Attachment A: The Euro

The euro was introduced gradually starting in 1999, when the European Monetary Union (EMU) was initiated. Today, 17 EU members use the euro as their currency, with more expected shortly. Estonia was the last country to adopt the Euro in 2011. Today, the euro is the currency of about 330 million people. The euro is managed by the European Central Bank, headquartered in Frankfurt, Germany and currently headed by Italian Governor Mario Draghi.

Why was it introduced?

Various explanations are used to justify the implementation of a single currency. Many policy makers argue that a single currency is a logical extension of the single market which has been gradually adopted by the European Union member states over the last two decades. According to this argument, a common currency facilitates trade and exchange amongst member states by creating stable price conditions and eliminating currency exchanges. Numerous economists have argued that a single currency encourages European Union countries to better manage their public finances, and keep inflation low. Centralizing monetary policies in the European Central Bank also leads to greater coordination amongst these countries. Another economic argument put forward is that the European Union is better equipped in international trade with a common currency, providing external traders with stable, standardized monetary conditions and helping the EU institutions play a larger role in international trade. There is also a link to increase foreign direct investment as a result of higher government credibility under the new currency system.

Political arguments are also put forward, foremost that a common currency helps European Union countries integrate further as an economic and political bloc. By centralizing monetary policy functions, these states are encouraged to increasingly cooperate and negotiate on a variety of economic issues.

How was it introduced?

It was the Maastricht Treaty in 1992, which, besides creating the European Union (EU), provided the framework for a single monetary and exchange rate policy through the Economic and Monetary Union. It called for a shared currency by January 1999 and established "convergence criteria" (the "Maastricht criteria") for countries to meet before they could adopt the euro, including low and stable inflation, exchange rate stability, and sound public finances.[1] The European Central Bank (ECB), came into being in 1998.[2]

In January 1999, 11 EU member states started using the euro in non-cash transactions: Austria, Belgium, Finland, France, Germany, Italy, Ireland, Luxembourg, the Netherlands, Portugal and Spain. In 2001, Greece joined after meeting the criteria. In these 12 countries, the currency finally came into common circulation on January 1, 2002 and the old currencies were phased out by the spring of the same year.[3]

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[1] European Commission (2012), "The euro," http://ec.europa.eu/economy_finance/euro/index_en.htm.
[2] Olmstead and Graves, "History."
[3] Olmstead and Graves, "History."

The next five countries to adopt the euro after the EU's enlargement were: Slovenia (2007), Cyprus (2008), Malta (2008), Slovakia (2009) and Estonia (2011).

In addition to these 17 EU countries, some European neighbours and former colonies also use the euro. A number of other EU member states will have to join the euro area, but have not yet qualified or have not yet taken the steps to implement the preparations.

For member states that adopt the euro, fiscal policy (tax and spending) and structural policies (labour, pensions, and capital markets) remain the member states' responsibility, but they pledge to keep their public finances in line with the Stability and Growth Pact (SGP), set national budgets within agreed limits for deficit (<3% of GDP) and debt (<60% of GDP), and co-ordinate polices to achieve the common goals of stability, growth, and employment.[4]

What are the costs and benefits of having a common currency?

The euro has come under increasing criticism in light of the global recession and European sovereign debt crisis. In fact, prior to the crisis, a number of countries have chosen to abstain from adopting the euro because of reservations about its potential benefits or strong feelings towards their national currency systems and traditions. These countries include, most notably, Sweden, Denmark and the United Kingdom, all of which decided that they preferred to maintain their existing currencies.

One of the biggest costs of having a common currency system is that countries can no longer select monetary policy based on the specific requirements of their own economies. Countries have a variety of economic situations that may differ from those of their neighbours. Paul de Grauwe identifies the following conditions as playing an important role in determining whether a common currency will be successfully adopted: differences in labour markets, differing degrees of comfort with inflation and unemployment (some countries will work hard to avoid both, whereas others view them as necessary in market economies), differences in legal systems and different rates of economic growth.[5] Due to these differences, many policymakers argue that the Eurozone countries do not form what is considered an optimal currency area. However, a number of EU policy makers believe that once they are a part of the Eurozone, economies will converge and will become an optimum currency area, but countries cannot use exchange adjustments to increase competitiveness of goods abroad.

In light of the recent economic downturn, criticism of the euro has focused on the fact that it prevents individual countries from unilaterally taking measures that could benefit their own economies. As the Eurozone countries now have to work with the European Central Bank to implement monetary policy, they can less easily take independent measures that they might have otherwise taken to improve economic conditions. Countries have agreed to set monetary policy not in their own capitals, but at the European Central Bank in Frankfurt, and this has had an impact on the choices they can make.

An example helps illustrate this point: prior to being joined under a common currency, the central bank of Greece would have been able to stimulate its economy using a variety of monetary policy tools, including devaluing their currencies to encourage

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[4] European Commission (2012), "Economic and Monetary Union," http://ec.europa.eu/economy_finance/euro/emu/index_en.htm.

[5] De Grauwe, p. 9-23

borrowing and spawn economic growth. Under the current Eurozone system, the Greek government cannot unilaterally depreciate its currency or lower its interest rate, because an institution representing many countries regulates its currency. This has been one of the most widespread criticisms of the euro; that in recent dire economic times, many of the countries most affected have been unable to take the measures deemed necessary to fix their own economies.

There are, however, many strong arguments in favour of a common currency. Most countries in the Eurozone have benefited from the euro because the system provides macroeconomic stability to the European economies. The European Central Bank works to maintain price stability for the Eurozone, which ensures that even countries that are prone to inflationary policy are constraint by the ECB common monetary policy. Thus, the credibility of these governments is increased, which results in larger levels of foreign investment.

Another benefit is that many countries in the Eurozone whose economies have traditionally been less competitive on the global market have been advantaged by belonging to a system alongside more competitive economies, such as France and Germany. For many smaller states, the euro provides credibility for their markets that their own national currencies would not have.

Other economic arguments in favour of a common currency focus on the economic efficiency of such systems. Such arguments assert that common currency systems can be more efficient because of reduced transaction costs incurred when differences in currencies have to be accounted for every cross-border transaction, as well as the stability provided by removing exchange rate uncertainty.

For more information, visit the European Commission's Website on the euro:
http://ec.europa.eu/economy_finance/euro/index_en.htm