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The real exchange rate of euro and Greek economic growth

Gregory T. Papanikos [a,b,*]

[a] University of Stirling, UK
[b] Athens Institute for Education and Research (ATINER), Greece

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ABSTRACT

This study argues that an overvalued euro has caused the largest ever drop in Greece's GDP growth since the World War II. Sharp declines of GDP growth would have been avoided had ECB's monetary and exchange rate policy been different and more conducive to countries that suffered the most from the world economic crisis of 2007. Greece was the last to be hit, but was unfortunately 'battered' really hard. In this study, it is found that (a) the real effective exchange rate of euro was 20% overvalued and (b) this has had a negative impact on Greek economic growth. A 10% undervaluation would have increased the rate of growth of per capita GDP by almost an additional 1.25% per annum. This would have made the economic recession less severe. During the crisis years, it seems that the ECB's monetary and exchange rate policy favored particular countries in the eurozone, and Germany emerges as the big winner.

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1. Introduction

In 1981, Greece became the tenth member of the European Economic Community, the predecessor of today's European Union (EU), mainly for political reasons. Nonetheless, many thought it would be an economic success story and they have been vindicated. The adoption of the euro in 2002 was expected to lead to another such triumphant story, which indeed seemed to be happening up to the end of 2009. However, the USA economic downturn of 2007 became a European crisis in 2008–2009 and a Greek economic tragedy in 2010.

As the model of a common currency union would have predicted, countries with the structural characteristics of Greece would have had to make painful fiscal and labor market adjustments with high unemployment rates and deep losses of output. This could most probably have been avoided if the euro, introduced in 2002 as the new Greek national currency, had been devaluated. Since World War II, Greece has achieved very successful national currency devaluations, the most famous among them being the one in 1953.

However, the devaluation of the euro is not an option for the Greek policy authorities. On the contrary, since 2002 the euro has been overvalued, the extent of this appreciation being the subject of this paper. The euro value is now monitored by the European Central Bank (ECB). It is of great interest, more than fifteen years after the establishment of the euro, to see how ECB's policy has affected the individual initial members of the eurozone, particularly in the years of crisis.[1] This

* Correspondence to: Athens Institute for Education and Research (ATINER), 8 Valaoritou Street, 10671 Kolonaki, Athens, Greece.
E-mail address: gtp@atiner.gr.

[1] The role of the ECB has been the subject of many papers, even before its official establishment. Dominguez (2006) provides an excellent overview of its role and also its impact in creating an overvalued euro. She concluded that "[I]t is less clear what role the European Central Bank would play if a European bank were to suffer a major collapse, or if one country or region within Europe were to go into financial crisis" (86–87).

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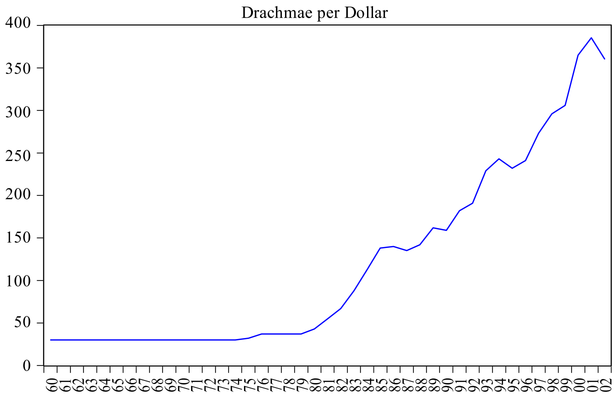

Fig. 1. Units of drachma to buy one dollar.

paper looks primarily at the impact this policy has had on Greek economic growth. I do though discuss the impact of euro's misalignment on all initial countries of the eurozone. To use the journalistic jargon, it seems that the eurozone has been divided between "butchers"[2] and PIIGS.[3]

I argue that the current protracted Greek recession is to a large extent the result of a prolonged overvalued euro. Rodrik (2008) has stated that overvalued currencies harm economic growth because the latter is "... associated with foreign currency shortages, *rent seeking and corruption*, *unsustainably large current account deficits*, balance of payments crises, and stop-and-go *macroeconomic cycles*" (italics added). As a description, it fits very well with what has been happening to Greece in the euro years, primarily after the current crisis in 2009. In this sense, Rodrik's paper can be considered a prophetic one.[4]

The rest of this paper is organized as follows. In the next section (section two), I discuss the issue of euro misalignment from Greece's perspective. Greece's foreign exchange history is split into the drachma years (up to 2001) and the euro years (after 2002). The drachma years are characterized by devaluations against the US dollar, and the euro years with strong appreciations. Section three of the paper finds that the overvalued euro has had a negative impact on Greek economic growth. Section four shows that the ECB's real effective exchange rate (REER) policy seems to favor countries like Germany which rose from the sick man of Europe to an "economic superstar".[5] Finally, my concluding remarks are contained in section five.

2. Measuring the amount of a misvalued euro

Greece is credited with one of the most successful examples of currency devaluations in 1953. Twice as many Greek drachma (from 15 to 30 drachma) were required to buy one US dollar. Along with other fiscal and structural measures, this set in motion a process of unprecedented economic growth in the late 1950s and early 1960s.[6]

The Greek drachma was fixed to the dollar till the collapse of the Breton Woods agreement at the beginning of the 1970s (see Fig. 1). Up to 2000, the Greek drachma was sliding against all international currencies. The adoption of the euro after 2000 reversed this trend of ongoing depreciations. From 2002 to 2008, the new Greek national currency (the euro), consistently appreciated (see Fig. 2).

In 2009 Greece was hit by what turned out to be one of the worst recessions in peace years. During the crisis, the euro value was slightly depreciating against the USA dollar. Even in 2014, five years after the beginning of the Greek recession, the euro's value was 30% higher than its 2002 value, while at some point in 2008 it reached a value of 60% higher than its 2002 value.

This section examines the over (under) valuation of Greece's national currency from 1960 to 2014. This period includes both the drachma years (1960–2001) and the euro years (2002–2014). I follow Rodrik (2008) in constructing an index

[2] As I was writing the first draft of this paper, coincidently, the same term was used by *The Committee for Employment and Social Affairs* of the European Parliament in a vote on the role of troika in countries like Greece, Ireland and Portugal. They voted on the 13 of February 2014 on troika's role and they concluded that the troika acted 'more like a butcher than a surgeon'.

[3] Portugal, Italy, Ireland, Greece and Spain.

[4] This is not to say that the overvalued euro is solely responsible for the current Greek economic problems. Monopolistic market structures and an inefficient public sector have had their share as well. However, these problems always existed, even before the adoption of euro and this did not prevent the growth of Greece's economy. What is different is an overvalued Greek real effective exchange rate. It should be noted here that even if these structural deficiencies have deteriorated during the euro years this might be the result of an overvalued euro. Rodrik (2008) mentions corruption and rent seeking behavior as one of many effects of an overvalued currency. An overvalued euro has a negative impact on the Greek tourism because there is a "menu" cost in adjusting prices when the nominal exchange rate appreciates. Greek tourism sells "all inclusive" packages which include services provided domestically at prices including in the package. Depreciation (appreciation) of the euro makes this package less (more) expensive to foreign tourists, including the ones who come from the eurozone countries.

[5] The term is used by Dustmann, Fitzenberger, Schönberg, and Spitz-Oener (2014).

[6] An early evaluation of the Greek economic development process of the 1950s is provided by Adelman and Chenery (1966).

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