

THE RISKS OF A TOO QUICK EURO ADOPTION BY THE EU MEMBER STATES. THE CASE OF PORTUGAL

Cristian Ștefan Ovidiu
Babeș-Bolyai University
Faculty of Economics and Business Administration

In this article we present the risks faced by the new countries that have joined the European Union, and which also desire to adopt the euro currency as quickly as possible. We will analyze the existing literature regarding the ways these risks manifest themselves, depending on the economic conditions present in these countries. The risks are mostly caused by an incomplete fulfillment of the optimum currency area conditions, especially the ones regarding the synchronization of the business cycles, the existence of mitigation mechanisms in the case of asymmetric shocks, and to a lesser extent, the insufficient flexibility of the European labor markets. In addition, because there are different economic conditions between the countries that plan on introducing the euro currency and the ones that already had, mostly related to a lower economic development and lower prices, there are specific risks that affect the former countries. Moreover, the benefits of entering the EMU – greater monetary stability, reduced transaction costs, lower exchange rate volatility and a decrease of the interest rates – can in some specific cases become also costs. In order to quantify all these elements, we have constructed a case study of Portugal, which has entered the EMU in the first wave. We have determined that Portugal's experience after the euro introduction was a negative one, when compared with the previous period, because the convergence process did not actually happened, as expected. Not only that, but the economic differences between Portugal and the other EMU countries deepened, and the country's fiscal situation also deteriorated badly in all these years, up to the point where Portugal was forced to ask for external help. The case of Portugal is very important for the countries that are eager to adopt the common currency without first achieving a sustainable economic development, through increasing labor productivity and exports. It shows that fulfilling the nominal criteria and entering EMU must not be a declared goal, but just the last measure implemented after reducing the economic disparities and reaching a balanced economic development. Based on the existing realities from the Central and Eastern European states, different scenarios can be constructed that will take into account the way these risks influence the future economic environment, should these states were to decide accelerating the common currency adoption process.

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1. Introduction

There are undeniable benefits of adopting the common currency, and the most important of these are a greater monetary stability, reduced transaction costs, decreased exchange rate volatility and lower interest rates. Still, it must be mentioned that these benefits are effective only if the Economic and Monetary Union functions as it was intended to, without major economic turmoil – a detail that a few years ago was not even mentioned, but which recently has surfaced. Moreover, these benefits are not unidirectional, but have a hidden sight, in some specific cases being able to become substantial costs.

Adopting the euro by a newly European Union member state would generate a climate of monetary stability. The experience demonstrated that the less developed European countries are exposed to a higher risk posed by massive external capital flows, or even speculative attacks against their own currency, perceived as being more vulnerable. Because the market expects that the economic development will accelerate following the start of the euro currency adoption process, or because of the existing investment opportunities in these countries, investment capital searching bigger returns will enter, quickly affecting the exchange rate. The massive capital inflows can also unexpectedly exit, if the economic growth is not on target, if the fiscal situation is not stable or if it finds better investment/speculative opportunities in other countries (Janackova and Borek 2004). Being part of a much more solid monetary structure build around the common currency would eliminate an important part of the monetary instability risk. Still, we must mention that this benefit is valid only when the euro currency is not affected internationally by global events that could erode its own stability.

Reducing the transaction costs is another benefit of adopting the euro currency. This benefit is especially visible in the trading sector among the Economic and Monetary Union member states, which use the same currency in their transactions. These countries experienced a fast increase of their trade after the launch of the EMU (Barr 2003). This advantage takes place just in the case of open economies, which are capable of exporting on the European market competitive products, in great quantities.

A third important benefit of adopting the common currency would be the decrease of the exchange rate. This would in turn eliminate the inherent higher exchange rate fluctuations experienced in relation with the country's external partners. Lowering the exchange rate volatility implies the reduction of costs incurred for protecting against these undesirable events. Moreover, if the volatility of the exchange rate diminishes, the risks experienced by the foreign investment projects are also lower, which in turn stimulate a more active investment environment, with immediate effects on the economic growth and the convergence process. Unfortunately giving up the ability to use this monetary intervention instrument has also negative consequences, because when economic imbalances appear, the adjustment costs can be higher by using other methods.

A last major benefit of adopting the euro currency is the rapid reduction of the interest rates, with positive consequences upon the economy. This interest rates reduction is

mainly determined by a lower monetary risk, an element that is always incorporated in the interest's nominal rate. A quick lowering of the interest rates can have negative consequences also, when it is accompanied by a relaxation of the credit standards, which determined in the new euro zone member states an increase in consumption and a decrease in savings, having as a final result an unsustainable increase in the households' level of debt (Fagan and Gaspar 2007).

2. The risks of a too quick adoption of the euro currency by the new EU member states

A too quick adoption of the euro currency by the new EU member states has major risks, especially if the economies of these states are not well developed. There are risks that derive from the theory of the optimum currency areas, as well as specific risks caused by an insufficient economic development or induced by the economic convergence process. Often the costs generated by these risks are very high, being sometimes able to surpass the advantages of adopting the common currency.

One of the basic conditions stipulated by the theory of optimum currency areas for a smooth functioning of a monetary union is the synchronization of the business cycles. Unfortunately even the countries that already take part in the Economic and Monetary Union do not meet this condition. There is a core in the euro zone that acts as a single economic entity, but there are also countries whose economies are far from being synchronized with this core. For example, the member countries that in the '70 had high levels of GDP/capita – Germany, France, Belgium, the Netherlands and Luxembourg – also exhibited highly synchronized business cycles, and entering the Economic and Monetary Union did not influence them in any significant way (Giannone, Lenza and Reichlin 2009). On the other hand, the states that in the '70 had relatively lower levels of GDP/capita – Spain, Italy, Portugal, Ireland, Greece – their business cycles were not correlated with the business cycles of the countries from the first category, and moreover, even after the introduction of the euro currency, this variability persisted, together with the increased volatility of their business cycles. Even more, before their accession in the European Union, the business cycles of the East European member states were not synchronized with the business cycles of the big euro zone countries, not synchronized with the business cycles of the countries situated at the periphery of the euro zone (Greece, Portugal, Ireland) and not even synchronized among themselves (Süppel 2003). It is very important that the harmonization takes place between the business cycles belonging to the euro zone countries and those of the acceding EMU countries, otherwise the common monetary policy of the Central European Bank would induce long term unbalances in the economies that do not fluctuate in the same manner.

Another aspect mentioned by the theory of the optimum currency areas is the existence of mitigation mechanisms for the asymmetric shocks, which affect just a country or a small group of countries. Because the common monetary policy can not solve specific problems that appear in a certain state, it is imperative that there exists price and wage flexibility, backed by a high labor and capital mobility, in order to successfully respond to these type of shocks. In the European Union the labor market rules used to be quite rigid (Silva 2004), containing many barriers for the quick wage adjustment, and on top of that, for the newly entered member states, there are restrictive regulations regarding their labor mobility internationally. Moreover, it has been determined that the countries that joined

the European Union in 2004 are more influenced by asymmetric shocks (Ramos 2004), compared with the rest of the countries that are already in the euro zone.

Besides these general risks that derive from the theory of optimum currency areas, there are specific risks that result from a lower level of economic development and lower prices, which exist in the new member states that in the future will also enter the euro zone. Entering the Economic and Monetary Union and having their products compete with the ones produced in the euro zone would cause a rapid increase in prices, if the production technology increases also. If the labor productivity increases at the same speed as the increase in prices, the conditions of a durable convergence are met, without experiencing major disturbances along the way. This is the successful way of increasing the real convergence that happened in the vast majority of the states that introduced the euro currency: a rapid increase of labor productivity and a remarkable export performance (Kolasa 2010). Still, this process is likely to be a long one, which will continue way after the introduction of the common currency in these countries. Therefore, reducing the economic disparities will probably determine a higher level of inflation in these particular states, which will likely persist for a long time. If this will influence the level of the harmonized index of consumer price (HICP) from the euro zone, a too strict monetary policy implemented by the European Central Bank would slow this process of reducing the economic disparities, with negative consequences upon the states that started the economic convergence process. Therefore, a too quick adoption of the euro currency can be sub optimal for the less developed states that have entered the European Union (Rostowski 2003), because the European Central Bank will never target the acceleration of economic convergence among euro countries, but a strict inflationary level of under 2%.

3. The case of Portugal

At the beginning of the '80, Portugal had a precarious economic condition, caused mainly by the 1975 revolution, the losing of its colonies and the second oil shock. The budgetary deficits often surpassed 12%, and the current account deficits 10%. This was an unsustainable situation, and indeed, between 1980 and 1987 the Portuguese escudo depreciated by 60%, wiping the current account deficit (Blanchard and Giavazzi 2002). After this stabilization took place, Portugal embarked on an accelerated process of economic development, which saw its GDP grow at a yearly average of 5.1% during 1985-91. During 1992-95 this growth slowed at an average of 1.5% yearly, but then again Portugal gained traction during 1996-2001, with an average yearly GDP growth of 3.5%. The average yearly inflation dropped from 14% during 1985-91 to 7% during 1992-95, stabilizing to 3.5% between 1996-2001. The labor market also improved, the unemployment decreasing from 7% in 1995-96 to 4% in 2000-2001.

After the start of the euro adoption process and the move towards the fulfillment of the Maastricht criteria, Portugal experienced a substantial reduction of its interest rates. This was caused by the previous economic performance and by the market perception that the euro adoption process will be a successful one. This nominal – as well as real – interest rate reduction, coupled with the liberalization of the financial sector and increased competition, determined an increase in the volume of loans, especially household loans, which in the end translated into an increase of internal demand. The process of credit

acceleration peaked just before the euro introduction, when the annual increase in the volume of loans was 28.6% in real terms, and the short term (3 months) real interest rate was 0% (Brzoza-Brzezina 2005). Coupled with the wage increases, particularly in the public sector, all fueled the illusory expectations that the incomes will keep rising indefinitely in the future.

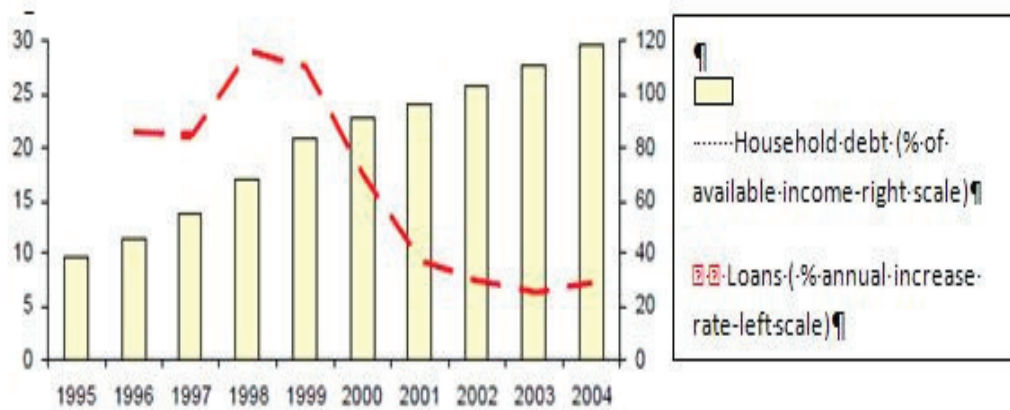


Figure 1. The increase of household loans and debt

Source: European Commission

Before entering the Economic and Monetary Union, Portugal managed to considerably reduce the budgetary deficit, from 7.7% of GDP in 1993 to 2.7% of GDP in 1999 (Abreu 2006). This was not based on a stricter fiscal policy – which in that period was expansionistic – but rather on a powerful economic development and low interest rates, which in turn determined lower costs for interest rate payments incurred by the Portuguese state. Unfortunately the structural reforms implemented towards increasing internal production were insufficient. However, with the national debt not surpassing the 60% limit, Portugal managed to successfully meet all the other nominal convergence criteria.

After entering the Economic and Monetary Union, it was discovered that some sectors, especially the textile and footwear industries, which held important shares in the Portuguese economy, were not prepared for the increased competition environment that followed. As a result they lost important market share, the export for these categories of merchandises falling from 2/3 of total exports in 1995-96 to 1/3 in 2004-2005 (Abreu 2006). Thus the Portuguese economy was forced to reorient to the constructions and services sectors, which in 2002 were already representing 76.7% of the total value added in the whole economy. Consequently the rising internal demand shifted towards foreign goods, the value of imports in this segments rising rapidly. In the end the current account deficit increased again, surpassing the 10% of GDP in 2000 and remaining at a high level ever since.

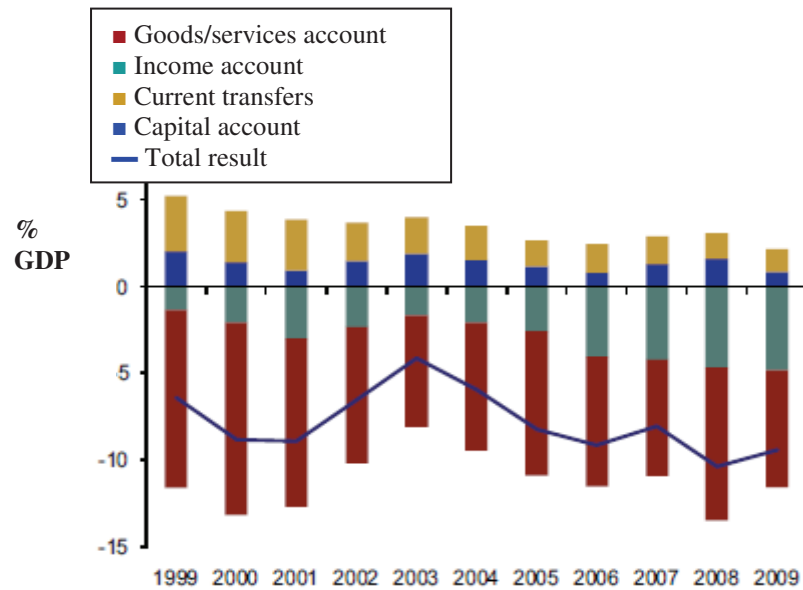


Figure 2. Portugal's current and capital accounts, 1999-2009

Source: Portugal National Bank

In the following years after Portugal entered the Economic and Monetary Union, the speed of economic growth decreased. Moreover, due to insufficient structural reforms, the country kept losing market share, while the salaries were increasing at a faster rate than the ones from the euro zone, mostly because the unemployment was low and there was a high pressure for constant wage growing. The process of credit expansion continued, coupled with the rapid decrease of the saving rates, which resulted in an increase of the debt burden of the households, which in 2004 reached 118% of disposable income, a level surpassed in the euro zone only in the Netherlands (Cardoso 2005). It was becoming more and more clear that the high consumption levels could not be sustained by the available incomes, especially in an environment of slower productivity gains and diminished market share. At the macroeconomic level the situation became dire in time, the main fiscal indicators experiencing deterioration, mostly determined by the higher sums that had to be allocated to finance the constant current account deficits.

Tabel 1. The evolution of Portugal's main financial indicators (percent of GDP)

	2005	2006	2007	2008	2009
Budgetary deficit	6,1	3,9	2,6	2,8	9,4
Public debt	63,6	64,7	63,6	66,3	76,8

Source: Portugal National Bank

4. Conclusions

Portugal's experience after entering the Economic and Monetary Union is not a positive one. The expected economic convergence never took place, the post adoption low growth rates deepening the existing economic disparities with the euro zone, which in 2009 were calculated to be 4% bigger than the level experienced before the euro adoption, in 1998.

At the end of 2010 the economy of Portugal was in a dire condition, having a high level of public and private debt, a significant commercial deficit, and a small GDP growth rate, of 1.4%, after a drop of 2.5% in 2009 (Banco de Portugal 2010). These weaknesses were observed before the economic crisis, but after the onsets of its effects, they become more evident, and the ensuing austerity measures could not reverse this trend. The interest rates of the Portuguese bonds increased dramatically, fueled by the successive downgrades operated by the rating agencies. In April 2011 Portugal, after Greece and Ireland, asked for external help in order to be able to honor its financial obligations and thus to avoid the restructuring of its debt.

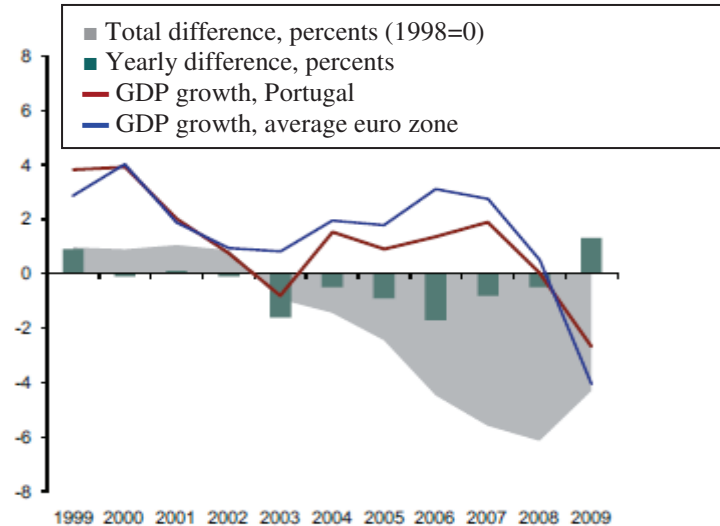


Figure 3. Economic growth difference, Portugal versus euro zone average, percents
Source: Portugal National Bank

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