

Ten Years of the Euro

Background

The euro was introduced as the new currency for 11 Member States of the EU on 1 January 1999 (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain). On 1 January 2002, notes and coins were introduced and national currencies phased out in the eurozone. Five further countries have joined EMU and adopted the euro as their currency since 1999 (Greece in 2001, Slovenia in 2007, Cyprus and Malta in 2008 and Slovakia in 2009), five other countries or territories use the currency by agreement (Mayotte, Monaco, San Marino, Saint Pierre & Miquelon and the Vatican) and six have unilaterally adopted the currency (Andorra, Kosovo, Montenegro, Saint Barthélemy, Saint Martin and the British Sovereign Bases on Cyprus). The system is managed by the independent European Central Bank through its President and full-time executive, with decisions on interest rates and other significant issues being taken by the bank's council, comprised of these executives and the governors of the central banks of the eurozone countries.

This paper looks at the history of the euro over its first 10 years, assesses its performance as a currency, looks at the political consequences of creation of the euro and examines the British position in the light of renewed media and political discussion about the UK adopting the euro.

The Introduction of the Euro

The euro was introduced following the signing and ratification of the Treaty of Maastricht in 1993. That Treaty was the final stage in a long process that led to the legal framework for the establishment of the new currency. Attempts had been made before at European currency co-operation, notably the 1972 Werner Plan for economic and monetary union by 1980, and the European Monetary System (of which the better-known Exchange Rate Mechanism was part). The EMS was set up in 1979 and functioned until the introduction of the euro.

The report of a committee of central bank governors chaired by the then Commission President Jacques Delors in 1989 recommended a three-stage process towards monetary union, although it did not say that should mean a single currency rather than fixed exchange rates.

Although the Delors Committee did not argue that a single currency was the only way to achieve proper completion of a single market, that argument was made by others in Europe. It became part of the political as well as the economic case for the single currency in the early 1990s partly as a result of the improvement in the EU economy that followed the push to create a true single market with the Single European Act in 1986. This included a specific reference to the “progressive realisation of economic and monetary union”, which had been announced as an objective of the European Community as long ago as 1972 by the then nine Member States, including the UK, and had provided for co-operation in economic and monetary policy, building on the original provisions in the Treaty of Rome for consultation on exchange rates and other currency matters.

The Treaty of Maastricht's provisions included the details of economic and monetary union. It set the "primary objective" of the European system of central banks as to "maintain price stability"; it went on to detail how the central banks and the European Central Bank would operate; it provided for the ECB to takeover the authorisation of bank notes within the eurozone; and it laid down the timetable during which the euro would be brought into being.

The Treaty also laid down several criteria which had to be met before a country could adopt the euro as its national currency. These Maastricht criteria are: low and stable inflation, interest rate convergence, exchange rate stability and sound public finances. The Treaty established a procedure by which the European Council had to decide whether a country had met these four criteria and could go forward to Stage III of economic and monetary union – the time when exchange rates between countries would be irrevocably fixed and the euro introduced. As has been noted already, 11 countries met these criteria and so the euro was introduced on 1 January 1999. The United Kingdom and Denmark had the right under the Treaty not to participate in the euro if they so chose (see section on the UK below).

The stability and growth pact (SGP) was an important additional measure supporting the new currency. It was seen to be necessary politically by the German Government because of the transfer of responsibility for setting interest rates to the European Central Bank. Member countries might have been tempted to counter the ECB's interest rate policy – designed primarily to keep inflation down – with their own fiscal measures, such as cutting taxes or increasing public spending, which would have undermined the ECB's anti-inflation policy. Such a situation would threaten the credibility, and potentially the stability, of the euro. The SGP therefore restricted public debt to below 3 per cent of a nation's GDP in any one year.

The introduction of the new currency inevitably led to some difficulties but the remarkable thing about the euro was how smooth its introduction proved to be. Some countries were able to withdraw national notes and coins earlier than anticipated because the process proved easier than anticipated in 2002. Yet there was one difficulty, more political than economic, over prices.

A perception developed in much of the eurozone even before the introduction of the new currency that it would lead to higher prices. Within months of the introduction of euro notes and coins in 2002, consumers across the eurozone claimed that prices had risen following the introduction of the new currency. This problem appeared in several countries, notably Germany, Italy and the Netherlands but subsequent studies have found no evidence of a general rise in prices. Average price inflation in the eurozone in 2002 was 2.3 per cent – the same as in 2001. It was estimated that the amount of inflation that could directly be attributed to the introduction of the euro was in the range of 0.1 to 0.3 per cent.¹ Consumers noticed the rises in everyday purchases such as bread and haircuts but were less aware of the fall in prices in "big ticket" items such as cars or household appliances.

¹ http://ec.europa.eu/economy_finance/publications/publication6796_en.pdf

The Politics of the Euro

For most EU Member States the introduction of the euro was a political as well as an economic goal. They saw establishing a single currency for the single market as part of the wider goal of greater European integration. This view was not universally shared, with some countries (of which Germany was the most prominent) nervous that the political desire to proceed with the euro could jeopardise the goal of a stable currency in a non-inflationary economy. The Maastricht Treaty criteria ensured that these concerns could be met but critics of the euro still argued that the currency would not survive.

The fact that the euro has lasted a decade, that other countries have joined, and others are considering joining (see below), has demonstrated that the fears of the euro's critics have not been realised. But the euro has not led to greater European political integration, as some of its supporters wanted it to (and some of its opponents feared). The difficult discussions over institutional treaties negotiated since the Maastricht Treaty, and the problems over ratification of EU treaties in some Member States, have helped to slow the pace of integration. The euro may have proved a catalyst for greater economic integration but a political level its main effect has been external, to demonstrate the economic importance of the EU.

The Performance of the Euro 1999-2008

In its assessment of the first 10 years experience of the euro², the European Commission has claimed a success. The European Central Bank successfully brought down interest rates and anchored inflation within the eurozone to an average of just over 2%. In the absence of exchange rate risks and transaction costs, trade and investment within the eurozone grew substantially. The conditions of the stability and growth pact (SGP) brought an impressive improvement in fiscal discipline with an overall budget deficit of only 0.6% of GDP in 2007. Externally, the euro became increasingly important as a world currency in trade and financial services. It is now the second largest global reserve currency after the dollar. Having fallen in relation to the dollar and other currencies at the outset, the euro gradually strengthened – from approximate parity with the dollar to a rate which reached \$1.60 to the euro so far.

Problems within the Eurozone

The success of the euro has not been achieved without stresses and strains between the different Member States, often regarding budgetary deficits that have exceeded the limits laid down in the SGP. The deficits of France and Germany exceeded the 3 per cent threshold in 2003, leading to a report from the European Commission to the Council of Ministers, as required by the Treaty. However, the Commission did not recommend the financial penalties for breaking the limit that it could have done and proposed giving France and Germany a further year to get their deficits down. To the dismay of some of the smaller eurozone countries, who had met the SGP rules, the Council set aside that proposal and gave France and Germany two years to bring their deficits back in line which the latter but not the former was able to achieve.

² *EMU@10*, the European Commission, 7 May, 2008

The deficit problem has now been exacerbated by the current financial crisis and economic downturn. Most eurozone countries, as in non-euro Member States as well as other countries, are meeting the economic downturn with increased public expenditure and/or tax cuts. In countries like Italy and Greece any further increase in Government debt would come on top of debt already close to or above 100% of GDP. The conditions in the SGP are having to be breached even by countries with stronger economies like France and Germany in order to combat the current recession. Higher inflation rates have, in some cases, probably temporarily, affected the competitive position of countries like Spain, Ireland, Greece and Italy, already struggling with serious external trade deficits. These countries will have to reduce their inflation rate down to a level closer to that in Germany which will require painful adjustments in their economies.

Germany has made considerable strides in order to reduce its deficit but this has been very difficult and current forecasts suggest its deficit will again exceed the limit in 2010. The French deficit is predicted to be 5.4 per cent in 2009 – well above the Maastricht limit. The European Commission has forecast that 7 out of the 16 eurozone countries will break the 3 per cent rule in 2009.³

Eurozone rules do not provide any obligation to give financial assistance to the weaker economies. This issue is being debated but any attempt to change the bailout rules would be highly controversial. This has led to speculation that one or other Member State might opt to leave or be forced out of the eurozone. But this is unlikely to happen. All eurozone governments are deeply committed to membership. Moreover, any serious suggestion that a country was contemplating abandoning the euro would lead to a disastrous flight of capital in anticipation of devaluation. This would be deeply damaging to the country concerned.

Future Members

Under the Maastricht Treaty all Member States (except the UK and Denmark) are obliged to join the euro if they meet the criteria. Iceland is considering applying for EU or eurozone membership as a way to alleviate its current financial difficulties. Similarly, the current crisis has reduced opposition to the euro in both Sweden (where a referendum rejected joining the eurozone in 2003) and Denmark (with a euro opt-out and where joining the euro was defeated in a referendum in 2000). The Danish government said that a new referendum on euro membership should be held in this parliamentary term and its Prime Minister proposed in October 2008 that it should be held in 2011.

The UK Position

In the UK, the only other EU country with a formal euro opt-out, discussion about the merits of UK membership has also resumed. A recently published survey, *10 years of the Euro: New Perspectives for Britain*, has highlighted the change in circumstances facing the UK economy and sterling since 2003 when the Blair Government decided that the conditions laid down in its five tests were not sufficiently met. Most notably, the sterling/euro exchange rate has altered dramatically with the pound now no longer arguably uncompetitive with the euro. Among the questions now being asked are

³ http://ec.europa.eu/economy_finance/thematic_articles/article13727_en.htm

whether the current rate would be the right one on which to enter and whether entry would be a desirable shelter from a sterling crisis. If the UK wished to join, that would be decided by majority vote but the rate would require unanimity amongst existing eurozone members.

Some commentators argue that the five tests are now adequately met and that a stable exchange rate would be beneficial in dealing with the shocks to the system following the financial crisis.⁴ Others argue that Britain is still better off with a flexible exchange rate and eurozone interest rates would not necessarily be appropriate for the UK economy – the UK now has lower interest rates than the eurozone.⁵ Would the UK be able to fulfil the conditions of the SGP at least as well as the existing members? Given that the Commission forecasts that the UK's deficit will be 8.8 per cent this year and 9.6 per cent in 2010, Britain is a long way from meeting the SGP criteria on budget deficits (although its overall debt/GDP ratio remains a long way below other eurozone members such as Belgium and Italy). Nonetheless, these are all questions which merit calm and rational debate. Although euro membership is clearly not on the political agenda of either of the main parties (and indeed is vigorously opposed by the Conservative Party), their reluctance to engage with the issue now need not, indeed should not, preclude a proper assessment of what is in the UK's interest over the longer term given the current economic situation and the prospects for the future European and global economy.

March 2009

⁴ See, for example, Willem Buiter's 'The Overwhelming Economic Case for the United Kingdom Adopting the Euro' in *10 years of the Euro: New Perspectives for Britain* published by John Stevens, 2009.

⁵ See, for example, Martin Wolff's 'Eurozone Membership is still no answer for the UK', *Financial Times*, 18 November, 2008