THE COMPETITIVENESS OF EMU MEMBER STATES IN THE FINANCIAL CRISIS

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In the context of the financial crisis the imbalances in the euro area have been underlined. The issue had been previously debated during the years preceding the financial crisis, but the strong global economic expansion and the ongoing economic integration within the euro area partly masked the problems arising from these differential developments. This paper analyses the advantages and disavantages of the monetary union before and during the financial crisis and focuses on identifying solutions to correct the structural problems that are at the root of the economic divergencies within the euro area. Another issue that we discuss is how did price competitiveness diverged from one euro-area member state to another since the introduction of the euro, causing gains in price competitiveness for a small group of countries and significant losses for a larger group. The issue of competitiveness is essential for Romania as we are heading towards joining the euro zone.

Key words: EMU, competitiveness, structural problems
JEL classification: H7, O2, O4

1. Introduction

It is clearly that since it was created ten years ago, the economic monetary union contributed to a favourable climate for economic growth within the euro area. Throughout the financial crisis, however, the euro proved to be far more than a growth factor for the euro area. In several respects it has stabilised the member economies (the absence of exchange-rate risk within the euro area has represented an additional benefit during the crisis avoiding problems like appreciating currencies and inflationary pressure). Practically, it has significantly diminished money market tensions and therefore served as a buffer against global financial market shocks.[66]

At the start of the global recession, the Euro appeared to be faring relatively well. Germany and France were two of the first major OECD economies to emerge from recession. The collapse of Iceland had many people suggesting the Euro as the solution to global instability. However, in the past few months, the growing problems of Greece and other peripheral Eurozone countries have highlighted some of the problems with the bold Single Currency experiment.

The first problem facing the Eurozone is the prospect of a deep and persistent recession in the southern Eurozone economies. Greece, Spain and Italy already have falling GDP, but, current economic policies make it hard to see how they will recover.

[66] Weber, A., Challenges and opportunities for the competitiveness of EMU member states. The euro in the financial crisis, Presentation at the Copenhagen Business School, Copenhagen, 22 March 2010

Taking the specific adjustment processes in a monetary union into account, we have to think about the conditions for sustainable growth in all euro-area economies and about how they can be achieved.

2. Literature review

There are several papers on the subject of the European Monetary Union. We will provide only a short description and analyse of the way the idea was created, developed and implemented.
After 1993, when economic growth was strong, both in Europe and The United States, the enthusiasm grew among European policy makers for completing the transition to the monetary union. Still, there were two countries that dropped aut of the process: the United Kingdom and Denmark. Targets for inflation, interest rates, exchange rate stability, and fiscal stability were set as criterion for participation in the monetary union (the most important: a budget deficit of not more than 3 % and a public debt of not more than 60% of GDP).[67]
In order to preserve the fiscal discipline, a Stability Pact was agreet in June 1997, and for stabilizig exchange rates between the euro and the currencies of the EU members that hadn't entered the monetary union, an ERM II was established. As for the ones that were do to enter the euro area, they agreed to lock their exchange rates from the mid-1998 for January 1999.
In 1998, The Economic Council decided for a large monetary union (including: France, Germany, Austria, Belgium, Luxembourg, Netherlands, Ireland, Italy, Spain, Portugal and Finland. The European Monetary Institute was created to prepare the common monetary policy.[68]
The European Central Bank developed the common monetary policy, focused on establishing anti-inflationary credentials. Critics argued that it was excessively rigid in what unemployment was concerned, but it allowed inflation to repeateadly stray above its target of 2%. The introduction of the euro began in 1999 and was completed at the beginning of 2002 (including Greece).
In 2002 and 2003, Portugal and then France and Germany violated the rule concerning the maximum percent of budget deficit in GDP. The Stability Pact was repeatedly bent and broken, under the umbrella of reformation in order to permit greater budgetary flexibility.[69]
The ECB considered price stability as an important objective, so in the context of a common monetary policy, the only tool that remained for dealing with each country's difficulties was national fiscal policy. The effective use of this instrument requires a budget close to balance in good times, so that a larger deficit would not damage confidence.

3. Implementation of the ECB Common Monetary Policy

3.1 Joining the euro area: advantages and disavantages for national economies

Obviously, a single monetary policy was difficult to satisfact the needs of several national economies. For example, Italy, which competed with China in the production of specialty consumer goods, would have preferred a weaker euro exchange rate and a looser ECB policy, in contrast with Ireland, whoose fast growing economy lead to rapid increases in property prices, so a tighter ECB policy would have been preferred.
For the relatively poor countries, like Portugal, joining the euro area meant decreasing the interest rates, which lead to growth of house-hold consumption and investments of firms. Increased demand resulted in increased wages, lagging competitiveness, and rising unemployment. The only solution was deflation and fiscal restraint, which were rising political issues at the national level.

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[67] Miron, D., Folcut, O., *Economia Integrarii Europene*, Editura Universitara, Bucuresti, 2008
[68] Ghica, L.A. et al, *Enciclopedia Uniunii Europene*, Editura Meronia, Bucuresti, 2005
[69] Eichengreen, B., *Globalizing capital – A History of the international monetary system*, Princenton University Press, 2008

The main advantage of the single currency is that it eliminates most of the financial risks, as the intra-European exchange rates fluctuations could no longer be a source of such risks, or of amplifing them. Another positive result of the euro was stimulating the growth of European secuties markets, by the effect of scale economies on bond markets, greater liquidity and lower transactions costs. It became easier for companies to issue bonds, which meant they benefited from a lower cost of capital, that resultes in an increased competitiveness.
An important beneficiary of the euro is the European consumer, as he can easily compare prices from different countries, which puts more pressure on the retailers and wholesalers. Studies by the OECD suggested that product market competition is critically important for stimulating productivity growth.

3.2 International currency competition
The short-term impact of the euro introduction was to reinforce the dollar's preeminence, as the foreign-currency reserves of two important European economies were tranformed into dollars. France needed to exchange it's reserve of deutsche marks into dollars and Germany did the same with it's reserve of francs.
After that, the euro began to gain strength, as the financial markets in euro area became more liquid than before, when there were many different national currencies.
Five years after the single currency creation, international debt securities issued in euros actually exceeded those issued in dollars (2004). The United States remaines the world's largest financial market, but the evolution of exports shows clearly that the EU is the international major exporter.

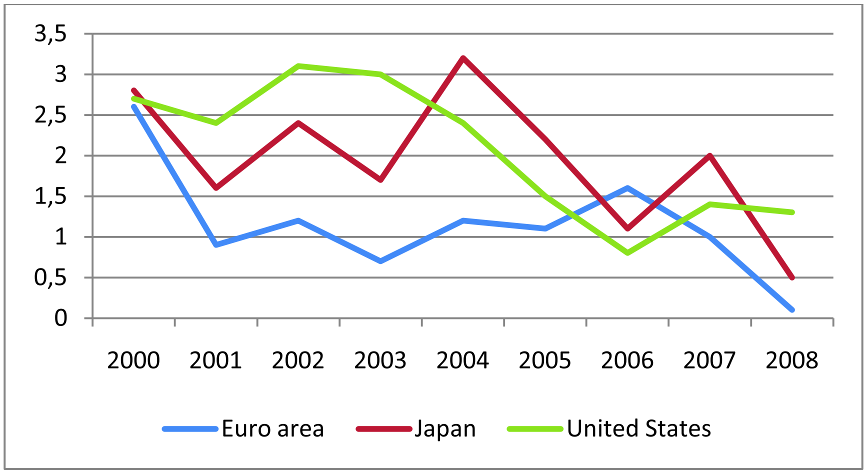
Table 1: Exports in goods (value), in billions of US dollars, monthly average

	2008	2009	2010 Jan
European Union	489,15	379,44	404,02
United States	107,29	88,07	98,40
China	119,16	100,13	123,70
Japan	65,31	48,25	63,68

Source: Monthly Statistics of International Statistics, OECD, 2010

The adoption of the euro by Slovenia (2007) and Malta (2008), extended the euro area, plus the prospect of new members from Central and Eastern Europe gives hope for the single European currency to gain more ground.
Of course, the evolution of the currency is directly related to labour productivity.

Figure 1: Labour productivity annual growth rate



Source: OECD, Statistics, 2010

3.3 Effects of the crisis on the euro-zone. The issue of price competitiveness

The financial crisis has led to a renewed debate about perceived imbalances in the euro area, which revealed the structural nature of the disparities. The issue had been previously debated during the years preceding the financial crisis, but the strong global economic expansion and the ongoing economic integration within the euro area partly masked the problems arising from these differential developments.

One of the practical problems that EMU member states have to face is that of differences in price competitiveness between them. Losses in competitiveness that some countries have experienced are not the root of the problem but rather a symptom of underlying unsustainable structural developments in some member states. Accordingly, the marked gains in price competitiveness the German economy has experienced have been a result of necessary structural reforms that were finally addressed in 2003 when domestic problems such as high structural unemployment, rising social security contributions and repeated excessive public deficits became more and more pressing. Analysing the German experience can help draw some conclusions for those countries that have lost competitiveness since the launch of the euro.

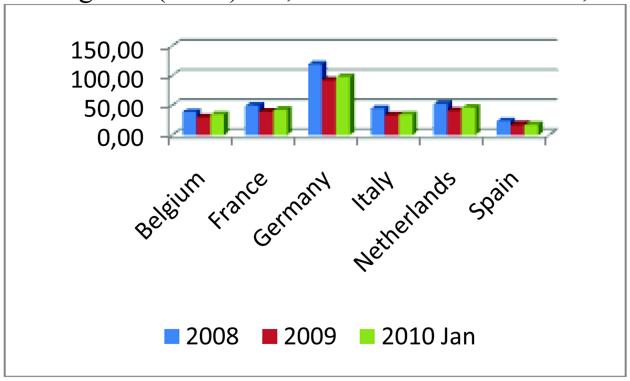
One important reason for growing heterogeneity within the euro area is that the benefits of monetary union, in particular lower interest rates and the elimination of exchange rate risk, have not always been used wisely and have tempted some countries to live beyond their means: Too often inflowing capital did not reach the most productive sectors, and in some cases cheaper and easier access to funding led to excessive credit dynamics facilitating a rise in household and corporate debt and ultimately causing the real estate markets to overheat. In addition, fiscal policy often failed to use higher growth and lower interest rates to reduce deficits sufficiently. In economies with rigid or only partly flexible labour markets all these large expansionary stimuli resulted in accelerated wage increases that were well in excess of productivity growth, reducing price competitiveness and exports of domestic firms.[70]

Consequently, price competitiveness has diverged significantly from one euro-area member state to another since the introduction of the euro. Whereas a small group of countries, led by Germany, has achieved gains in price competitiveness, a larger group suffered significant losses, amongst others Greece, Italy, Spain and Portugal. These underlying economic divergencies within the euro area are also reflected in persistent discrepancies in the current account positions of EMU member states.

[70] Weber, A., Challenges and opportunities for the competitiveness of EMU member states. The euro in the financial crisis, Presentation at the Copenhagen Business School, Copenhagen, 22 March 2010

The evolution of exports in the OECD countries can be observed in Figure 2, the main trend is descending between 2008 and 2010.

Figure 2: Exports in goods (value) s.a., in billions of US dollars, monthly average



Source: Monthly Statistics of International Statistics, OECD, 2010

As long as a flourishing world economy and the growth dynamics within the euro area masked the associated problems, those developments were neglected. However, the financial crisis has revealed the unsustainability of this state and therefore increased awareness of the risks it involves. These risks imply depressed future growth prospects, disturbances in capital flows if markets doubt the sustainability of large external borrowing requirements as well as difficulties for monetary policy as a result of the growing heterogeneity of euro-area member states. Hence, correcting the structural problems that are at the root of the economic divergencies is one of the major challenges for the future: For example, domestic firms have to become more competitive by increasing productivity and keeping costs in check, labour market flexibility has to be increased in order to mobilise a larger share of the working age population and to facilitate reallocation of workers to more profitable sectors (BIS Review 34/2010).
And structural deficits have to be brought down to sustainable levels by broadening the tax base or, preferably, cutting expenditure on government consumption and certain transfers.
Taking the current account as one indicator of the extent of these divergencies, one could get the impression that the financial crisis has halted the trend of growing heterogeneity within the monetary union, since current account positions have narrowed significantly in the years 2008 and 2009 (except for Italy and France). However, a closer look at the developments that underlie the changes in current account deficits shows that the reductions are still largely cyclical as they have been driven mainly by sharply falling imports rather than increasing export market shares. Hence, more profound and far-reaching changes have to be undertaken in countries that have lived beyond their means and thereby driven the divergencies within the euro area.

3.4 The competitiveness of Romania

The problem of competitiveness is becoming a vital issue for the future of every country and it is especially important for Romania as it is heading towards joining the euro zone.
A correspondent level of competitiveness needs to be mirrored first in the central parity which paves the way for ERM2 and, later, in the conversion rate agreed with the European Central Bank, the European Commission and the other member states. Blockages caused by the drop in prices and salaries would burden and would make it more costly for the adjustment of a over-evaluated parity under the relation between employment and economic growth.[71]

[71] Isarescu, M., Europe's problem is the competitiveness difference between North and South, Speech at Symposium on competitiveness, april 2010

In some economies, the authorities want depreciation due to the favourable effects on external competitiveness, but the negative impact may overcome the positive one. At least that is the opinion of specialists at The National Bank of Romania, so our currency is not overdepreciated.

4. Conclusions

Growth in the last quarter of 2009 has been revised downwards to 0.0%. Markets show no sign of letting up on the Greek Bond Market. The impact of this bad news has been to depreciate the Euro. The question is what will be the impact of a weaker Euro on the EU economy.

A weaker Euro would make Eurozone exports more competitive and increase the cost of importing goods into the Eurozone. A weaker Euro would make exports cheaper and could provide a boost to EU growth and employment. This is particularly important for Eurozone countries who rely on export led growth such as Germany.

However, the impact of a weaker Euro may be limited. Evidence suggests that demand for exports is often inelastic, a weaker currency is no guarantee of strong growth. The impact of a weaker Euro will have a different impact within the Eurozone. However, a weaker Euro will do nothing to redress the imbalance within the Eurozone area. Much more is needed than a depreciation in the Euro, as the majority of trade in the Euro is within the Eurozone. For example, a depreciation in the Euro would not restore the competitiveness of Spain's exports with regard to EU partners such as France and Germany. Other solutions must be found to solve the pressing problems in many Eurozone economies.

Structural reforms should be initiated for achieving the necessary adjustments to the market and bring back heterogeneity within the euro area to a natural and sustainable level. In addition, the effort and inconvenience associated with those adjustments will pay off as they lead to strengthened economic conditions in the individual economies and the euro area as a whole. The EMU urgently needs such market-based adjustments as they are a prerequisite for economic divergencies to come to a halt, for sustainable economic growth within the euro area and thereby for the continuing success of the euro.

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