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THE EURO: READY OR NOT?*

by

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HAY STOCKS AND PRICES LOWER

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Introduction¹

On January 1, 1999, fifteen independent nation-states of Europe are set to relinquish their national currencies in favor of a single European monetary unit, called the **euro**. While the origins of the European Union (EU) (formerly referred to as the European Community) date back to the Marshall Plan, the inception of the euro occurred in February of 1992 with the passage of the Treaty on European Union, or *Maastricht Treaty*.²

To economists, the prospect of a European Monetary Union (EMU) is nothing short of remarkable. The notion that fifteen independent nation-states of Europe are about to (willingly!) dissolve their national currencies and adopt a single monetary unit of exchange is difficult for most of us to fathom. But, while economists are obsessing over such matters for obvious reasons, why anyone else, particularly Americans, should care about the EMU is not immediately clear. Nonetheless, the answer is simple. The European Union overpowers the US in both production and population, hence if the EMU succeeds, the increased competitiveness offered by a single European currency may threaten the US's dominance as a world economic power. Should the EMU fail - data on each of the 15 member states suggest that the transition to a single currency will be difficult for some and nearly impossible for others - the effects on European and American economies could be destabilizing.

(Continued on p.2)

*The author thanks Evert Van der Sluis for reviewing and commenting on the SDSU Economics Pamphlet #98-1 from which this paper is drawn. In addition, many thanks are extended to the Money and Banking students at SDSU, by whose class project this paper was inspired.

Hay stocks in South Dakota as of December 1, 1997 totaled 8.180 million tons, down 350,000 tons (4.1%) from December 1996 and down 780,000 tons (8.7%) from 1995. This makes South Dakota second only to Texas, with 8.632 million tons, in the amount of hay on hand as of December 1. US hay stocks totaled 102.52 million tons and the states bordering South Dakota plus Indiana, Illinois, Kansas, and Missouri totaled 48.940 million tons.

Despite the lower hay stocks this year, local hay prices are lower compared to a year ago. One reason is that more hay is available per head of livestock this year. On December 1, 1997, in South Dakota, there were 2.40 tons of hay available per head of cattle compared to 2.36 tons a year earlier. Nationally, there is not much difference between 1996 and 1997. On December 1, 1997 there were 1.030 tons per head available, compared to 1.032 in 1996. For the area consisting of South Dakota and the six states bordering it plus Indiana, Illinois, Kansas, and Missouri, the inventory on hand December 1, 1997 was 1.23 tons per head, down from 1.27 tons per head a year earlier.

A second reason for lower prices this winter is the mild weather. The weather this fall and first part of the winter has been very mild, reducing the amount of feed needed and consumed by forage consuming animals. The mild weather also allowed for late fall and early winter grazing, reducing the demand for hay. This is in sharp contrast to the 1996-97 winter, which came early and was much colder than normal for much of the winter.

As a result of lower demand for feed due to mild weather, hay prices have eased back since late October-early
(Continued on p.4)

The EMU and the US: The Costs of Ignorance

If a united Europe is to pose a threat to the US, it will come in the form of economic competition. While the individual nations of Europe are not very large relative to the United States - Germany is the largest at just under 30% of US GDP - the Union as a whole out-produces the US in any given year. Moreover, the EU is nearly one and a half times larger than the US, with 371 million inhabitants living in 15 separate nations.³ In addition, the European economy is highly concentrated, with four nations - Germany, France, Italy and the United Kingdom - comprising 73% of total production within the Union. Indeed, even if the EMU were to be comprised of only Germany, France and Italy upon its inception, as some observers predict will be the case, the value of its output will be equivalent to 65% of that of the US.

But, the European Union is *already* large, so why the fuss about the adoption of a single currency in 1999? While it is true that the European union is not going to expand suddenly on January 1, it has the potential to become increasingly more competitive because of the benefits associated with monetary union. Indeed, the adoption of a single medium of exchange (currency) enhances competitiveness in three ways. First, transactions costs are reduced by eliminating national currencies. In particular, since exchange rates between the European currencies no longer exist, the costs associated with the changing of monies disappear. In addition to freeing tourists of the commission costs on currency exchanges, European corporations and investors experience reductions in the costs of doing business in other (European) countries. Second, resources are allocated more efficiently through the elimination of exchange rate risk. Exchange rate uncertainties can cause a firm to limit its investments to domestic resources, even if foreign resources are more efficient, for fear that foreign currency devaluations will erode its profits. Hence, in the absence of exchange rates, European resources will be used more efficiently. Third, governments participating in a monetary union are more likely to commit to a policy of price stability (Eichengreen 1992:4). Hence, the damaging effects of inflation and disinflation are eliminated as well.

Consequently, the EU's adoption of a single currency will increase the economic efficiency of the Union, thus, transforming it into a formidable economic foe. Even if these efficiency gains are not enough to threaten the dominance of the US in the world economy, the EU and the proposed EMU are clearly issues which merit our attention.

The Pitfalls of Monetary Union: The Economics of a Single Monetary Unit

Since a common currency will require a common monetary policy, each nation will be forced to relinquish control of its monetary authority (central bank), and

monetary policy will fall into the hands of the proposed European Central Bank (ECB); the ECB will be immune to political pressures, committed solely to the objective of maintaining price stability in the Union (Corden 1994: 152). With the ECB focused on managing the performance of the entire European Union, it will be unable to pursue discretionary policies specific to a particular nation's economic circumstances. That is, the adoption of a single currency will effectively tie the hands of each nation's policy makers, rendering their economies defenseless to shocks. So, in order for the ECB's monetary policy to satisfy every member of the Union, all economies within the Union must 'converge' so that each expands and contracts simultaneously, and at similar speeds.

For example, if Spain is growing more slowly than Finland, a tight monetary policy will be appropriate for the Finnish economy, but harsh on the Spanish economy. Likewise, a loose monetary policy that seeks to encourage growth in Portugal can cause inflation in Germany. In summary, under a single currency, directing monetary policy to one region of the EU without affecting the economies of the other regions will be impossible. Hence, the member economies must be synchronized so that region-specific problems simply do not arise. For this reason, the Maastricht Treaty requires that Union members' economies sufficiently 'converge' prior to their joining the Union.

The Maastricht Treaty: The Rules of the Game

Passed in February of 1992, the Treaty on European Union, or *Maastricht Treaty*, requires the European Union to achieve "a single stable currency;" this single currency has come to be known as the **euro**, set to take effect on January 1 of 1999 (Holden 1992: 12). The agreement specifies five criteria to which member states' economies must adhere in order to gain acceptance into the EMU by the 1999 start date: (1) price stability, defined as a rate of inflation within 1.5 percentage points of the three best performing EU countries; (2) low long term interest rates, defined as within two percentage points of the three lowest scoring EU countries; (3) exchange rate stability, meaning that for at least two years the country concerned has kept its currency within the normal fluctuation margins of Europe's exchange rate mechanism; (4) a sustainable government financial position, defined in two ways: a budget deficit no higher than 3% of GDP; and, a ratio of public debt to GDP of no more than 60% (Economist 1997: 7).

With less than one year to go before the scheduled start date of the European Monetary Union, the critical issue centers on whether or not the 15 member economies are sufficiently similar to warrant a single currency between them. In the next section, we approach this question by examining data on the European Union pertaining to the convergence criteria stipulated in the Maastricht Treaty.

The Prospects for Convergence: A Look at the Data

The following cursory analysis examines the behavior of

output, inflation, exchange rates, interest rates and government finance for each of the 15 member states in an attempt to provide some insight as to the feasibility of implementing the euro.

Growth in Real GDP. If the Union's economies have sufficiently converged, one should observe similar rates of growth for each of the member states. Of the larger member states, Germany's growth in the last 18 years has outpaced that of France, Italy and the United Kingdom by as much as 125% - 150%. Moreover, these differences in growth continue to exist today. Namely, an examination of average growth rates within the last six years suggests that Germany outpaces the other large Union members by 160% to 260%.⁴

Growth in the Price Level. Over the long run, Greece, Italy, Portugal and Spain have suffered with double digit inflation, while price levels in Austria, Germany and the Netherlands have remained under control; of the remaining large economies, France and the United Kingdom have had relatively high, albeit not excessive, rates of inflation. However, while the average rate of inflation over the last 24 years differs significantly among countries, only that of Greece remains disturbingly high today.

Foreign Exchange. Exchange rate volatility has decreased considerably in the last decade and only Greece and Italy continue to have difficulty with this criterion.

Long-Term Interest Rates. Presently, interest rate stability is not a problem for any of the member nations (Economist 1997: 7).

Deficit to GDP and Debt to GDP. Four EU members have maintained deficit to GDP ratios under the Maastricht specified 3% in the last 24 years.⁵ However, three of the members have experienced ratios in excess of 3 times the Maastricht specification. In terms of debt to GDP ratios, Belgium and Italy appear to be in greatest violation of the 50% ceiling. Meanwhile, three of the largest members, Germany, France and the United Kingdom, should have little difficulty meeting this criterion. In any case, the survival of the euro is not integrally dependent upon the Union's adherence to these two ratios, and hence it is possible that Union members will overlook violations in this area.

In summary, while inflation and interest rate volatility do not pose a problem for any of the members, divergent growth rates, exchange rate volatility and fiscal instability suggest that some member states will have difficulty gaining entrance into the proposed monetary union.

The notion that the EMU could collapse is disconcerting as well as destabilizing in two respects. First, should the euro fail before being implemented, investors may abandon European currencies as expectations regarding the future strength of the Union dissolve. The uncertainty caused by this event would hamper investment within the Union as

well as increase the value of the dollar relative to EU currencies. The former would diminish the growth of the EU while the latter would hurt the US as exports to Europe decreased and imports from Europe increased. Second, if the euro were to fail *after* Union members relinquished their national currencies, the value of the euro would depreciate as nations attempted to re-introduce their national currencies. This case would be particularly destabilizing for Europe as newly issued (but abandoned) euros co-existed with re-issued member currencies. A period of uncertainty, coupled with investor speculation, would most likely result in an international collapse of confidence in the European Union.

Conclusion

According to the Maastricht Treaty, on January 1, 1999, fifteen independent currencies of Europe will be dissolved in favor of the euro, a single European currency unit. But, with less than one year to go before the scheduled start date, few nations have sufficiently satisfied Maastricht's convergence criteria. This finding is disturbing because the failure of the euro could lead to uncertainty, thus hampering investment within the Union as well as hurting US exports.

On the other hand, if the EMU succeeds, cost reductions and efficiency gains are certain to make the EU more competitive. Therefore, that the US prepare to compete with a larger, more streamlined Europe is crucial. In either case, the changes taking place in the European Union are monumental, and hence warrant the attention of all nations, particularly the US.

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Endnotes:

1. All data used in this analysis are from: International Financial Statistics Yearbook 1997, International Monetary Fund. For a more complete analysis of these data, see the author's Econ Pamphlet #98-1, published by the SDSU Economics Department, titled The Euro: Ready or Not? A Retrospective on European Unification: Some Lessons for 1999.
2. The term 'European Union' replaced 'European Community' with the passage of the Maastricht Treaty in 1992.
3. Currently, the EU consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, the Irish Republic, Luxembourg, The Netherlands, Portugal, Spain, Sweden and the United Kingdom.
4. The average rates of growth for the period 1990-1996 were as follows: Germany 2.6%, UK 1.6%, France 1.1% and Italy 1.0%.
5. Data were unavailable for Italy and Luxembourg. The former is believed to have a deficit near (but above) the required 3% of GDP, while the latter is in compliance (Economist 1997: 7).

(Hay ... cont'd from p.1)

November. It appears that hay prices peaked about the first of November when small square bales of premium alfalfa were selling at auction in the \$145 to \$175 per ton range. During January, auction prices have been mostly between \$95 and \$120 per ton with a bottom of \$85 and a top of \$150. By contrast, a year ago prices were between \$130 and \$200 per ton, depending on the weather on sale day. South Dakota hay dealers were quoting \$100 to \$120 per ton (FOB farm stack or barn) at the end of January, down slightly since the first of the month and \$10 to \$30 under year ago prices.

Very little premium alfalfa in large round bales has been sold recently at auction, so it's hard to get a good reading on price. Maybe \$90 per ton, plus or minus \$10, would be representative in recent weeks. Good quality has been more abundant and has been selling mostly between \$67 and \$90 per ton, about \$25 less than a year ago. South Dakota hay dealers were quoting \$70 to \$90 the end of January for good alfalfa in large round bales, compared to \$80 to \$100 a year ago.

Grass hay has followed much the same pattern. Premium grass in small square bales has declined \$10 to \$35 a ton since the first of November. Current prices are in the \$80 to \$115 range.

A year ago, prices were between \$120 and \$175 per ton. Good grass in large round bales is in the neighborhood of \$57 to \$87 per ton, \$3 to \$15 under two months ago and about \$8 to \$15 under year ago prices. Fair quality grass in round bales has bounced around some, but the pattern is sideways, mostly between \$45 and \$55 per ton.

Although hay prices are lower this year, they appear to be holding at profitable levels for the grower. So far, it has not paid for sellers to store their hay this year. Normally, hay prices increase about 1% per month, peaking in February or March. This is not happening this year. Prices can be expected to strengthen only if the winter turns cold and snowy, thus forcing the feeding of more hay for more energy and pasture replacement.

ECONOMICS COMMENTATOR

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