

EUROZONE AND WORLD ECONOMY

Part II.

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Professor Robert Mundell who is deemed one of god-fathers of euro appraises the previous performance of the European Monetary Union as rather successful. In his opinion, the ECB has attained even better results than national central banks of Eurosystem. Among others, interests rates have decreased, low inflation levels have been maintained, currency speculation have vanished together with the hedging costs against monetary risk, which resulted in remarkable drop in gains of hedging funds within the Eurozone. Unlike some other American experts, Mundell's visions of further development of euro are quite optimistic. To his mind, in some 10 to 12 years the Eurozone could comprise 50 countries with 500 millions of population and with GDP surpassing that of USA by 40 to 50 percent.¹

Some euro-optimists had expected more from the start of the European Monetary Union (particularly with respect to development of the euro/dollar rate), though, and the forecasts of euro-pessimists, who had unsuccessfully struggled against the monetary integration, embraced even catastrophic scenarios. But the real development proved opinions of euro-realists who had not expected neither a miracle nor a catastrophe, to be right. EMU is an inseparable constituent of the European Union and its functioning, successes as well as failures depend from many short – and long-term factors (so called fundamentals) associated particularly with the economic performance of the Eurozone. The crucial role shall be played by further achievements of the new quality of the Eurozone in competition with USA and Japan.²

Main Indicators of Real Economy of Eurozone, USA and Japan

The Eurozone can be basically characterised as mega-economy, which lags to some extent behind USA, but in many aspects surpasses Japan. The main characteristic feature of the Eurozone is the fact that formerly relatively small and middle-size open economies were integrated even in the monetary area, thus constituting relatively new, much more closed economy with an large internal (single) market. Until establish-

ment of the monetary union individual countries comprising the today's Eurozone were remarkably open economies, whilst the Eurozone represents a large and less open economy.

The Eurozone surpasses USA and Japan with respect to population, though its age-structure is worse than that of USA. Namely, euro area countries have a lower share of population below 15 and higher share of people above 55, if compared with USA.

Measured in terms of its share of world GDP, the largest economy in 2000 was U.S. economy. The share of USA in global GDP was 22%, followed by the euro area with 16.0% and Japan 7.3%.

There are only minor differences in the **sector structure of GDP**. In all the three mega-economies, the highest share of total output accounts for the services; the share of industry is notably lower and that of agriculture is just nominal. The significance of European agricultural issues is suggested by comparison with USA, where the share of agricultural sector in total GDP makes about a half of that of the Eurozone (EMU – 2.7% and USA – 1.4%).

Labour market is of a particular importance to functioning of the monetary union, and it is characterised by certain specific features in the euro area.³ The unemployment rate in the euro area reached very high levels in the 1980s and 1990s. In 2000, it was only slight below 9.0% on average which implied 12.2 million of unemployed in the euro area as a whole. Despite certain decline, unemployment rate is still remarkably higher in the euro area than that in USA or Japan. The gap in unemployment rate between the Eurozone and USA reflects the differences in their rates of economic growth in the late 1990s, and structural differences between the labour markets in the USA and in the Eurozone. However, the labour market reforms have been implemented in the Eurozone, too, thus contributing in some cases to significant reduction in the level of unemployment.

There are other noteworthy differences, though – e.g. in the labour force participation rate and in the unemployment rate. While unemployment rate was remarkably higher in the euro area in 2000, the labour force participation rate was notably lower (67.3%) than in USA (77.2%) or Japan (72.4%). The gap between labour force participation rate in USA and the Euro-

¹ On the other hand we must have in mind that the position of the USA changes. In Latin America and the South-East Asia some economies undergo the dolarisation process either by assuming USD or through so called Currency Boards, or by means of fixing the exchange rate of national currency against dollar. Such fixation of exchange rates was typical, for instance, for Argentina which, however, has not avoided monetary and financial crisis of an incredible extent and thus has suspended payments of foreign debts.

² The case of Eurozone should corroborate the premise that the whole is always more than the sum of the parts (i.e. economies of EMU member states).

³ In this context, particular attention is paid to the institutional aspects of labour market - the legislation framework of job protection, unemployment benefit system, the wage formation process and the taxation of labour. Structural rigidities in the labour markets are deemed to be of a great importance in explaining the high and persistent unemployment, which arises from the fact that these rigidities slow the responses of economy to negative shocks (such as recession) down.



Main Macroeconomic Indicators of the euro area, USA and Japan in 2000

	Unit	Euro area	USA	Japan
Population:	millions	303	276	127
GDP (share of world GDP) ¹⁾	%	16.0	22,0	7,3
GDP per capita ¹⁾	EUR	22 322	35 034	24 922
<i>Sectors of production ²⁾</i>				
Agriculture, fishing, forestry	% GDP	2.7	1,4	1,7
Industry (including construction)	% GDP	28.8	24.7	34.5
Services	% GDP	68.5	73.9	63.8
Unemployment rate (share in labour force)	%	8.9	4.0	4.7
Labour force participation rate ³⁾	%	67.3	77.2	72.4
Employment rate ^{3) 4)}	%	61.2	74.1	68.9
<i>General Government</i>				
Surplus (+) or deficit (-)	% GDP	-0.7	2.3	-8.6
Gross debt	% GDP	70.3	57.3	130.4
<i>Revenue</i>				
	% GDP	47.9	34.0	30.3
of which direct taxes	% GDP	13.0	15.5	7.0
of which indirect taxes	% GDP	14.2	6.8	8.5
of which social contributions	% GDP	16.3	7.1	11.0
<i>Expenditures</i>				
	% GDP	48.6	31.7	38.9
of which final consumption	% GDP	19.8	14.1	16.6
of which social transfers	% GDP	16.7	10.5	17.5
Export of goods ⁵⁾	% GDP	14.8	7.8	9.7
Export of goods and services ⁵⁾	% GDP	19.1	10.7	11.1
Import of goods ⁵⁾	% GDP	14.3	12.3	7.2
Import of goods and services ⁵⁾	% GDP	18.7	14.4	9.7
Export (share of world export) ⁶⁾	%	19.0	15.0	9.2
Current account balance ⁵⁾	% GDP	-0.7	-4.4	2.5

¹⁾ GDP shares are based on a purchasing power parity (PPP).

²⁾ Based on real value added. Data for Japan refer to 1998 and for USA to 1999.

³⁾ Data for Japan and USA refer to 1998.

⁴⁾ As a ratio of the number of persons to the working age population (those aged between 15 and 64).

⁵⁾ Balance of payments data; in case of the Eurozone, only extra-euro area trade flows are included. Data for USA and Japan refer to 1999.

⁶⁾ External trade statistics; world exports exclude intra-euro area trade flows.

Source: The Monetary Policy of the ECB (2001).

zone was even higher for women (around 13 percentage points) than it was for men (around 7 percentage points). In general, labour force participation of younger people in Europe is significantly lower than participation of their American counterparts. "The lower participation rate combined with the higher unemployment rate results in a much lower employment rate ... in the euro area than in either the United States or Japan".⁴ This lower employment rate is one of the main reasons why GDP per capita in the euro area is lower than in USA or Japan.

Almost all data concerning the **government sector** imply great differences between the Eurozone, USA and Japan. Despite these differences the Eurozone – unlike Japan, where budget deficit amounted to 8.6% in 2000 – is directed towards a balanced government budget, which is attained thanks to the Maastricht criteria and The Stability and Growth Pact. Particularly these institutional arrangements are expected to provide for sound finances within EU under the circumstances when budgetary policies remain the exclusive competence of Member States.

The share of the general government sector (i.e. central, re-

gional and local government, as well as the social security sector) in GDP is remarkably higher in the Eurozone than in USA or Japan. The share of government expenditure in the Eurozone (48.6%) is notably larger than that in USA (31.7%) and in Japan (38.9%). Similar relations can be observed also in the sphere of government revenues. The relatively large share of government expenditure in GDP in the euro area reflects particularly the large shares of both final government consumption and of social transfers to households. With regard to the structure of government revenue, the euro area relies more heavily on social contributions and indirect taxes than either USA or Japan. An interesting picture can be obtained from the data on budget deficit and government debt. As we have already mentioned, budget policy within the Eurozone develops in a direction resembling that of USA. The Eurozone budget deficit widened to almost 6% of GDP in 1993, but then it gradually declined to stand at 0.7 % in 2000, which meant reduction deep below the reference value set by the Maastricht Treaty. Though, the Eurozone is still rather distant from the surplus budget of USA (+2.3% of GDP). Since 1997 the government debt to GDP ratios has been slightly improving in the euro

⁴ Refer to The Monetary Policy of the ECB (2001).

area, but its level of 70.3% of GDP in 2000 is still above the Maastricht reference value (60%), not mentioning the government debt level in the USA (57.3% in 2000). Japan still significantly lags behind with respect to both fiscal indicators, as the country's budget deficit dropped to -8.6% of GDP and the government debt to GDP ratio rose up to 130.4.⁵ It seems as if Japan, which even despite that is characterised by a particularly low level of inflation, attempted to refute text book theorem of the relation between budget deficit (or government debt) and the inflation rate.

Though the economy of the Eurozone is remarkably influenced by developments in the global economy, this impact is lower than it used to be in individual euro area countries prior to the establishment of the monetary union. This is attributable to the fact that the degree of openness of the Eurozone economy, if measured through the average share of exports and imports of goods and services in GDP, is much lower than was the degree of openness of economies of individual member countries in the past. But even though, the Eurozone is still more open than either USA or Japan. The role played by foreign trade in the economy of Eurozone is suggested among others by the exports of goods and services to GDP ratio, which was 19.1% in 2000. (In USA and Japan this ratio was 10.7% and 11.1%, respectively.) Similar relations (18.7%, 14.4% and 9.7%) are shown by imports of goods and services to GDP ratios. These data are basically in line with the data related to world exports. In 2000, the share of the Eurozone in world exports was 19.0%, the share of USA was 15% and that of Japan was 9.2%.

As for the geographical structure, main trade partners of the Eurozone include the United Kingdom, USA, Switzerland and Japan. In 1996-1999, beside the aforesaid economies there was no other individual country exceeding level of 5% with respect to its share in foreign trade of the Eurozone. The share of Russia and the central and eastern European countries together accounted for 12.8%, and the share of China and the rest of Asia (excluding Japan) was just the same.

Unlike USA having a long-run deficit of the balance of payments (in 2000, deficit of the current account reached -4.4% of GDP), the Eurozone reported just a minor deficit in the current account (-0.7%). On the other hand, Japan shows a long-run current account surplus.

Main Features of Eurozone Financial Structure

In this section we will briefly characterise the financial structure of the Eurozone which in many aspects differs from that of USA. It should be noted that the main function of the financial system is to transfer monetary funds from those who have saved surplus funds (their expenditures are below their revenues) to those who have a shortage of funds (i.e. they wish to spend more than their income). The most important lenders (savers) include households, firms, government and non-residents. The

funds flow from them to financial markets and to financial intermediaries (credit institutions, other monetary and financial institutions (MFIs) and other financial intermediaries).⁶ There is a link between the financial markets and the financial intermediaries, since part of funds flows from the financial markets to the financial intermediaries. The final "stage" of this process is represented by the movement of funds in two directions: first, from the financial markets to the borrowers – i.e. firms, government, households and non-residents, and second, from the financial intermediaries to the borrowers. The first route is called **direct or market-based financing**, the second route is **indirect or bank-based financing**.

The Chart 1 data imply that financing by means of bank loans plays an important role in the Eurozone and Japan. While bank loans amounted to EUR 6,136.1 billion in the Eurozone in June 1999 (i.e. 100.4% of GDP), in USA they amounted to only EUR 4,154.8 billion (48.4% of GDP). While in the Eurozone the share of bank financing is almost double of that in USA, in direct financing the ratio is basically contrary. In June 1999, financing by means of debt securities represented 88.8% of GDP in the Eurozone (i.e. EUR 5,422.7 billion), while in USA it was as much as 165.6% of GDP (i.e. EUR 14,140.8 billion). The above data suggest that in June 1999, the value of domestic debt securities issued in USA was 2.6 times higher than the value of domestic debt securities issued in the Eurozone. These differences would be even higher if we considered solely debt securities issued by the private sector.

Similar differences can be indicated also in corporate self-financing, i.e. in financing via share issues (stock market capitalisation), where USA / Eurozone ratio is even higher (3.2) than in debt securities (2.6). Stock market capitalisation in the euro area amounted to EUR 4,346.0 billion (i.e. 71.1% of GDP) in October 1999, compared to EUR 13,861.1 billion (163.3% of GDP) in USA. This indicator, however, reported continuous rise within the Eurozone in the 1990s. Whilst it reached only 21% of GDP at the end of 1990, at the end of 2000 it was 93% of GDP.⁷

Though several changes have occurred in the financial structure of the Eurozone in recent years, it can be still deemed the financial structure close to a **bank-oriented** financial structure (i. e. a structure based on indirect financing). U.S. financial structure, on the contrary, shows many signs of a **securitised** (direct or market-based) financial structure (i.e. a structure based on prevalent financing through domestic debt securities). The establishment of the European Monetary Union provides pre-conditions for the financial structure of the Eurozone developing in the same direction.

During 1999 – 2000, the euro area undergone the process of further consolidation of the financial services sector. Between end 1998 and end 2000, the number of MFIs in the euro area decreased by 7.7% (from 9,856 to 9,096). The major group of MFIs (credit institutions) declined by 10.1% (from 8,320 at the end of 1998 to 7,476 at the end of 2000).

⁵ Such level is absolutely unknown to any member of EU, including Belgium, Italy and Greece.

⁶ MFIs include particularly money market funds; other financial intermediaries include insurance corporations, pension funds, mutual funds, financial auxiliaries and others.

⁷ Refer to The Monetary Policy of the ECB (2001).

**Financial structure in the euro area, USA and Japan**

	Period	Unit	Eurozone	USA	Japan
Bank deposits	June 1999	EUR bilion	4 752.2	4 742.8	4 467.5
	June 1999	% GDP	77.8	55.2	111.7
Bank loans	June 1999	EUR bilion	6 136.1	4 154.8	4 280.8
	June 1999	% GDP	100.4	48.4	107.0
Outstanding domestic debt securities	June 1999	EUR bilion	5 422.7	14 140.8	5 061.1
	June 1999	% GDP	88.8	164.6	126.5
– issued by corporates	June 1999	EUR bilion	202.3	2 403.8	583.4
– issued by financial institutions	June 1999	EUR bilion	1 891.5	3 900.1	753.7
– issued by public sector	June 1999	EUR bilion	3 329.0	7 746.8	3 723.9
Stock market capitalisation ¹⁾	October 1999	EUR bilion	4 346.0	13 861.1	6 275.8
	October 1999	% GDP	71.1	163.3	137.7

¹⁾Data related to the euro area, USA and Japan are not fully comparable.

Source: ECB Monthly Bulletin, January 2000.

The integration and standardisation process involving the entire euro area reflects the response to the introduction of the euro and to new framework of monetary policy. Nevertheless, the degree of integration achieved to date differs among the various market segments. Further integration would increase the effectiveness of financial markets in the euro area, which would provide benefits to all market participants as well as to effectiveness of the single monetary policy of ECB.

Is the euro area an Optimum Currency Area?

The answer to this question is as a rule no – the euro area is not an optimum currency area. This conclusion eventually results from the analysis of criteria of OCA mentioned in Part I of this paper. Particularly unfavourable (e.g. in relation to USA) are the key indicators of labour force mobility together with the lower elasticity of wages and prices, and the lower degree of fiscal integration (which is implicitly given by the autonomous character of budget policy, which falls under the competence of national governments of Eurozone member countries).⁸

With respect to the response to asymmetric shocks, one of the Eurozone's problems is constituted by the absence of fiscal federalism, which e.g. in USA enables government to automatically execute fiscal transfers from the federal government, if any of states of the Union reports certain decline in GDP. Certain "solidarity" mechanism does exist in the Eurozone, too (so called Structural Funds and Cohesion Fund), but their impact is not directly anticyclical and their scope is lesser.

Some other facts however operate in the reverse direction and thus support better functioning of the European Monetary

Union. They involve particularly high level of commodity diversification, almost identical inflation rate, decline in budget deficits and interest rates, similar structure of member countries economies, high share of mutual trade and synchronised economic cycle. Nevertheless, all the countries constituting the euro area do not represent an optimum currency area. Some member countries (Germany, Austria, Belgium, the Netherlands, Luxembourg and Ireland) had been, however, indicated to be the hard core representing an optimum currency area even prior to the third stage of EMU. The number of countries constituting this hard core of the monetary union is gradually extending (Italy, Greece).⁹ After entering the third stage, not all aspects of the Eurozone developed in an ideal manner. Critics of the monetary union mention for instance the fact that the euro to dollar ratio has declined below the expected level. The actual power and stability of the European Monetary Union can be proved only in a longer time period when exposed to several asymmetric and symmetric shocks, however. The first significant test is imposed by the current global recession which, however, has not implied any essential defaults in the functioning of EMU.¹⁰ But EMU faces a much more challenging test of stability, which is the accession of several Central and East European countries expected to occur after 2004.

The introduction of euro has essentially changed the world of money. Right after its birth euro became the second most important world currency and together with dollar and yen it constitutes the third pillar of the world of money. " The exchange rates among these three islands of stability will become the most important prices of the world economy".¹¹

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⁸ This autonomous character is, however, limited by the Stability and Growth Pact together with the harmonisation particularly with respect to indirect taxes. This involves the following measures: 1) Budget deficit of any EU member exceeding 3 % of GDP is subject to sanctions up to 0.5 % of GDP; 2) If the country concerned does not provide for improvement of such adverse situation in two years, this amount is transferred to EU budget; 3) Sanctions do not apply to countries which report decline in GDP of 2 % or more in four successive years; 4) If GDP declines by 0.75 %, exception from the sanctions may be sought, subject to EU Council's voting.

⁹ However, some members of the current Italian government present themselves to be Euro-pessimists with respect to euro, which is up to now the only spot in otherwise successful transition to implementation of euro as the exclusive single currency.

¹⁰ So far the most significant impact of the recession was suffered by Japan, the emerging countries of South-East Asia (excluding China) and key countries of Latin America (Argentina and Mexico). But even the world's strongest economy - USA - has not evaded the recession.

¹¹ Mundell, R. A. (2000).



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