the government should invest in this sectors, which would be restrict by the convergence criteria. So British people believe that their economy is ideal and they could not make benefits from the EMU joining. (Cini, 2006; Losonczi, 2005)

CONCLUSIONS

It can be concluded, that in the EMU the interest rates did not significantly increase during the crisis, contrary to the decaying finances position, showing market trust in the stability of the area. The single currency prevented the deepening of the crisis. But there is a danger that the capital flow to the less-developed countries leads to an unsustainably high debt, endangering the Monetary Union. The crisis showed the dangers of the free capital flow as well.

Considering all of the above, the member states must put a great emphasis on obtaining a balanced and sustainable fiscal position. Differences in the finances positions prevent to similar fluctuation of business cycles, therefore making it hard to continue single monetary politics.

As regards Hungary, among the candidate countries we have the highest government debt (80.2% in 2010). The inflation rate of Hungary compare with the candidate countries is higher, but not the highest. The Long term interest rate was higher only in two countries, than in Hungary in 2010 (Latvia and Romania). On my opinion a first step for Hungary is to reduce the government debt with the reformation of the government finances structure (e.g. pension system, tax policy). If we could reduce the debt, the market trust will improve, which could be see in the country risk assessment, the interest rate as well.

It is very important that the inflation aim of the monetary policy infiltrate in the market expectancy as well. The accession date was postponed several times, which could be dangerous because it would cause the loss authenticity of economy policy. We should obtain the market trust to improve our economy indicators, and position.

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