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CURRENCY COMPETITION IN THE EUROZONE: AN ANSWER TO THE CRISIS

Krzysztof Spirzewski[1]

Abstract

The common currency was created as a result of theoretical considerations regarding the functioning of optimum currency areas. This theory refers to a number of benefits as well as costs. It imposes a number of requirements that are necessary for the newly created structure to be considered optimum. The economies of Eurozone countries did not meet these requirements. In consequence, the present functioning of the Eurozone encounters many disturbances – the strong differentiation of the balance of payments is a significant example. The reforms initiated in the European Union and undertaken in response to the financial crisis encompassed the Eurozone countries, yet they only concern financial policy. The adopted strategy of action arouses questions as to its effectiveness. The aim of this article is to present one of the reasons for the Eurozone crisis and a proposal for changing the monetary policy, in particular the exchange rate. In view of this objective, the main hypothesis reads as follows: one of the methods of counteracting the crisis is to introduce currency competition within the Eurozone.

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1 University of Warsaw WNE, kspirzewski@wne.uw.edu.pl.

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Introduction

Following the last global crisis, viewed as the greatest since the 1930s Great Depression, many questions have appeared in the public space on whether the adopted model of the functioning of the Eurozone should be continued. Publicly pronounced questions such as "the euro – until when?", assertions such as "Athens in the Eurozone is a high risk" (DeAnne, 2015) or "the Eurozone today is a place for superheroes" (Radziwiłł, 2015) invite reflection upon the reasons for such a state of affairs and a search for appropriate remedial measures. The reasons for the prolonged crisis in the Eurozone may be determined by factors related to its very structure, but also by external factors related to the operations of the international financial system.[1]

As regards the potential structural factors of the Eurozone that contributed to the crisis, literature specifies in particular the differentiation of economic cycles, impermanence of adopted convergence criteria and different levels of economic development of countries admitted to the Eurozone, which additionally reinforce the asymmetric shocks ensuing from the functioning of so-called core countries and peripheral countries within one economic zone.

Considering the issues outlined above, the aim of this article is to present one of the main reasons for the Eurozone crisis, which is the lack of flexibility in conducting monetary policy, and in particular exchange rate policy, by the European Central Bank. In view of the specified objective, the hypothesis put forward in the article is the following: the answer to the Eurozone crisis is introducing currency competition in the form of a currency alternative to the euro, functioning in countries with a permanent external account surplus.

1 For the purpose of this article, the currency system issue has been limited to the currency exchange policy.

The future of the Eurozone in the face of crisis

The euro – until when? The reason for questioning the fundamental principle of the Eurozone (the common currency) is negative economic information. The zone where the euro is legal tender posts very weak economic results. The GDP in December 2013 was 3 percent lower than in Q1 2008. This value must be confronted with the US economy, which increased by 6 percent in the same period. The situation looks even worse when we consider EU Member States individually. In Ireland, the economy declined by 8 percent, in Italy by 9 percent and the Greek economy shrunk by 12 percent (Hjortshøj O'Rourke, 2014).

The above information belongs to rare data showing the Eurozone economy in a bad light. Data referring to the labour market are even more disturbing. All this leads to a negative perception of the consequences of introducing the common euro currency despite slightly better data for 2014.

Opinions questioning the capacity of the EU to cope with the financial crisis and economic recessions are brought up ever more frequently in public debate. What is more, the capacity to maintain the single currency is also being called into question. Of course recent perturbations

Figure 1: Ireland GDP (in USD Billion)

Source: http://www.tradingeconomics.com/ireland/gdp

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Figure 2: Italy GDP (in USD Billion)

Source: http://www.tradingeconomics.com/italy/gdp

Figure 3: Greece GDP (in USD Billion)

Source: http://www.tradingeconomics.com/greece/gdp

must be viewed in perspective. However acute the current crisis may have been, this does not denigrate the great accomplishments of the European economy in integrating the region, where living standards are among the highest in the world.

The concept of currency integration: a critical approach

The term "integration" refers to the processes of joining together groups of elements composed of regions or entire national economies. When speaking of economic topics, these elements will be composed of particular sectors of the economy. Monetary integration, on the other hand, will concern a scope narrowed to voluntary economic and political integration (Mongelli, 2002). Theoretical analyses of the subject are abundant in academic literature of the second half of the 20th century. One concept highlights the necessity of bringing down barriers in commercial exchange between countries entering into integration.[2] The entire process goes through five stages, starting from creating a free trade area, then a customs union, a common goods and services market which is then transformed into a currency and economic union, and finally a monetary union (Belassa, 1973).

When discussing the current situation in the Eurozone, it is essential to present the theoretical rationale behind currency integration within the European Union and this is the theory of optimum currency areas. The pioneers of this theory are Mundell (1961), McKinnon (1963) and Kenen (1969), whose work (under the same title *Optimum Currency Areas*) triggered the debate on the advantages and disadvantages of such a solution. Significantly, these authors tended to emphasise the costs and threats of such an enterprise, underpinned by resignation from the national currency. Generally speaking, this theory discusses the prerequisites that make adopting a common

2 All considerations presented in this article refer to democratic countries with a market economy.

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currency or mutually fixing exchange rates by two states advantageous for both parties.

In the above theory, "optimum" means that the newly created organisation will guarantee the fulfilment of the basic goals of economic policy, understood as full employment, external accounts balance and price stability. Apart from the target effect, the prerequisites for starting the integration process are also defined and described as the characteristics of the given economy. These characteristics include in particular: (Ghosh & Wolf, 1994):

1) mobility of production factors,
2) wage and price flexibility,
3) a similar unemployment and inflation rate,
4) a similar economic growth rate.

The decision to start the process of setting up a common currency area can be made when the candidate countries present the above characteristics. The lower the convergence level, the smaller the probability of success in creating an optimum single currency area. However, such a strategic enterprise entails very serious threats. As has been noticed by Mundell, within a common currency area it is not possible to conduct a policy focused on the economic growth of one member state without affecting the remaining states; otherwise, the market balance is disturbed (Mundell, 2000). An analysis of the costs and benefits of a common currency area has been presented by Krugman and Obstfeld (2000). The starting point for their considerations are the benefits stemming from an increase in monetary performance. This increase in performance is due to: eliminating exchange rate risk (including the cost of hedging foreign exchange transactions), foreign exchange costs and the costs of settling international transactions. The correlation is that the more a given economy is integrated with others (which also entails a higher commercial exchange level), the greater the advantages. An additional advantage is importing lower inflation, as strengthening economic ties usually leads to lower inflation. However, according to the authors, joining a common currency area is also connected with costs and threats which are referred to in literature as: economic stability loss. The source of this threat is the loss of the possibility to restore external balance by changing the exchange rate level of the national currency. If there is a fall in the demand for national products on international markets, there is no possibility of protecting domestic manufacturing against the negative consequences (Krugman & Obsfeld, 2000).

The lack of the possibility of counteracting huge commercial imbalances between Eurozone countries (both preventing their occurrence and reacting post factum are impossible) is a very serious shortcoming in the functioning of the common currency area (Staniłko, 2010).

The Treaty on European Union: convergence criteria

The introduction in 1999 of the single European currency was preceded by establishing criteria for participation in the Economic and Monetary Union. The Treaty on European Union was signed in Maastricht on 7 February 1992. The strategy of creating the European Union (EU) was based on two principles:

1) The transformation was to take place in stages and was spread over several years,

2) EU membership was tied to the necessity of meeting the convergence criteria.

It is worth noticing that this was not the only available strategy. From the long history of creation of united areas, it is worth mentioning the example of Germany and the chain of events that began on 1 July 1990. The characteristic feature of this process was speed and lack of convergence requirements. The decision to unite East and West Germany was taken at the end of 1989, and six months later Germany – as a common currency area – was a reality. However, this does not mean that this mode of organizing such a serious enterprise is recommendable (De Grauwe, 2005).

The convergence criteria in the Treaty on European Union are contained in four points:

1) high degree of price stability i.e. inflation must not exceed by more than 1½ percentage points that of the three best-performing Member States,

2) sustainability of the government financial position which means that the ratio of the annual government deficit to GDP must not exceed 3% and the ratio of gross government debt to GDP must not exceed 60%,

3) stable exchange rates which means the observance of the normal fluctuation margins provided for by the Exchange-Rate Mechanism (ERM) for at least two years,

4) the durability of convergence achieved by the Member State being reflected in the long-term interest-

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rate levels (the level of this rate must not exceed that of the three best-performing Member States in terms of lowest inflation).

It is worth noting that the interpretation of the above criteria by the European Commission and by the European Central Bank differed in terms of their stringency (Orłowski, 2006).

However, the listed criteria do not relate to the theoretical assumptions contained in the Optimum Currency Area Theory, where mention is made of production factor mobility, wage and price flexibility, unemployment level and economic growth rate. On the other hand, the Treaty on the Union stresses criteria such as public finance stability, size of government debt and budget deficit. Consequently, it is legitimate to claim that the Eurozone does not present the characteristics of an optimum currency area (Krugman, 1993; Bayoumi & Eichengreen, 1994).

Moreover, the current situation is very different from the situation when the European Union began to function. At the time all countries met the convergence criteria, yet just a few years later, as a result of a drop in GDP growth dynamics, the public finance situation deteriorated and some countries repeatedly overstepped the convergence criteria.[3]

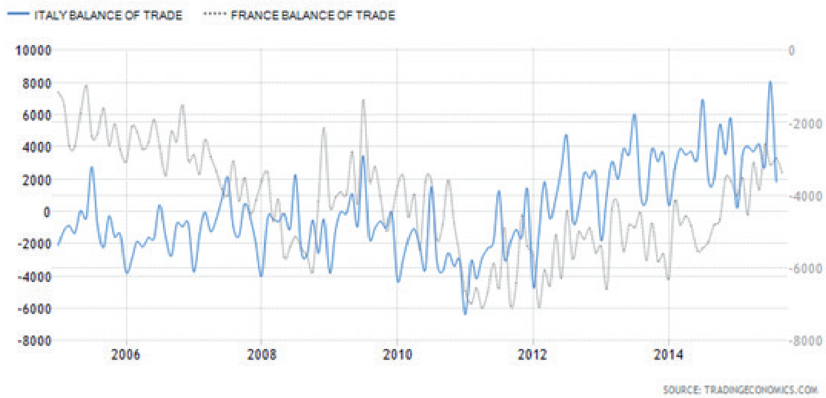
Balance of trade as an important parameter

Among the numerous problems in the functioning of the Eurozone, a particularly noticeable one is the balance of trade which features strong differences between Eurozone members.

High levels of external deficit lead to the determination of countries with a permanent deficit and those with a permanent surplus. The first group includes: Portugal, Spain, France, Italy, Greece and Ireland and the second group encompasses: Germany, Austria, Holland

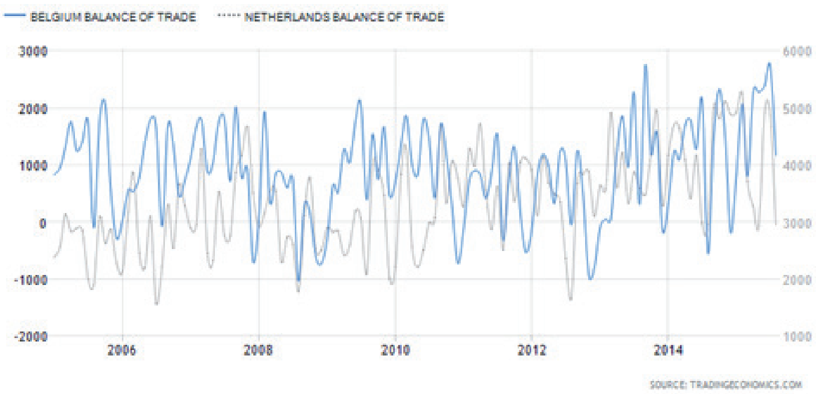
3 In fact, certain Member States, in particular France and Germany, struggled with the public sector deficit criterion in 1998

Figure 4: Italy and France Balance of Trade (in EUR Million)



Italy: values on left *Source: http://www.tradingeconomics.com*

Figure 5: Belgium and Holland Balance of Trade (in EUR Million)



Belgium: values on left *Source: http://www.tradingeconomics.com*

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and Belgium. Such a situation occurs not only within the EU but also outside of it, which testifies to disturbances in the structural balance of the global economy (Opolski & Górski, 2012).

Similar conclusions regarding a lack of synchronisation of economic cycles and structural differences between Member State economies are found in the article by Święcicki and Michałek. The authors present several studies regarding the subject (Święcicki & Michałek, 2014). One of the studies mentioned is that by Michaelides P., Milios J., Papageorgiou T., (2010), stating that although between 1992 and 1999 synchronisation was greater than before, correlations decreased after the creation of the European Union. At the same time, the division between economies within the Eurozone into the so-called core and peripheries became clearly visible. The authors classified Germany, France, Spain, Austria, Holland, Belgium and Portugal as core countries and Greece, Finland, Ireland, Great Britain and Italy as peripheral ones. The presented composition of these groups underwent small changes over time (Michaelides et al., 2010).

Structural differences make it significantly more difficult for the European Central Bank to implement a cohesive macroeconomic policy. The difference in economic development of individual countries, such as Germany or France, in comparison, e.g., with Portugal and Greece has not decreased but, on the contrary, increased. One of the reasons for this phenomenon are different economic cycles in these countries. As a result of these structural mismatches, the difference in competitiveness between EU[4] countries has increased and cannot be corrected as the single euro currency leads to a closed system with no possibility to devaluate the domestic currency in order to balance trade turnover.

Currency competition: proposal

The answer to the main reason for the Eurozone crisis thus diagnosed is to consider the concept of introducing currency competition in the form of a currency alternative to the euro, functioning in selected Eurozone countries.

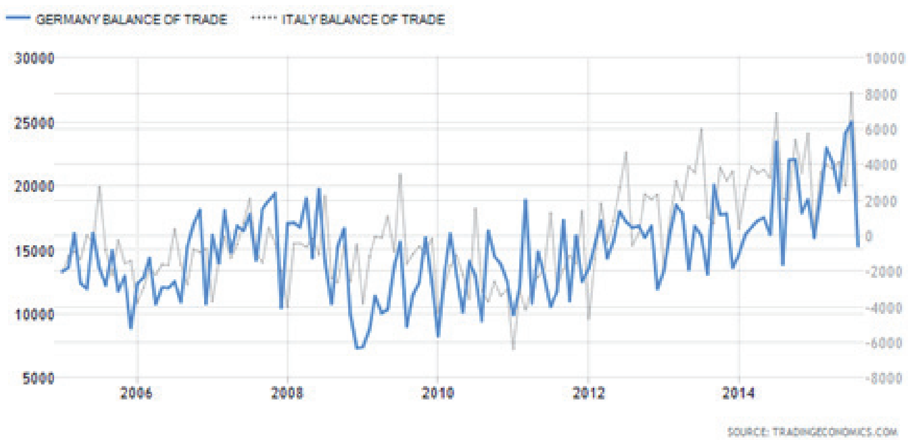
Many economists express criticism about the practical aspects of the functioning of the Eurozone. They underline the fact that instead of convergence, the disparities in development and competitiveness between certain countries have grown. The situation of unnecessarily maintaining Greece in the Eurozone is particularly highlighted. The project of an alternative common currency for states with trade surpluses was submitted for consideration by Prof. Markus Kerber. This new currency, given the working name of "Guldenmark", could function alongside the euro. It would be created by countries with significant external trade surpluses (Kerber, 2014).

Implementing this project would mean that the European Central Bank would obtain a tool enabling it to conduct a selective monetary policy, mainly with respect to the exchange rate, but possibly also interest rates. This would create the possibility of counteracting trade imbalances between Eurozone countries but also with respect to trade partners from outside the EU.

As the European Union is mainly a political concept, the postulate of returning to the national currencies is

4 Best exemplified by the surplus level in the trade balance between Germany and Italy.

Figure 6: Germany and Italy Balance of Trade (in EUR Million)



Germany: values on left *Source: http://www.tradingeconomics.com*

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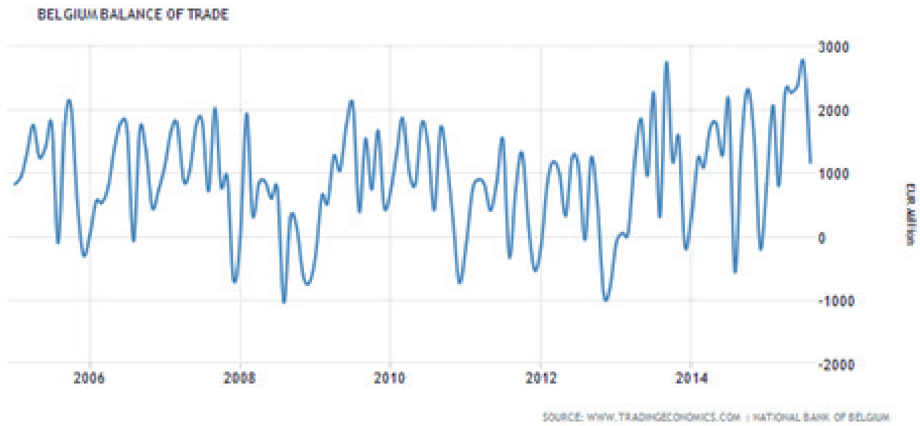
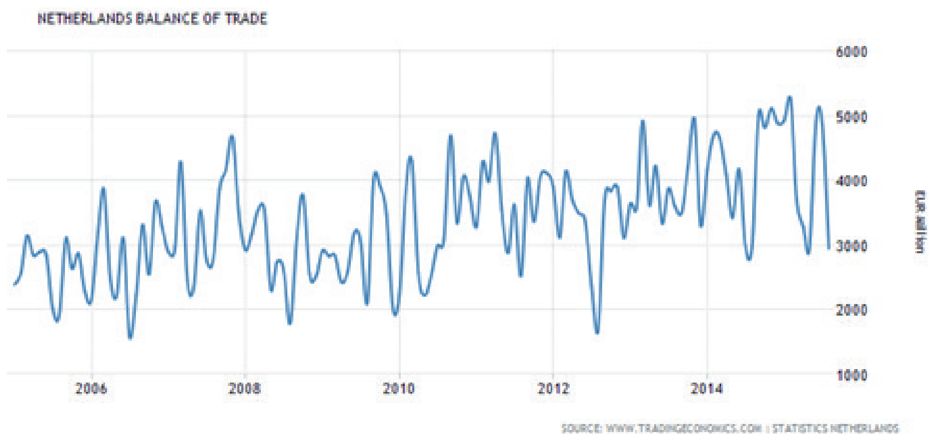
Figure 7: Belgium Balance of Trade (in EUR Million)



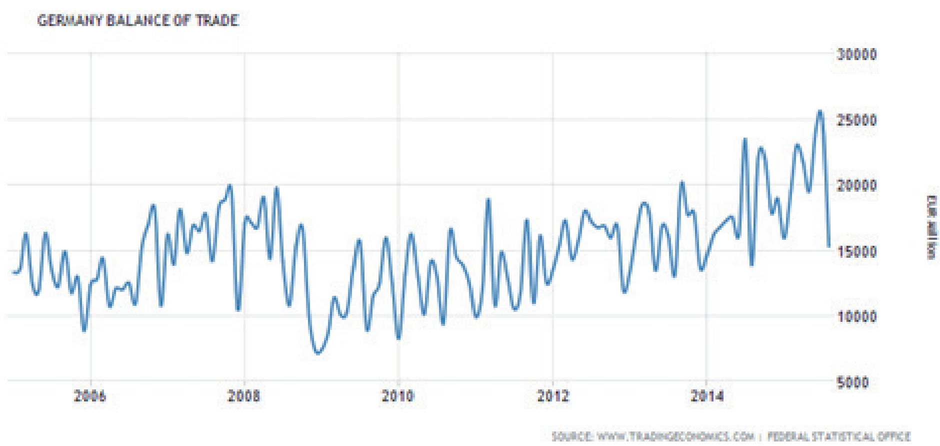
Source: http://www.tradingeconomics.com

Figure 8: Holland Balance of Trade (in EUR Million)



Source: http://www.tradingeconomics.com

Figure 9: Germany Balance of Trade (in EUR Million)



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too far-reaching, yet at the height of the Greek crisis in mid-2015 the concept to limit the Eurozone to Germany, the former Benelux countries (Belgium, Holland and Luxemburg) plus Austria was mentioned by significant EU politicians. Interestingly, De Grauwe wrote in 2000 that the optimum currency area may be successfully implemented in the following countries: Germany, Belgium, Holland, Luxemburg and France (De Grauwe, 2000). The listed countries are very much concurrent.

Conclusions

The acute consequences of the Eurozone crisis (particularly affecting some of its members) and the resulting public comments have led to examination of the model adopted for the functioning of the single euro currency. The lack of possibility of counteracting huge commercial imbalances between Eurozone countries is a very serious shortcoming in the functioning of the common currency area.

The theoretical rationale behind currency integration within the European Union is the theory of Optimum Currency Areas. However, the Eurozone that has been established does not satisfy most of the necessary requirements mentioned in this theory. What is more, joining the common currency area is tied to a large risk of economic stability loss due to the impossibility of overcoming trade imbalances by changing the exchange rate level. If there is a fall in the demand for national products on international markets, there is no tool available to protect domestic output of goods and services against the negative consequences.

Among the numerous problems in the functioning of the Eurozone, a particularly noticeable one is the external accounts balance which is characterised by strong differences between members of the monetary union. Other problems include lack of synchronisation of economic cycles and structural differences between the economies of Member States. These features lead to the emergence of countries with a permanent external deficit and those with a permanent surplus.

The proposal to introduce currency competition in the form of an alternative currency to the euro, which would function in selected Eurozone countries, introduces a new approach to the existing situation. It would allow the European Central Bank to act in a flexible manner. An efficient, selective policy with respect to the exchange rate would make it possible to counteract trade imbalances between Eurozone countries.

The far-reaching euro project is the answer to global problems related to foreign exchange rates. These concern all economies. As a general rule, a national currency and the possibility to depreciate it helps the economy avoid crises or minimise their consequences. Of course, adaptive measures making use of the foreign exchange rate will not guarantee economic success, particularly in countries aspiring to join the best in the class. This is true for large countries and all the more so for smaller ones. In the long-term perspective, effective convergence of economies, combined with actions in the fiscal sphere, may be advantageous.

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