THE EU AND THE WORLD: CHALLENGES AND TRENDS

27 IDEAS FROM THE ERASMUS GENERATION

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The Euro: situation and perspectives

by

Monika Liepinytė & Neringa Puškoriūtė

Kaunas University of Technology

LITHUANIA

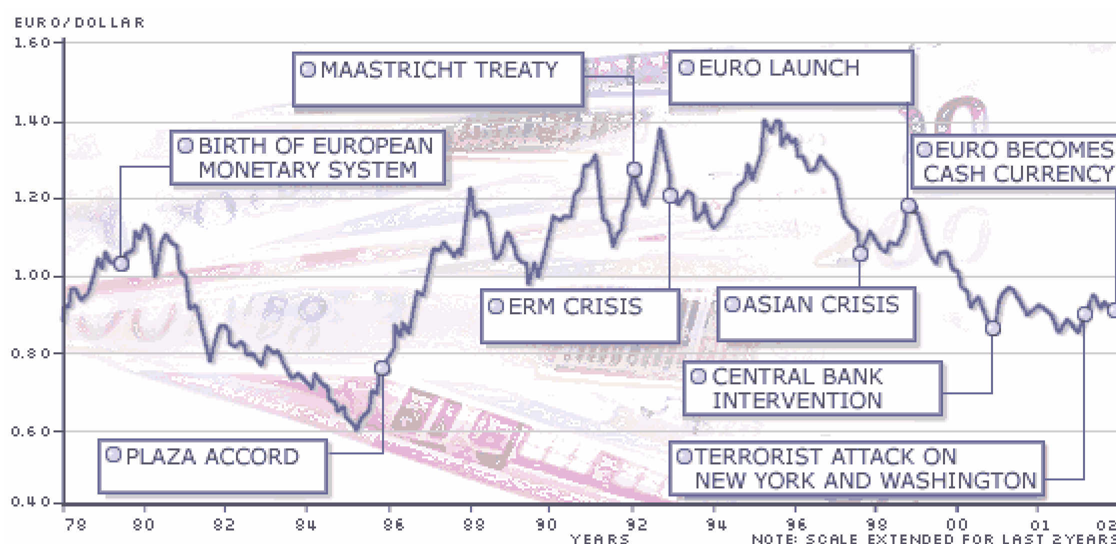
Monika Liepinytė
m.liepinyte@gmailo.com

Neringa Puškoriūtė
neringa.puskoriute@gmail.com

Introduction

The euro is the official currency of the euro zone, which consists of 17 of the 27 member states of the European Union. It is also the currency used by the Institutions of the European Union. The euro zone consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. The euro is the second largest reserve currency as well as the second most traded currency in the world after the United States dollar.

As the 1st picture shows, European currencies have always fluctuated against the dollar, even as debates have raged about the euro. Rapidly took over from the former national currencies and slowly expanded behind the rest of the EU. In 2009 the Lisbon Treaty formalized its political authority, the Euro Group, alongside the European Central Bank. This picture shows the value of the euro (before 1999 as a basket of the 11 legacy currencies) against the US dollar.



1 pic. The value of the euro against the US dollar

History of the euro

The euro was established by the provisions in the 1992 Maastricht Treaty. To participate in the currency, member states are meant to meet strict criteria. The name euro was officially adopted on 16 December 1995. The euro was introduced to world financial markets as an accounting currency on 1 January 1999 - the currency was introduced in non-physical form (traveller's cheques, electronic transfers, banking, etc.), replacing the former European Currency Unit (ECU) at a ratio of 1:1. Euro coins and banknotes entered circulation on 1 January 2002. June 30, 2002 was the last day for changing old currency to Euro at any bank for the original twelve member states (Germany, France, Italy, Spain, Portugal, Belgium, Luxembourg, the Netherlands, Austria, Finland, Greece and Ireland).

The rates were determined by the Council of the European Union, based on a recommendation from the European Commission based on the market rates on 31 December 1998. The European Currency Unit was an accounting unit used by the EU, based on the currencies of the member states; it was not a currency in its own right. They could not be set earlier, because the ECU depended on the closing exchange rate of the non-euro currencies that day.

The changeover period during which the former currencies' notes and coins were exchanged for those of the euro lasted about two months, until 28 February 2002. Even after the old currencies ceased to be legal tender, they continued to be accepted by national central banks for periods ranging from several years to forever (the latter in Austria, Germany, Ireland and Spain).

Direct usage

As mentioned before, the euro is the sole currency of 17 EU member states. These countries comprise the "euro zone", some 326 million people in total. Outside the EU, the euro is also the sole currency of Montenegro and Kosovo and several European micro states (Andorra, Monaco, San Marino and the Vatican City) as well as in three overseas territories of EU states that are not themselves part of the EU (Mayotte, Saint Pierre and Miquelon and Akrotiri and Dhekelia). Together this direct usage of the euro outside the EU affects over 3 million people.

It is also gaining increasing international usage as a trading currency, in Cuba, North Korea and Syria. There are also various currencies pegged to the euro. In 2009 Zimbabwe abandoned its local currency and used major currencies instead, including the euro and the United States dollar.

Currencies pegged to the euro

Worldwide use of the euro and the US dollar: Euro zone, External adopters of the euro, Currencies pegged to the euro, Currencies pegged to the euro within narrow band, United States, External adopters of the US dollar, Currencies pegged to the US dollar, Currencies pegged to the US dollar within narrow band. Note that the Belarusian ruble is pegged to the Euro, Russian ruble and US$ in a currency basket.

Outside the euro zone, a total of 23 countries and territories that do not belong to the EU have currencies that are directly pegged to the euro including 14 countries in mainland Africa, two African island countries, three French Pacific territories and another Balkan country, Bosnia and Herzegovina.

With the exception of Bosnia (which pegged its currency against the Deutsche Mark) and Cape Verde (formerly pegged to the Portuguese escudo) all of these non-EU countries had a currency peg to the French Franc before pegging their currencies to the euro. Pegging a country's currency to a major currency is regarded as a safety measure, especially for currencies of areas with weak economies, as the euro is seen as a stable currency, prevents runaway inflation and encourages foreign investment due to its stability.

Within the EU several currencies have a peg to the euro, in most instances as a precondition to joining the euro zone. The Bulgarian lev was formerly pegged to the Deutsche Mark, other EU member states have a direct peg due to Exchange Rate Mechanism (ERM II): the Danish krone, the Lithuanian litas and the Latvian lats.

In total, over 150 million people in Africa use a currency pegged to the euro, 25 million people outside the euro zone in Europe and another 500,000 people on Pacific islands.

Euro convergence criteria

The euro convergence criteria (also known as the Maastricht criteria) are the criteria for European Union member states to enter the third stage of European Economic and Monetary Union (EMU) and adopt the euro as their currency.

In 2009 the International Monetary Fund floated a suggestion that countries should be allowed to "partially adopt" the euro - adopting the currency but not qualifying for a seat on the European Central Bank (ECB). Monaco, San Marino and the Vatican City State are in a similar situation: they have adopted the euro and mint their own coins, but they do not have ECB seats.

For euro zone members, there is the Stability and Growth Pact which has similar requirements for budget deficit and debt. However some euro zone countries have without action from the EU severely violated these criteria, which has resulted in European sovereign debt crisis.

The European Commission, after consultations with the European Parliament (EP) and discussion in the European Summit, may propose to the EU Council to decide whether a country meets the criteria to introduce the euro.

The main Maastricht criteria:

● *Price stability*. A Member State's inflation rate must not exceed the average of the three Member States who have achieved the best results by more than 1.5 percentage points.

● *Public finance*:

- government deficit must be less than 3 percent of GDP;
- government debt must be less than 60 percent of GDP or approaching this level at a satisfactory rate.

● *Exchange rate.* A Member State must participate in the second ERM II for at least two years and maintain the exchange rate of its currency stable against the euro. Whether this criterion is being met is first evaluated on the basis of whether the currency rate is similar to the set euro exchange rate, as well as factors that could have affected a larger exchange rate. On 1 January 1999, the third stage of Economic and Monetary Union (EMU) the exchange rate mechanism was set where participating currencies‘ standard main exchange rates vis-à-vis the euro are set at ±15 percent.

● *Interest rates.* The nominal long-term interest rate must not exceed the average of the three Member States who have achieved the best results in terms of price stability by more than 2 percentage points. The Government securities long-term interest rate is one of the main indicators of a country's economic reliability, and for new EU members' – an indicator of progress in real convergence.

The situation in the euro area

The important steps to exit the crisis already taken by the euro area have been numerous and important. But recent market developments have reminded us that there is still a tremendous need for further demonstration of the determination of all the players in the European crisis to rise to the challenges facing us. One thing is very clear: this crisis is fundamentally a sovereign debt crisis; hence the priority in order to exit it once and for all must be a return to a sustainable fiscal path. In fact, an impressive effort has already been made. The Portuguese deficit shrank from around 10% in 2009 to around 6% last year. The Italian deficit has been reined in from 5.4% in 2009 to 3.9% in 2011, and Italy actually ran a primary surplus of 1% last year, which is very rare among developed economies. The French deficit has been cut from 7.5% in 2009 to 5.3% in 2011. It is clear that the absolute level of the euro area's deficit is half what it is elsewhere, but also that the pace of fiscal consolidation is actually faster.

It is absolutely necessary to strengthen banks' balance sheets to enable them to better absorb shocks, protect public finances and re-establish normal market functioning. On the other, a disorderly deleveraging would create enormous problems and add credit constraints to the many headwinds currently facing our economies. The euro area is currently making sure that these two objectives – although sometimes difficult to reconcile – are achieved. Banks are meeting their new capital

requirements. The capital plans submitted to the European Banking Authority (EBA) indicate an intention to exceed the benchmarks set by BIS central bankers' speeches 3 more than 20%. At the same time, bank lending seems to be stabilizing, although at a relatively low level. Banks are starting to assess their financial situation more positively and in many cases their willingness to grant loans is increasing.

As it is known, two exceptional three-year liquidity-providing operations have been decided on and successfully implemented over the last two months. For the second operation, it is decided to have an expanded collateral pool, so that smaller banks – which tend to lend to smaller businesses that are crucial for the European economic activity – could benefit more. It is clear that banks were facing major funding uncertainties in 2012 and 2013: these funding pressures have now been removed. This could in turn contribute to the issuance of new shares and hence to the meeting of the capital requirements without forcing excessive deleveraging.

The weakness of European economic union in the context of monetary union contributed to the development of the current crisis and, if it is emerged from it stronger, real improvement is required in this area. European governments have fully understood this issue and have made concrete and significant progress towards a more integrated economic union. On the one hand, Europe has considerably enhanced its fiscal discipline framework. The legislative package entered into force in 2011 and considerably reinforces the Stability and Growth Pact: the surveillance powers of the European Commission over national budgets have been enhanced and sanctions have become quasi-automatic. In addition, 25 European Heads of State or government signed the Treaty on Stability, Coordination and Governance which establishes a comprehensive new "fiscal compact". It includes in particular a requirement for national budgets to be in balance or in surplus, a criterion that will be met if the annual structural government deficit does not exceed 0.5% of GDP.

At the last European Council meetings, it was decided to accelerate the creation of the permanent European Stability Mechanism (ESM) to July 2012, and to make it more powerful. An important step in this direction has been provided by the agreement to accelerate the payment of the paid-in capital for the ESM, starting with the payment of two tranches in 2012. All in all, these changes constitute the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of Economic Monetary Union almost 20 years ago.

The euro situation in Greece

The Greek situation is the big problem in the euro zone – total debt of 360 billion euro. First was the Greek rescue package and its failure this is why it lead to the second hand out – a temporary Band-Aid emergency funding with a second bailout, Euro Zone agreed on Greece a second bailout package. The second bailout programme for Greece involves financing of 130 billion euros and aims to cut Greece's debts to 121% of GDP by 2020. The problem is not the fact that Greece has had two bailouts or liquidity injections given that is required, it is that there current economic structure could not be facilitate through these strict austerity measures.

The fact that European officials are openly talking about the prospects of a Greek exit from the Euro zone highlights just how drastic the situation has become. Greece is going to the ballot box in what will effectively be a referendum on whether the country stays in the euro. Voters have to decide whether to back parties in favour of austerity measures or those who want to defy the EU and default on loan payments. The country is heading back to elections in under very bad circumstances because certain people coldly put their short-term party interests above the national interest. They reject all further cutbacks but they want to renegotiate the bailout package and keep Greece in the euro.

If Greece refuses to make cuts, European leaders are likely to withdraw bailout funding agreed in March and an exit from the euro is almost certain. A Greek exit would imply a new currency drachma for the country, a separate monetary policy etc. However, any competitive gain from a weaker currency would be lost in a huge increase in inflation while the local corporate sector would be forced to default en mass on any EUR debt that they hold. Confidence in the new currency would be weaker leading to an exodus of capital further strengthening the EUR. If Greece removes out of the EURO – it will cause a major financial crisis. Not just for the people in Greece but also global financial institutions that have holdings in Greece there investments and bonds will be devalued all most instantly this will also effects many Governments and will be a ripple effect at its best – the impact on the UK and other European countries would be devastating. Admittedly the Euro zone would be stronger without Greece but it would not be long before market attention turned to Portugal and Ireland and even Spain as the next candidates for exit. Indeed, a Greek exit would set a precedent that did not exist previously.

On the other hand, the fears over Greece have seen the pound hit three-year highs against the euro in recent days, which is good news for tourists heading for the Continent. The euro staged a slight recovery these days, boosted by the stronger growth in Germany.

The euro situation in Lithuania

Lithuania wants to follow as soon as they can bring their budget deficits into line with the entry criteria, because other Baltic state - Estonia has become the 17th nation to adopt the euro as its currency in January, 2011. After joining EU in 2004 Lithuania had a purpose to enter the euro zone in 2007, but as everybody sees this goal was not executed – Lithuania still does not have a euro as his national currency. In the 1st table you could see the situation of Lithuania according to Maastricht criteria, in order to have euro in the state.

1 table. Convergence Indicators

	Lithuania					Convergence Criteria figure
	2007	2011	2012	2013	2014	
Inflation	5,2 %	4,2 %	3,2 %	3,3 %	3,3%	2,6 %
State finances: -government deficit -government debt	0,9 % 17,7 %	5,3 % 38,1 %	3,2 % 37,9 %	3 % 37,1 %	2,9 % 35,4 %	3 % 60 %
Long-term interest rate	4,5%	5,7 %	5,8 %	5,7 %	5,9 %	6,4 %

It is quite clear that we still have some problems concerning our economic indicators. Although, Lithuanian Prime Minister said his government intends to make further big cuts to its budget deficit to secure membership of the currency area in 2014. For Lithuanian Prime Minister there simply isn't a thought to joining the euro zone for a small European nation in an increasingly integrated global economy. In his view, Lithuania doesn't have the freedom of choice open to larger countries around the Baltic Sea – such as Sweden and Denmark – which have chosen to stay out of the currency area. "It's an instrument that will allow us to feel a little more safe in the global financial system," he said. Lithuania has long pegged its currency to the euro, so in our view, Lithuania "almost has the euro, without the benefits," such as a say in forming euro-zone policy and cheaper access to bond-market financing.

In addition, the President of Lithuania is saying that it is impossible to enter euro zone in 2014. She also agrees that in some respect we have Euro today, because LTL is closely connected with the currency. But what is most important is that all countries, Lithuania included, should act responsibly. Earlier Lithuania planned to introduce it in 2014, but in the recent months state officials more and more often note that they do not want to speculate with certain European currency introduction dates.

Benefits of euro from Lithuania's position:

● Lithuania's participation in the euro area will help our country expand its commercial and financial ties with other euro area countries, and this will stimulate income and employment growth in Lithuania.

● When Lithuania adopt the euro, she will no longer have currency exchange expenses – this is beneficial for travelers, those studying and working abroad and those who trade with the EU countries.

● Lithuania's participation in the single market of the EU and use of the euro will guarantee price stability (lower inflation rate), and this is socially important, because it will minimize swings in the purchasing power, and enterprises will have a better planning environment.

● The euro encourages more competition in the EU single market, resulting in better prices for consumers. Furthermore, it becomes easier to compare prices across the EU.

● Participation in the euro area will create conditions where people and enterprises are able to borrow at lower interest rates, thus increasing consumption and investment.

● While preparing to adopt the euro, or already using it, a Member State must abide by the EU financial discipline. This helps preventing the increase of the national debt and other major economic policy mistakes.

Until the euro is introduced, Lithuania cannot make full benefit of the advantages offered by the euro area.

The euro future

The euro zone cannot survive in its current form – that is the alarming prediction of top economists and politicians of all political hues, among them the former Chancellors Alistair Darling, Nigel Lawson and Norman Lamont.

The experts and politicians were asked for their short-term and long-term predictions for the future of the euro. While most believe the euro zone may well survive the current Greek debt crisis – especially given the political will invested in preventing a disorderly default – none is confident that the contagion could be contained.

Many of the politicians and economists criticized the rush to austerity being imposed on Greece and Italy, suggesting it would be counter-productive by depressing growth, and said the competitive imbalances between euro zone members would be impossible to overcome. They suggested the ultimate consequence of the crisis would be a much smaller euro zone with Germany at the centre and countries such as Greece, Portugal, Italy and Ireland on the outside.

The only strong note of optimism was sounded by Olli Rehn, vice president of the European Commission responsible for the euro, who predicted the currency would emerge stronger from the crisis. "We are undertaking nothing less than an economic reformation of Europe," he said.

Some of the economists are saying that the euro zone is a slow-motion train wreck. Not only Greece, other countries as well are insolvent. There's a 50 per cent probability that over the next three to five years the euro zone will break up. Not all the members are able to stay. Greece and maybe Portugal may exit the euro zone - Greece within the next 12 months. Portugal may take a while longer.

Gerard Lyons (chief economist Standard Chartered Bank) is thinking that the euro cannot survive in its current format. He thinks that the euro is fundamentally flawed. For the euro to survive it needs the politics to really change. But if it’s left to the economics then the euro will collapse. Europe’s leaders have identified the wrong problem. And when you identify the wrong problem you get the wrong solution. Europe does not have a debt problem, Europe has a growth problem. Debt is high, but a debt problem can be contained by growth. If you address it from the beginning as only a debt problem then you get the wrong solution.”

Here are hard facts about life with the Euro that have to be faced: facts that will not change and will dominate the long term future of Europe. These facts lock all nations inside the euro zone into an economic prison from which there can be no escape – unless they leave.

In conclusion, the answers to the questions: Will the Euro currency survive? Almost certainly yes. Will it have as many members as today? Almost certainly no. There is the opinion that EU could have a two tier Euro – effectively splitting the currency into two kinds of Euro for two different kinds of nations and possibly each smaller group will continue to face most of the problems above from common exchange and interest rates.

Would it make sense for a strong nation like Germany to leave the Euro? Possibly. Germany is a dominant economy within the EU so interest rate policy has to be set with that in mind, and Germany, like France, is often as we have seen at a different stage in its boom and bust cycles than many smaller economies, with different requirements. Taking Germany out of the picture could make alignment easier.