THE DISADVANTAGES OF JOINING THE EURO: LESSONS FOR ROMANIA

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Abstract: *The article covers the disadvantages the countries that are currently within the Eurozone are facing at the moment and how these disadvantages will impact the Romanian society if it joins the Euro. The article is divided into 3 chapters: the deflationary impact, the decline in competitiveness and asymmetric shocks.*

Key words: *Eurozone, deflation, competitiveness, asymmetric shock.*

1. Introduction

The experience of the past few years has been that membership of the Euro can devastate an economy. Given a chance, half of the members of the Euro countries would wish they had never joined. Greece, Spain, Italy, Portugal, Ireland would all be better off outside the Euro [7]. But leaving the Eurozone is even more difficult. Membership of the Euro dooms an economy to inflexible exchange rates and can create a very strong deflationary tendency.

The result is mass unemployment, political instability and a feeling of being squeezed and ordered around by European Union officials. An economic system which creates recession and unemployment cannot help in any way improve European unity. The most important causes that lead to this presumption are the deflationary impact of the Euro that is threatening to create splits within Europe, the decline in competitiveness that affected more countries than it helped and asymmetric shocks which may be found in most currency areas.

2. The deflationary impact

Deflationary bias means that there is a tendency for the economic policy to promote lower growth and lower inflation. It means that there are pressures which keep demand subdued leading to lower inflation, higher unemployment and lower growth.

The ECB has a very tight agenda to keep inflation less than the target of 2%. For example, in 2011, cost factors led to an increase in the headline rate. The ECB responded by increasing interest rates. The Bank of England responded by keeping interest rates at 0.5% (even though inflation was much higher in the UK than EU). The Bank of England argued it was important to consider wider economic issues of growth and unemployment [4]. The ECB is much less willing to accept even a temporary deviation from the inflation target over fears temporary inflation would increase inflation expectations. Thus, the ECB is willing to risk lower growth than risk higher inflation.

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Members of the Eurozone have a common currency. Therefore, they cannot devalue the currency if they lose competitiveness. By contrast, in 2007, UK exports were relatively uncompetitive. In the recession of 2008-2009, this led to a sharp fall in the value of the pound to restore competitiveness and reduce the UK current account deficit with the Eurozone. Since January 2007 when 1 EUR cost 0.65 GBP, the pound depreciated to almost parity (1 EUR cost 0.98 GBP in December 2008).

Fig. 1. *Weekly chart with the depreciation of GBP against the Euro*

Other Eurozone countries had become relatively uncompetitive. This is reflected in the size of the current account deficits as a percentage of GDP (Portugal – 6,42%, Cyprus – 8,47, Greece – 9,67% as of 2011) [6]. These countries cannot devalue the currency. To regain competitiveness, create jobs and reduce current account deficit, they need to reduce inflation by reducing wages and other costs. However, to regain competitiveness they may require very substantial reduction in wages and costs. Therefore, this may lead to a prolonged period of low inflation or deflation. This in turn leads to lower growth. Reducing a current account deficit of 5-10% of GDP through internal devaluation does create an inbuilt deflationary bias. If devaluation was an option, they could restore competitiveness more quickly with less adverse impact on the rate of growth.

Markets are afraid that the Eurozone countries will have liquidity shortages because their Central Banks cannot buy bonds in case of liquidity shortages. Therefore, many countries are facing pressure to reduce government spending and reduce budget deficits which leads to lower growth.

As opposed to the Federal Reserve in the United States and the Bank of England, the ECB is reluctant to engage in any quantitative easing because:
- they are reluctant to create any possibility of future inflation
- they are reluctant to start buying bonds of different countries, deciding on which to buy and thus create discrimination among EU countries.

The result is that countries with many deflationary pressures (strong exchange rate and fiscal austerity) do not have any monetary stimulus to offset the fall in demand. For example, the Bank of England pursued quantitative easing when they experienced deep recession, but countries in the Eurozone could not.

3. Decline in competitiveness

Countries have a tendency to have different productivity and growth rates. A supply shock might make their exports more expensive. But, in the Euro they will not be able to devalue. Since they cannot devalue or pursue an independent monetary policy, they have to rely on internal devaluation. This means wage restraints, spending cuts and low economic growth, as companies seek to regain competitiveness through lower prices. Internal devaluation may work, but then the country may experience several years of high unemployment. If one looks at the countries which have the ability to devalue, this tends to be quicker and a less painful process of readjustment.

The purpose of harmonized competitive indicators is to show changes in relative competitiveness of countries. They are also consistent with the real effective exchange rates (EERs) of the euro. Table 1 shows the divergence in competitiveness between a country like Germany (improved competitiveness) and other countries such as Greece and Ireland which have seen higher unit labour costs.

Harmonised competitiveness indicators based on unit labour costs indices for the total economy   Table 1

	Euro area	BE	DE	EE	IE	GR	ES	FR	IT	CY	LU	MT	NL	AT	PT	SI	SK	FI
1. Period average	96.6	102.6	83.0	144.6	107.9	105.0	107.9	103.1	107.8	112.8	118.1	111.8	106.2	92.3	106.8	106.0	174.7	102.5
2. Percentage change versus previous period	-1.5	-0.2	-0.9	-1.9	-2.2	-3.6	-1.3	-0.5	-0.2	0.6	-0.2	1.5	-0.6	-0.7	0.0	-1.0	-0.7	-0.5
3. Percentage change versus previous year	-5.8	-0.5	-3.5	-6.2	-6.8	-3.4	-3.5	-1.7	-2.6	0.6	0.7	-2.2	-2.3	-2.5	-1.7	-2.9	-1.6	-3.6
4. Percentage change since 1998 Q4	-6.7	2.3	-19.0	39.7	1.8	8.8	7.5	2.6	4.4	10.6	15.4	12.0	4.1	-8.0	7.3	5.4	74.6	1.0

The ECB also shows harmonised competitive indicators based on consumer price indexes. The issue of competitiveness and relative prices becomes much more important in a single currency. This is because uncompetitive countries cannot rely on devaluing the exchange rate.

Harmonised competitiveness indicators based on consumer price indices   Table 2

	Euro area	BE	DE	EE	IE	GR	ES	FR	IT	CY	LU	MT	NL	AT	PT	SI	SK	FI
1. Period average	96.6	102.6	83.0	144.6	107.9	105.0	107.9	103.1	107.8	112.8	118.1	111.8	106.2	92.3	106.8	106.0	174.7	102.5
2. Percentage change versus previous period	-1.5	-0.2	-0.9	-1.9	-2.2	-3.6	-1.3	-0.5	-0.2	0.6	-0.2	1.5	-0.6	-0.7	0.0	-1.0	-0.7	-0.5
3. Percentage change versus previous year	-5.8	-0.5	-3.5	-6.2	-6.8	-3.4	-3.5	-1.7	-2.6	0.6	0.7	-2.2	-2.3	-2.5	-1.7	-2.9	-1.6	-3.6
4. Percentage change since 1998 Q4	-6.7	2.3	-19.0	39.7	1.8	8.8	7.5	2.6	4.4	10.6	15.4	12.0	4.1	-8.0	7.3	5.4	74.6	1.0

The result of competitiveness can be seen in statistics such as the current account. Countries which have become uncompetitive usually experience a large

current account deficit. The graph below shows how Greece has a current account deficit of 10%. This is unusually high and a signal of how uncompetitive Greece has become. Germany, by contrast, has a large current account surplus.
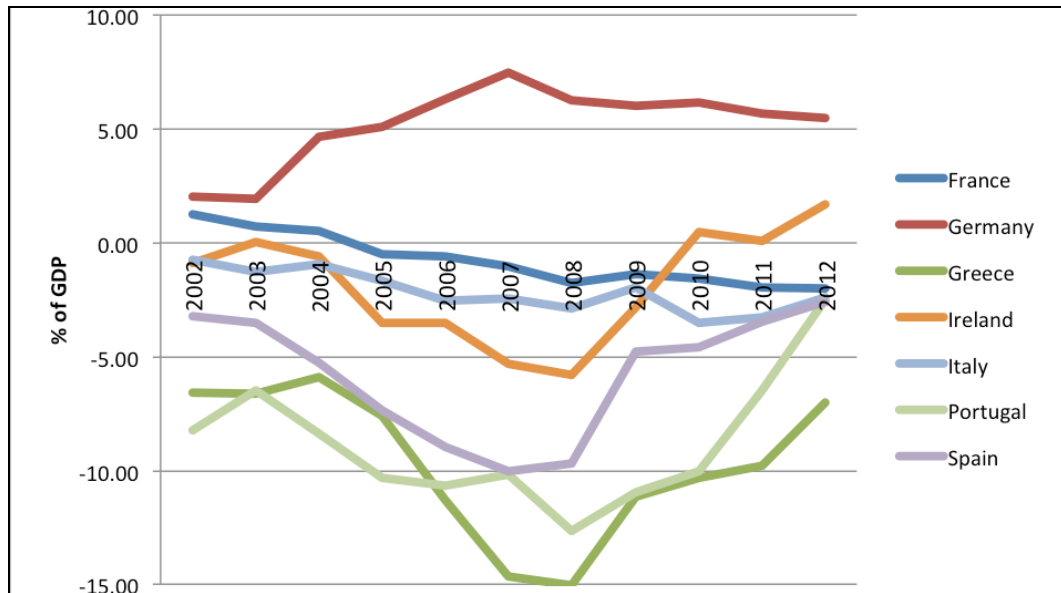

Fig. 2. *Selected countries' current account deficits as percentage of GDP*

4. Asymmetric shocks

Researchers have looked at the cyclical patterns in Central and Eastern European (CEE) countries. Fidrmuc examines all European countries and confirms that correlations with the German economy increased for Hungary and Poland during the 1990s and that the correlation for Hungary is one of the highest in Europe, but that the correlations are much lower in other CEE countries [3].

Darvas and Szapáry examined eight CEE countries joining the EU in 2004. They found that three have achieved a high degree of synchronization with the Euro zone economy: Hungary, Poland and Slovenia. Slovenia has already joined the Euro. The lesser correlation for the Czech and Slovak republics is attributed to the financial crises in the late 1990s and the lack of any correlation for the Baltics is attributable to their greater relative exposure to Russia and Sweden. It is no coincidence that the EU makes up a higher share of the exports of Hungary, Poland and Slovenia than of the exports of the other CEE countries [2].

One could also note the importance of geographical proximity in determining trade links and cyclical correlations: except for the Czech Republic, the CEE countries that border the euro area are the ones with high Euro zone trade links and correlations.

The effect of trade on cyclical correlation holds as much when high bilateral trade originates in low bilateral exchange rate variability or adoption of a common currency as it does when the bilateral trade originates in proximity, common membership in free trade areas, or other determinants.

All these findings contradict earlier findings by Krugman. He suggested that, because a higher trade level would lead to greater specialization, it would also lead to

lower synchronization of shocks. His view is that specialization works against common currencies and that diversification of the economy works in favour of it [5].

It is common to assume that the debate about whether trade raises cyclical correlations or lowers it, turns on whether the trade is primarily intra-industry or inter-industry. Fidrmuc extend the estimation to take specific account of intra-industry trade as a determinant of cyclical correlation. The presumption is that shocks in a world of inter-industry trade take the form of shifts from one industry to another: one country's loss is the other's gain, yielding negative correlations. In a world of intra-industry trade, industry shifts are assumed to affect all the product varieties produced in different countries, thus yielding positive correlations. Tests confirm the argument that intra-industry specialization is in fact the source of positive cyclical correlations, driving out total bilateral trade as an explanatory factor.

Two ideas may be wrong with this argument. First, a large share of trade today is in inputs and intermediate products. For example iron ore is made into steel, which is in turn made into machinery parts, which are made into the finished machine tool that is used in the production of something else. A positive shock at one point in the chain of value added in one country will tend to have positive spill over effects at the other points along the chain in other countries [8]. Thus, trade in inputs and intermediate products create positive correlations and may be recorded as inter-industry trade. Empirical studies by Fidrmuc seem to find that intra-industry trade links are associated with cyclical correlation and inter-industry trade links are not.

The second objection concerns supply versus demand shocks. Academics should be more interested in demand shocks than

supply shocks. Independent monetary policy is not much good at addressing supply shocks. Therefore, it does not much matter whether a country shares them with its neighbours. Independent monetary policy is more useful in addressing demand shocks. For these, bilateral transmission could come from either intra-industry trade or inter-industry trade. A shortfall in demand, originating in a fall in investment, will be transmitted to trading partners as a reduction in demand for imports of all sorts, products that are in the same industry as well as products in different industries. If the partners are unable to respond to shocks because they have given up their monetary independence, this will be less of a hardship to the extent that the common monetary policy is determined by a set of countries all experiencing the common loss in demand. But the distinction between intra-industry and inter-industry trade may be less useful than supposed.

5. Conclusion

When Romania joined the European Union, it agreed to join the Eurozone as well at some point. The promised date of January 1st 2015 is no longer in question, because Romania was supposed to join the Exchange Rate Mechanism (ERM II) two years before turning to the Euro.

Romania needs strong economic growth, around 4% a year, to converge to the standard of living in the Eurozone and to reduce the economic structural decays. But the forecasts for economic growth are 1.1% for 2013 and 2.5% for 2014, far below what Romania needs. The deflationary impact of joining the Euro would doom Romania to slow growth and widen the gaps in the standard of living.

The Romanian economy also needs structural change to become more competitive. Romania cannot join the Eurozone with 7% of GDP coming from agriculture. It needs more third sector

activities (services) and these come from prolonged economic growth and increased productivity and quality.

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