Greece and the Euro

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Abstract

The recent debt crisis in the EU has revived interest in the costs and benefits of membership in a currency union for a country like Greece as well as in the implications of such memberships for union wide performance. The present note utilizes insights from the voluminous literature on monetary unions to address a set of questions concerning Greece and the Euro. It argues that: a) It made good economic sense for Greece to join EMU in order to enjoy a lower and more stable rate of inflation. b) It was not unwise for the core countries to let Greece in. c) The cost of Greece exiting the Euro would be substantial without any countervailing -even small- benefits. And, d) contrary to popular beliefs, the Greek sovereign debt crisis does not by itself pose a substantial threat to the Euro. Whatever threat exists, it comes from inappropriate policy response by the ECB and leading EE countries.

Greece and the Euro

The recent debt crisis in the EU has revived interest in the costs and benefits of participation in a currency union. The objective of this note is to review the extant literature and to utilize its main insights to study Greece and the euro. In particular, it addresses the following questions:

a) Did it make sense for Greece to join EMU?	YES
b) Was it unwise for the core countries of the EMU to admit Greece?	NO
c) Would Greece be better off -and over what time span- if she abandoned the Euro?	NO
d) Does the sovereign debt crisis pose a threat for the Euro and how?	NO

The basics

<u>When does monetary union matter?</u>

A currency union simply represents a particular way for conducting monetary policy. As such, it is of consequence only when monetary policy matters. While monetary policy is the key determinant of inflation it is debatable whether it also matters for the level of economic activity and how much. The prevailing view in macroeconomics is that monetary policy exerts important influence on the short term rate of economic growth due to the presence of price (and wage) stickiness.

<u>Why sacrifice control of national monetary policy?</u>

If monetary policy is a valuable macroeconomic tool then a natural question that arises is why would a country ever choose to give it up by adopting some other country's currency over which it has limited, if any control.

The *traditional* optimum currency area -OCA- theory actually offers no answer to this question. It simply admits that a currency union is a costly affair that is undertaken because of unspecified (typically political) reasons. And it preoccupies itself with the identification and description of conditions that contribute to making this cost small (the so called optimum currency area criteria, see Tavlas, 1993). This cost is small when monetary policy is not particularly useful (for instance, when nominal prices adjust quickly to disturbances) or essential (for instance, when there exist alternative means for mitigating macroeconomic shocks). A long list of OCA criteria has been proposed, the most prominent of those being inter-country labor mobility (so that labor can move from poor to better performing countries), the predominance of union wide shocks (such as oil or global financial shocks), similar economic structure, *fiscal integration* and so on. Note that according to the OCA theory, fiscal integration makes a currency union more desirable.

The traditional OCA theory assumes that central banks do their job right, which makes them valuable. A more recent branch of the OCA theory assumes that this is not always the case. Due to political constraints or the lack of credibility, some central banks do not pursue price stability (low inflation) in the medium and long run. Consequently, inflation in those countries tends to be both high and volatile. If inflation is costly then a country would be better off -that is, it would enjoy a lower and more stable inflation rate- if it let some other, more capable and trusted central bank be in charge of its monetary affairs. An additional benefit of outsourcing policy arises from the fact that central banks lacking credibility cannot carry out macroeconomic stabilization efficiently (Dellas et al, 2011). Dollarization in S. America and the adoption of the Euro by countries, such as Italy and Greece (the delegation of monetary control to more disciplined EU countries), that have had perennial problems controlling their inflation rate captures exactly this credibility consideration.

Currency union and the associated monetary policy credibility lead to lower risk premia and real interest rates. It is often claimed that this represents an important benefit of a currency union because it lowers the cost of public debt. This claim is dubious because it ignores the fact that higher risk premia on government debt represent an insurance policy the government buys in order to maintain control over the real amount repaid. To the extent that such control is valuable for the debtor (for instance, by allowing indirect -through inflation- default during bad times), its elimination cannot count as a benefit.

Combining the traditional and the credibility arguments for currency union allows us to evaluate the costs and benefits of participation in monetary union and to determine the overall *net* effect. Recent research (Dellas et al, 2011) indicates that monetary union may be beneficial even for countries that have quite modest levels of inflation bias (say, countries with an average inflation rate that exceeds the German inflation by 2%). As yet, there is no *economic* theory that explains why a low inflation country like Germany would form a monetary union with other, higher inflation countries. A plausible explanation may be that Germany agreed to it in order to eliminate the scope for competitive devaluations undertaken opportunistically by various EU countries (Italy, France, Spain), a practice that eroded support for and undermined economic union in Europe.

Finally, note that additional costs and benefits of monetary union have been mentioned. For instance, claims have been advanced concerning the effects of currency union in supporting higher economic growth, in promoting greater competition (because of the easier comparability of prices in the single currency), in enhancing international trade, in reducing international transaction costs and so on. These claims are either quantitatively unimportant (such as the lowering of transaction costs) or unsubstantiated and dubious (the other ones mentioned above).

Implications of the analysis for Greece

Armed with the results from the preceding analysis we are now in a position to address the questions raised in the introduction.

Did it make economic sense for Greece to join EMU?
The answer seems to be an unqualified yes. The inflation bias in Greece (the differential from the German rate) was very high (17% over the period 1980-90). The high real interest rates also distorted the allocation of investment as explained below. Admittedly, economic structure and shocks in Greece are quite different from those in the rest of the EMU countries, which calls for monetary independence. Nonetheless, the fact that the lack of policy credibility impaired the ability of the Greek monetary authorities to cope efficiently with country specific shocks (see Dellas et al, 2011) meant that maintaining independent monetary policy in Greece had limited macroeconomic value. In this context, it should be kept in mind that the much praised tool for restoring international competitiveness, namely, currency devaluation, never proved effective in Greece (but also in other countries) because of the low degree of trade openness, the quick

adjustment of nominal wages and the prices of exportables, the low elasticities of the demand for Greek exportables (agricultural and tourism) and the widespread oligopolistic practices.

It is often overlooked that international competitiveness is a structural, not a monetary concept. This is true even when one -very narrowly- identifies international competitiveness with the terms of trade. Both theory and empirical evidence strongly support the view that sustained adjustments in relative prices (such as the terms of trade) do not occur via inflation-exchange rate policies, in particular in countries with high inflation, but are driven by supply (mostly productivity) and demand (preferences and foreign income) factors.

Was it unwise for the core countries of the EMU to admit Greece?
Greece is a small country with a marginal role in the management of the Euro. As such, and in combination with the growth and stability pact that was supposed to insulate monetary from fiscal policy, Greece's entry into the Euro zone was perceived to be economically inconsequential for the Euro. This was true then and would have remained true nowadays if the ECB had chosen to treat it as such. In particular, had the ECB insisted on good collateral in its provision of liquidity, it would have caused liquidity problems for the Greek banking system (which could, however, have been addressed by EU fiscal measures, such as the provision of guarantees) but it would have also dispelled any notion that the ECB compromised its inflation credibility by engaging in debt monetization. It is uncertainty about how far the ECB will go with debt monetization that is the source of trouble for the Euro.

Would Greece be better off -and over what time span- by abandoning the Euro?
The answer seems to be an unqualified no. On the negative side, the average rate and volatility of inflation would increase. Risk premia and real interest rates would also increase substantially. While this might not necessarily be suboptimal from the point of view of the government (as argued above), it could be punishing for those private issuers of debt whose fortune did not correlate perfectly with that of the government. This would both discourage and distort investment allocations. On the positive side, the benefits from the ability to devalue the Greek currency and in general to conduct independent monetary policy seem quite limited (as both history and theory show) due to the lack of credibility and the characteristics of the Greek economy presented above. Finally, note that exit from the Eurozone does not create additional (or more effective) tools for coping with the Greek sovereign debt problem.

Does the sovereign debt crisis in Greece pose a threat for the Euro, what type and why?
I understand "threat to the Euro" to mean market perceptions of the possibility of an unacceptably -to the core countries- high rate of inflation in the Euro zone and an associated substantial Euro depreciation. Inflation and depreciation would reduce the real value of Euro debt obligations, providing (most likely short term) relief to heavily indebted countries. This scenario could only happen if the ECB came to the view that high inflation represented the best solution to the problems emanating from -mostly sovereign- debt. I view this as a highly unlikely event for several reasons. First, even if there were contagion from Greece to the other S. European countries, Ireland and Belgium, the number of afflicted countries would still fall short of majority in the governing council. Second, due to central bank independence, even central banks in countries with high debt levels would not necessarily support excessively loose monetary policies by the ECB. And third, the fact that the core countries can withdraw from the Euro and issue a new currency limits the benefits from (and thus the incentives to pursue) high current inflation to

those who would be left outside the new currency.   All these considerations imply that there is a rather low limit to how much Euro debt (public and private) the ECB will choose to monetize.

References

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