

## **ADVANTAGES AND DISADVANTAGES OF THE EURO**

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**ABSTRACT:** *Creating a single European currency has, undoubtedly two great advantages: on the one hand, lower transaction costs resulting from exchanging various national currencies and, on the other hand, removing the uncertainty arising from these exchanges. Mugur Isarescu, the Governor of the NBR, has recently said that the adoption of the euro in 2014 could not be possible, if inflation does not drop a sustainable level in 2010 and 2011. He noted that current experience with the inflation and devaluation of the national currency shows that reducing inflation without improving other indicators is counterproductive. The problem of estimating the main advantages of a single currency and of a monetary union in general is that it is difficult to clearly distinguish them from those resulting from other aspects of economic integration. The success of a monetary integration requires a certain degree of coordination of macroeconomic policies. It is unanimously agreed that if countries cooperate with each other, together they shall have better results than in the case they do not cooperate. In budgetary process local authorities have the right to establish, observe, control, follow and charge municipal taxes. In this process they also have to report local budgets implementation and rectification.*

**KEY WORDS:** *a single European currency; inflation; devaluation; monetary integration; European Union; budgetary process*

**JEL CLASSIFICATION:** *F15*

### **1. GENERAL CONSIDERATIONS REGARDING EURO**

The introduction of the euro on the EU market was, at that time, a political and economic success. If the EU citizens needed a period of adjustment to the new currency, for those outside the eurozone the transition was more sudden and more limited. This means that, practically, only traders, who were carrying out import-export

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activities with the European Union and with other institutions involved, could use the euro.

Since the 1989 revolutionary changes, Romania has been faced with two processes which are able to frighten even the great idealists that are absent anyway.

The first was called the transition from communism to capitalism, although the starting point was not necessarily communism while the next step was too vague to be considered capitalism. The second major process that we faced was acceding to the European Union. Most of the times it is difficult to distinguish between the two phenomena, especially when the European integration has become a programmatic adjustment process with the *acquis* "in hand", to the operating conditions of the EU, so that "anybody can understand" the membership criteria adopted in Copenhagen. In short it can be called modernization. There is a consensus of the entire society about the necessity to develop Romania. It is only normal and, in anticipation, we can say that here we find the strongest support, in large percentage, of the European integration. This shows that the Romanians equal the modernization process, meaning the overcome of communism, and the European integration process.

Obviously, after becoming a new Member State - from January 1st, 2007, the next step for Romania is joining the eurozone.

From legislative point of view, the problem was solved, meaning that when reviewing the constitution in 2003 the Article 137, paragraph 2 mentioned that the national currency is LEU while the fractional currency is BAN and after Romania has acceded to the European Union can admit the circulation and replacement of the domestic currency with that of the European Union, by organic law.

As far as the transition to the euro is concerned - Mugur Isarescu, the Governor of the NBR, has recently said that the adoption of the euro in 2014 could not be possible, if inflation does not drop a sustainable level in 2010 and 2011. He noted that current experience with the inflation and devaluation of the national currency shows that reducing inflation without improving other indicators is counterproductive. "We were taught that reducing inflation with unsustainable measures is not advantageous. If we are not able to bring the inflation within limits, in a sustainable way, plan B is to collect other policies and allow the economy to correct it using the toughest measures", said Isarescu.

Central Bank's official explained that inflation expectations, as well as the exchange rate were changed, which shows that playing only one single card may turn against the very purpose. He gave for example the large current account deficit and the persistence of an aggregate demand which is too high. "If someone does not reduce these imbalances and they turn against inflation, you can not just sit and watch. My message is that we need to lift the pressure from the monetary policy, as far as the current account deficit is concerned", said Isarescu. Under the circumstances, Isarescu says that even a downward adjustment of 0.2 percentage points of the GDP planned for this year could be beneficial because at this moment even the message counts.

The governor of the NBR also pointed out that low inflation is not enough to convince the EU authorities and the European Central Bank that Romania is ready to join the eurozone. "Before the two years prior to ERM II (exchange rate mechanism), another two years are required to demonstrate and convince that the country is stable.

If we won't have a low inflation by 2010, which should have been reduced together with other indicators, the ECB and the EU will ask you if you get a lower inflation on a large current account deficit and on an overrated national currency," explained Isarescu.

The target for the euro adoption might be compromised, because in 2012 and 2013 some tough correction measures would be necessary.

## **2. THE ADVANTAGES OF EURO**

For many years, political and economic debates on the existence of a Single European Market and of an Economic and Monetary Union waged between supporters and opponents of this idea have separated the public opinion. Each of the two sides highlighted the advantages and disadvantages of this Union, including those that could result from issuing a single currency to replace gradually all current national currencies, seeking to minimize, in a certain way, negative and positive influences that this Union might have on the national economies of Member States. Therefore, an objective and lucid overview of all these effects of the existence of a single currency, which highlights both positive and the less positive aspects is absolutely necessary.

Creating a single European currency has, undoubtedly two great advantages: on the one hand, lower transaction costs resulting from exchanging various national currencies and, on the other hand, removing the uncertainty arising from these exchanges.

Among the general advantages of the single currency, here are the following:

- lower transaction costs;
- reducing the uncertainty affecting the profitability of international transactions;
- lower cost of capital;
- improve capital allocation;
- better use of the common monetary reserves;
- reducing losses due to different rates of inflation within EMU member countries;
- improving macroeconomic management and cooperation;
- improving macroeconomic stabilization within EU Member States.

The costs mentioned above, transaction and capital costs have a direct impact at the microeconomic level, on the private sector. While aggregate calculations at macroeconomic level, are made in order to study the impact on the economy; generally the effectiveness of these changes will be clearly visible in balancing costs and profits of each company. For businesses involved in international trade there will be a balance between the costs of these changes supported by taxes and the reduction of transaction costs resulting from those changes. It should be mentioned here that these costs affect firms only once, while reducing transaction costs will have beneficial effects throughout the activities undertaken by the company after adopting the euro.

The problem arises in a different way for companies are that not directly involved in international trade, they do not have to deal with transaction costs resulting from exchanging various national currencies. The responsibility lies with national governments to study the problem of covering the costs of these changes in a different

way from companies operating in an international environment and those carrying out strictly domestic activities.

Besides the reduction of transaction costs, switching to a single currency brings other advantages as well. Therefore, a monetary union will ensure convergence, on a medium term, of various interest rates that exist within member states, thus decreasing capital costs by lowering the country risk premiums that formerly presented high rates of inflation. Risks associated with private companies or some states, as reflected by the various "ratings" and real interest rates paid by them will fall, due to convergence of national inflation rates. This will result in a more efficient allocation of circulating capital.

On macroeconomic level, one of the fastest visible benefits will be given by the more important role played by the central banking system reserves, as compared to the role played by the reserves established for various currencies. It should be noted that, just like in the case of any economic reform measures, negative effects are the ones that occur the earliest, while positive effects occur on medium and long term. In the case of the euro, the costs of these reforms are immediately visible, while the potential benefits will be long in coming. Moreover, the costs of creating reserve currency are perfectly quantifiable, while its benefits are more difficult to be measured, this measure showing a degree of uncertainty. Political factors, faced with the existence of real costs related to the creation of the Monetary Union, had great difficulty in persuading electorates of the validity of subsequent benefits. The issue got even more complicated because transaction costs and the benefits of the single currency are divided equally among participating countries.

The problem of estimating the main advantages of a single currency and of a monetary union in general is that it is difficult to clearly distinguish them from those resulting from other aspects of economic integration. The success of a monetary integration requires a certain degree of coordination of macroeconomic policies. It is unanimously agreed that if countries cooperate with each other, together they shall have better results than in the case they do not cooperate. In the case of international cooperation we come across a problem similar to "the prisoner's dilemma": if everyone agrees to cooperate, they will get optimal results, but if some refuse such cooperation, the best strategy is to encourage self-interest, even though the results shall be inferior to those determined by global cooperation. This is why EMU member states get better results by coordinating their own policies than by acting on different pathways. The Monetary Union will help stabilizing policies within member states because it automatically makes a transfer of resources within areas facing difficulties, thus adverse internal balances of payments can be controlled. Moreover, underdeveloped areas are to improve more rapidly and thus, unemployment is more easily fought with within these areas.

Last but not least, reserve currency has the advantage of facilitating price comparison in different countries. In case there are many national currencies, companies may require different prices for the same product sold in several countries, depending on the elasticity of the price demand. This monopoly power exercised by some firms leads to a loss of the consumer. When all goods and services will be valued in the same currency the conversion of process will no longer be needed, thus

facilitating their comparison. The reserve currency will lead to greater satisfaction of consumers and to the strengthening of competition within the EMU.

More recent studies clearly demonstrate the advantages of the Monetary Union for countries in transition from Central and Eastern Europe. Thus, an increase of the GDP by 1% within the eurozone will increase exports to Central and Eastern European countries by 0.6%; this increase of exports has a multiplier effect on the GDP growth by 1.5%. However, at the same time it will have a negative effect upon these economies: the effect of "trade diversion" within the eurozone, which will result in a decrease of the GDP in Central and Eastern Europe. Since trade diversion effect occurs only once, as a stock, the first effect, the positive one, occurs as a flow.

### **3. THE DISADVANTAGES OF EURO**

The disadvantages of the reserve currency are just as important as its advantages. These disadvantages are grouped into two categories: those faced with during the transition to the Monetary Union (transition costs) and those that will appear after Monetary Union has been established.

The costs of adopting the euro are:

- deflation;
- costs of change;
- loss of income resulting from issuing currency.

There are inherent costs of the monetary union such as:

- loss of sovereignty;
- increase of costs necessary to make "shock" adjustments;
- lower economic growth rates.

The costs of changes are relatively minor: mainly changing the information and accounting systems. However, for some companies, these costs can be considerable. They will be transferred to customers, but with inflationary effects. Since benefits will not be taken until the end of the process, because they are not necessarily produced by those who bear its costs, their redistribution arises between the protagonists of these changes.

The most important costs of the reserve currency are macroeconomic. Two of them are inextricably linked to the transition process. The first arises because one of the accession criteria is the achievement of low inflation rates, therefore countries with high rates will have to undergo difficult and painful economic restructuring. This process is not symmetric meaning it does not compel countries with low rates of inflation to adopt inflationary policies, in order to tend towards an average rate. Countries with high inflation have several means available to achieve the objective of reducing it. It would be best to achieve an increase in aggregate supply, but this could take time. Another means would be provided by using the tax lever; however this leads to reducing living standards.

A second macroeconomic problem concerns the loss of income deriving from the right to coin money. Due to the fact that during the transition a tight budgetary policy is required, the loss of income will clearly have an adverse effect upon public

expenditure. An increase of direct and indirect taxation could solve this problem, also having a strong deflationary character.

At national level, EU governments will be faced not only with the loss of control of their own monetary policies in favour of the ESCB, but they will also suffer serious limitations and fiscal policies. This inconvenience does not occur if the policy objectives of the Economic and Monetary Union coincide with the objectives of member states in particular. In addition, the transition could achieve their objectives in less time and with less cost than in the case they would not have adopted the reserve currency. Under the circumstances, taking part in a joint sovereignty could provide advantages that Member States could not achieve by themselves.

#### **4. CONCLUSIONS**

In conclusion, we can say that the short term disadvantages are those which can be visible and measurable, while the advantages occur on medium and long term. Time will tell whether the establishment of an economic and monetary union is a good step towards increasing the prosperity of European Member States or whether, as some Euro sceptics say, it is only a step towards creating a stifling bureaucracy and centralization.

As far as the pros and cons regarding the European reserve currency are concerned Maurice Allais, a Nobel laureate for economics, expressed his negative opinions towards the euro. He believes that the euro can not and must not only refer to improving the EU and it should be used only when all conditions, not only economic but also political ones, will be met.

These conditions are:

- to ensuring convergence of monetary policies of member countries, ie convergence to a single value of inflation and exchange rate stability within the Community;
- in order to replace national currencies with the euro, all prior economic adjustments must correspond to the relatively fixed exchange rates within the EU;
- establishing a MU and the implementation of a single currency is linked to the forming of a political union. "The idea that the European integration will result in an irreversible political union, is totally groundless" - Maurice Allais says. "If you refuse such a political union, then a monetary union and the reserve currency are also denied.

Peter Sutherland, European commissioner between 1985 and 1989, General Manager of the World Trade Organization until 1996, supported the euro, but said, that according to the political implications of this act: "What is ultimately at stake is politics. A final decision on which countries should enter the monetary union will also be a general decision on which Member States can be counted on in order to meet future obligations arising from monetary union. This is not commonly admitted in public - says Peter Sutherland - because it has inappropriate connotations but it is unavoidable."

Bernard Connoly, former chairman of the Monetary Policy Committee of the European Commission is a known dissident Monetary Union who asserts that "Monetary Union is a dangerous fantasy." "The setting up of a Bundesbank in Europe or the implementation of a European Central Bank in Germany is impossible because Germany's Bundesbank place in German federalism is totally private and unique at a different scale. As long as Germany remains a strong national state, the Germans will keep Germany within the eurozone because they need partners to promote their interests. In case there will be a single Europe, the Germans would have interest to make it a German one." Therefore, Bernard Connoly considered the project of single European currency as a political struggle between France and Germany for taking control of Europe.

José Maria Gil-Robles, former President of the European Parliament ruled in favour of the reserve currency. "EURO will provide protection against the risks involved by currency transactions; it will be easier to compare prices of goods and services in different countries. Euro shall stimulate competition, which will be beneficial for consumers and producers; it shall facilitate trade within the Single Market, also stimulating investments." According to the opinion of the former president of the European Parliament "EURO will be one of the most stable currencies in the world."

Considering the transition to the European reserve currency - the euro - there are few estimates regarding the direct cost generated by the changeover. According to calculations made by the German bank, this cost is approximately 0.5% of the GDP, while the same cost forecast made by the ECB is located between 20 and 50 billion. These figures cover all expenses supported by the public sector (production of new banknotes and coins, destroying old ones, their transport and public information) and those paid by the private sector.

As far as exchange rates are concerned, the changeover has had a double effect. First, national currencies circulating in the underground economy were converted into dollars in order to avoid declaring them to the authorities. On the other hand, the lack of confidence of those who held currencies of various European countries that were outside the monetary union made them convert the money into U.S. dollars.

People who had undeclared money tried to spend it, thus increasing the private consumption and the demand for goods in the last quarter of 2001. The impact upon prices is difficult to assess. In principle, the impact should have been very limited because the introduction of new currency did not affect marginal cost, even if currency conversion costs increased by rounding up could have created inflation.

A first estimate made by Eurostat in the European Monetary field shows that the impact of the changeover upon prices was of 0.16 points, at a monthly rate of inflation of 0.5% in January 2002. In France, the consumer price index grew by 0.1% and the bank of Italy forecasted 0.2% in January and February. According to another study carried out by the Bank of Spain and due to the rounding resulted from exchanging into euro, it was of 0.2% if the superior cent was rounded and of 1.65% if the superior decimal was rounded. German central bank has not published a global

forecast, but it admitted that prices have increased, especially in the field of services in 2002, announcing that the adjustment process has not ended yet.

Although theoretically, it was assumed that the changeover could not increase inflation, practically this is exactly what happened. However, if we compare inflation within the eurozone with that of EU member countries that have not adopted the euro, it should be noted that they had almost the same trend.

In 2002 the European Central Bank found that there was no tension in the prices resulting from the changeover; a greater transparency in prices should generate increased competition and thereby restricting inflation.

We are waiting to see whether the euro will be that dreaded rival of the US dollar on the global market. The Euro is still young, with a little experience related to the existence of a European reserve currency, therefore we cannot say with certainty that its future shall not prove that it has enormous potential.

Euro-dollar parity has known decreasing trends as well. This is also due to the contribution of a series of political and economic factors. First, a leading political factor was the dispute between former Finance Minister Oskar Lafontaine and the European Central Bank, which resulted in an unstable market. Lafontaine, who was sending clear populist signals, backed away from the idea that there could be sound public finances and questioned the independence of the ECB. Such attacks have had a disastrous impact on the euro. After his resignation the market became satisfactory and the exchange rate recovered. Another political problem was the crisis of the European Commission. It is well known that the Court of Accounts initiated a report in which it accused several members of the Commission of poor management or even fraud. This report caused a real European "government" crisis resulting in a depreciation of the euro. The third factor that influenced the evolution of the euro was, without doubt, the war from Yugoslavia. It affected the whole continent, thus questioning its stability. Although the war took place outside the eurozone, its consequences were felt by Member States as well, especially as far as the budget plan was concerned.

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