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IMPLICATIONS OF THE EURO CHANGEOVER ON SOCIAL POLICIES

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Abstract: *The paper is aimed at investigating the consequences that the Euro changeover has generated on social policies in the EU countries, both the developing and the developed ones. The sharpening of inequality within the most exposed developed economies is a fact. And at an European and global level it has caused the polarization of society. The paper identifies the means through which the Euro changeover has had negative or positive effects over the social indicators inside the European Union. By analyzing these indicators, the paper determines the effects that the changeover has on all social aspects, including those of social inequality. By doing so, it can therefore be established, if the changeover is a solution or yet another problem on the globalized European social market.*

Key words: *changeover, social inequality, globalization.*

1. An historical approach to the euro introduction

The euro has been in existence just long enough to generate sufficient data for a first look at its actual performance, having been introduced in January 1999. This assessment presents eight studies that use post-1999 data to provide a first look at how the euro is actually affecting trade, financial markets, macroeconomic policy-making, and Europe's economic performance. The Euro is the single currency used in 12 EU member states. The euro came into being, at first in a cashless form on 1 January 1999, when these member states formed an Economic and Monetary Union (EMU) and permanently locked the exchange rates of their currencies against the Euro. Euro notes and coins were put into circulation in these 12 EU states on 1 January 2002.

The first 12 countries in the euro area are: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and Greece. The United Kingdom (UK) has decided not to participate but has indicated that it may consider joining at a later date.

Euro notes and coins were put into circulation on 1 January 2002. The euro is part of the process of EMU. EMU is provided for in the Maastricht Treaty, which the people of Ireland endorsed by referendum in June 1992. As well as the Euro, EMU has involved the creation of an independent European Central Bank (ECB). The euro is used also in Andorra, Monaco, San Marino and Vatican City. Several overseas territories of the 12 "Euro zone" countries use the euro: these include

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the Canaries, Madeira, the Azores and the French Outre-Mer territories (Guyana, Martinique, Guadeloupe, Reunion and the collective territories of Mayotte and St Pierre and Miquelon).

On 1 July 1990 stage one of economic and monetary union begins. Capital movements in the EU Member States are fully liberalized (except where temporary derogations have been granted). On the 1st of January 1993 the single market is completed and on the 1 November 1993, the composition of the ecru basket is frozen. Further on the Treaty on European Union signed in Maastricht enters into force. On 1 January 1994 the European Monetary Institute (EMI) is set up in Frankfurt. Procedures for coordinating economic policies at European level are strengthened. Member States strive to combat 'excessive deficits' and to achieve economic convergence.

On 31 May 1995 the Commission adopts Green Paper on the single currency (reference scenario for the transition to the single currency).

On 15th and 16th of December 1995 at the Madrid European Council the name 'euro' is adopted for the single currency. A technical scenario for introduction of the euro and timetable for changeover to the single currency is finalized in 1999 (end of the process scheduled for 2002). Further on, on 1 June 1998 the European Central Bank is created. Then, on 31 December 1998 conversion rates are fixed.

On 1 January 1999, stage three of EMU begins. The euro becomes the new currency for eleven Member States and a single monetary policy was introduced under the authority of the ECB, heralding the third and final stage of monetary union. Euro area financial markets are switched to the euro, including foreign exchange, share and bond markets. New euro area government debt is exclusively issued in euro as from this day.

On 1 January 2001 Greece becomes the twelfth EU Member State to adopt the euro, and following that on 1 January 2002 the euro is launched.

1 March 2002 is the official date on which the euro becomes the sole legal tender in all euro area countries. On the 28th of June 2004 among the 10 Member States that joined the EU in May 2004, Estonia, Lithuania and Slovenia enter ERM II, and one year later on the second of May 2005 Latvia, Cyprus and Malta join ERM II.

2. Financial objectives of the Euro-zone

2.1. The effects of economic trade on the Euro

The classic currency union trade-off highlighted by Robert Mundell in 1960 weighs a trade gain against a stabilization loss. While the existence of both the trade gain and the stabilization loss has always seemed intuitively plausible to most observers, measurement of the trade effect probed elusive. Indeed until Andy Rose published his path breaking paper in the April 2000 issue of Economic Policy, the received wisdom was that the trade effect of exchange rate volatility was negligible. What Rose found was that the pro-trade effect of a currency union was huge, with a common currency boosting trade between nations by as much as 300%. Subsequent studies confirmed the existence of the effect, but found it to be smaller. For example, using a different statistical technique, an article published in the October 2001 issue of Economic Policy by Torsten Persson finds the effect to be something like 10-20%.

The applicability of these findings to the euro has always been questioned. Rose's results stemmed from data on currency unions involving very poor and very, very small nations. Fortunately, the time for extrapolating from evidence on other currency unions is at an end. Alegandro

Micco, Ernesto Stein and Guillermo Ordonez (2003) use data on the actual trade performance of Euro-land nations to check whether the euro has boosted trade. They find that the euro has already had a noticeable impact on trade of Euro-land nations by between 4 and 16%. The findings of Micco et al., however, raise many questions as the discussion by Karen Helene Midelfart points out. The extensive sensitivity analysis performed by the authors makes it clear that Euro-land membership is not a magic formula for trade. The reason for this is that the trade effect is quite different for the various euro nations. It ranges from a negative impact for Greece to a very big positive impact for the Netherlands. Moreover, the authors find that adoption of the euro tends to boost a nation's trade with all nations, not just other Euro-land members. This suggests that adoption of the Euro promotes trade in a way that is more akin to a unilateral trade opening than it is to formation of a customs union.

While much additional research needs to be done before the profession can confidently assert that it knows how and how much the euro boosts trade, studies so far do manage to establish that the euro has already boosted trade.

2.2. Macroeconomic objectives of the Euro at a European Level:

1. Price stability:

This is the primary objective pursued by the European System of Central Banks (ESCB), which operates in full independence.

2. Sound public finances:

The Treaty sets out a number of requirements in order to avoid that Member States run excessive levels of government deficits or excessive levels of government debt relative to GDP. The Stability and Growth Pact moreover prescribes that Member States should have budget balances close to balance or in surplus over the medium term.

3. Low interest rates: The level of interest rates benefits from low inflation expectations, improved control of government debt (which allows for improved borrowing possibilities for private companies) and the increased size of euro securities markets, which improves liquidity. In addition, the elimination of exchange rate fluctuations has a positive impact on intra-European trade and a further downward impact on the level of interest rates.

4. Incentives for growth, investment and employment:

Price stability, sound public finances and low interest rates constitute ideal conditions to foster economic growth, investment and employment creation within the euro area.

3. The influence of the changeover on the European welfare state

3.1. Welfare effects of the monetary union

In this section, the paper investigates various theoretical arguments pertaining to the welfare effects of a monetary union. More mechanical effects of common currencies (e.g., transactions-cost savings on currency conversion, the loss of foreign exchange trade, or the liquidity effect reducing the transactions costs of buying and selling financial assets) are specific to each currency-union project, and they are described in more detail in this section, which outlines the first experience of European financial markets under EMU.

Here, the paper will focus on the two main principles regarding the long-run macroeconomic implications of monetary union operating through financial markets. The underlying assumption is that multiple currencies prevent national financial markets from integrating more deeply, thus depriving agents of the potential benefits of financial market integration.

First, this chapter examines the benefits of risk-sharing through asset markets, whereby risk-averse agents can insure against income shocks by diversifying their portfolio across the whole unified currency area, rather than being restricted to the (smaller) national asset markets. Second, the paper tries to examine the theory and empirical evidence of the allegedly positive link between financial market integration and growth, and give some estimates of the potential growth effects of EMU. Regarding international risk-sharing, a first theory that will be analyzed is that of interregional and international risk-sharing It is a well-known result of the general-equilibrium theory that if asset markets are complete, risk averse individuals can and will fully insure against consumption fluctuations across states. In an environment that has neutral money and multiple currencies, this implies that the choice of an exchange rate regime will not have any impact on social welfare (Helpman 1981, Kareken and Wallace 1982, Lucas 1982). In practice, however, asset markets will be incomplete and risk cannot be completely hedged, in particular at the more aggregate level, and so the exchange rate regime may indeed matter. There are two approaches to considering the impact of the exchange rate in the context of region-specific shocks hitting the economy.

First, flexible exchange rates may substitute for other adjustment mechanisms (like price and wage adjustments or central fiscal transfers) if the latter are not available. This important insight, by Mundell (1961), underlies most of what has become known as the Theory of Optimum Currency Areas. What is perhaps less known is that, several years later, Mundell presented a new view of common currencies as a means of smoothing shocks by better reserve pooling and portfolio diversification. According to this approach, which has recently been rediscovered by McKinnon (2000), countries sharing a single currency can mitigate the effects of asymmetric shocks among themselves by diversifying their income source and adjusting their wealth portfolio. The international diversification of income source can operate through income insurance when residents of a country hold claims to dividends, interests, and rental revenue in other countries. Such ex-ante insurance allows the smoothing of both temporary and permanent shocks as long as output is imperfectly correlated.

A country's residents can adjust their wealth portfolio in response to income fluctuations by buying and selling assets and borrowing and lending on international credit markets. Such ex-post adjustment allows the smoothing of transitory shocks (Mongelli 2002, 13, and references therein).

By emphasizing the foreign exchange market's forward-looking nature, Mundell (1973) shows how future exchange rate uncertainty could disrupt the capital market by inhibiting international portfolio diversification and risk-sharing. As McKinnon (1996) demonstrates, the gains from proper risk-sharing through a common currency should show up as a net reduction in risk premia on interest rates for the system as a whole.

3.2. The Euro influence on the welfare state

Following the introduction of euro cash on 1 January 2002, the perception of strong increases in prices was a much discussed topic in nearly the entire euro area. Public opinion polls showed that euro-area citizens believed that the introduction of euro cash would cause price rises. Over 93% held this opinion according to a recent survey from the European Commission. Brachinger (2006) for Germany and Fluch and Stix (2005) for

Austria established in detailed studies that perceptions of price increases can be observed, even when other variables are controlled for.

However, official statistics showed that average price inflation remained fairly constant during the introduction of the euro. Indeed, only 0.09% to 0.28% at most of the observed 2.3% price inflation could be attributed to the euro, while unrelated factors, such as new tobacco taxes, extra travel security costs following 9/11, the impact of bad weather on fruit and vegetables prices, and high energy prices, all contributed to "normal" inflation.

The Deutsche Bundesbank concluded that the introduction of the euro did not have a major impact on the cost of living as a whole (cf. Deutsche Bundesbank 2002). Significantly, inflation rates outside the euro area, such as in Denmark and the United Kingdom, showed similar behavior for similar sorts of reasons (cf. European Commission 2006a). This apparent gap between the actual inflation rate and the perception of inflation must be seen as a first reason for a possible loss in financial satisfaction because of the introduction of the new currency. The reasons for this gap are twofold. First of all, sectoral studies show a "grey zone" of consumer goods and services that did indicate unexplained price rises during the euro changeover. Most of these were in the service sector, including restaurants and cafés, hairdressers, and repair and cleaning services. Notably, these are sectors with relatively little competition—small local shops rather than large retailers—and they are for everyday goods and services that people frequently purchase but that form only a minor portion of the cost of living. Many national studies confirmed large price increases in these sectors, particularly in the period 1996 to 2005, when prices for durable goods remained either stable or fell. A second explanation is a subjective approach to consumer behavior. The psychological observation is that price increases are noticed more than decreases, and the fact that consumers tend to compare 2006 prices with the price in national currency in 2001. This approach appears potentially fruitful in explaining the large and persistent perception gap and its origin.

If inflation or, equivalently, the prices of consumption goods are overestimated, the subjective perception of purchasing power decreases. Thus, the individual is less contented with income when household income remains constant. In addition, the subjective value of a given income may be valued less when it is changed into euros if the euro is associated with higher inflation rates.

A second reason for the decline in well-being may have evolved from the change in the nominal value of incomes. The tendency to value economic transactions in nominal, rather than real, terms is called money illusion (cf. Fisher 1928). In principle, the actual value of income can be assessed in either nominal or real terms. Shafir et al. (1997) propose that a nominal representation of income is a common phenomenon because the nominal value is a salient and natural unit of money. In view of the fact that most units of measurement do not change (for example, the meter-kilogram-second systems of units), the introduction of a new currency - and with it a new unit of measurement - represented a deep intervention in the usual frame of economic reference. However, the evaluation of the true value of income is feasible only with reference to the real representation. In reality, people expect to to evaluate their income in accordance with neither a purely nominal nor a purely real representation. Instead, they are supposed to make use of a mixture of both concepts. This behavior induces, as a consequence, a bias in the evaluation of the

actual value of income. The reference to nominal terms also applies to the assessment of prices. However, Shafir et al. (1997) provided evidence that people are particularly averse to nominal cuts in earnings. It is proposed, therefore, that the impact on incomes overcompensates for the impact on prices. In addition, and as argued earlier, the perception of disguised increases appears to dominate people's opinions on prices.

4. The effects of the EURO changeover on the Romanian Welfare State

4.1. Economic effects on the Welfare State in Romania

As presented so far, several effect can be observed, that tend to affect the welfare state, after the euro changeover would be realized. The most important aspect concerns the national economy. Studies have shown that Romania would suffer a 50% fall in its standard of living, if the euro changeover were to take place before the year. Specialists declare that such a measure would mean a step back for the Romanian economy as it would turn as back to the year 2002. In 2002 the Romanian GDP was around 40 billion euro, while in 2011 the GDP had increased to 120 billion euro. The changeover would mean a return to a smaller GDP similar to that of the 2000-2002 period. Seeing how Romanian social policies are in most of their part financed by the state, the changeover would clearly affect social policies as we know them in Romania. Romania has not managed so far to develop its third private pension pillar and has poor or un-existing private sectors in education and health services.

In the last period of time, several thoughts have been expressed by the Romanian National Bank, regarding an euro changeover. Specialists working for the BNR seem to consider inadequate a changeover, due to the Greek example. Not only has Greece economy been one of the most affected economies in Europe after the changeover, but it now has one of the poorest welfare states inside the European Union, rising questions for Romanian authorities on whether the changeover would affect not only the Romanian economy, but several other sectors, like the one of social policies.

Another problem that has risen doubts after witnessing the Greek experience is that of the high increase in prices. Even so, specialist tend to think that an increase in price, shouldn't be a particular problem as long as the exchange rate will not be overrated. Some advantages could come from transaction costs for companies and for population.

4.2. The EU solution to the welfare stare-changeover problem

Positive effects from the euro changeover come from the increase in the euro base, every time another country enters the euro zone. The European Union gains an increase in incomes, and therefore every national GDP will benefit from an increase generated by higher incomes. Therefore, states that finance social policies will benefit from the euro changeover, and will have a stronger financed welfare state. European leaders do not necessarily look to save states that have problems in the euro changeover. The European Union looks to save it on financial resources that have been transferred over the years, through banks, by means of purchasing shares and stocks. Banks from Germany, France or Italy have bought shares and stocks for several years, and are now trying to get a refund. The principle requires that all European states contribute to the incomes that the European Union requires and therefore a larger euro base is necessary.

Another aspect that concerns the welfare state and the relation it has with the euro changeover is that of the federalization that

is supposed to happen in the EU. Such federalization would generate a higher cohesion of all internal structures of the European Union, including that of social policies. Studies have shown that the biggest benefit would be that of less expensive transaction costs. Another important problem that would need to be solved would be that of fiscal polices. Specialists claim that without a unified fiscal policy, the euro will not be able to be solid for a long period of time. Further on, once fiscal policies are united in an European version available for all member states, it will likely help social policies be financed through an unique model through the European Union. Only when regarded by the same law, at an entire EU level, will we be able to finance social policies, in a way that we will be able to once again develop the welfare state. With a fiscal policy directed from Brussels and with a stronger euro zone, we will perhaps have a unique social welfare model, different the classic models that we study today, one that will perhaps answer the need of citizens through Europe, regardless of the country they come from.

In the end, the euro introduction is undoubtedly beneficial for the country, but same of negative can be observed. The fulfillment of the economic convergence criteria already beginning of 2007 is realistic, but the national authorities must carefully monitor macroeconomic developments and pursue prudent economic policies.

This paper has reviewed both the theoretical and empirical literature on the impact of euro to Europe on financial markets. The euro currency can improve welfare. Agents will be encouraged to diversify their portfolios internationally, thus obtaining decentralized insurance against asymmetric shocks to their income. The evidence shows that idiosyncratic shocks are larger, and smoothing is lower, internationally relative to nationally, and that a large share of international risk-sharing is due to diversified property holdings in the European case. The experiences that European financial markets have had introducing the euro shows that monetary union can indeed provide an important stimulus towards financial integration, both directly and indirectly.

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