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Does EMU Membership Contribute to Economic Stability?

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The Unification and Ramifications of the Euro

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On January 1st, 2002 euro cash was introduced in the twelve countries of the euro area, replacing the former national currencies which are no longer legal tender. This was done to unify Europe's currencies and eliminate the problems associated with pricing, exchange rates and importing/exporting. This solution was supposed to help fix some of the economic problems that several European countries were experiencing, but after a year of use, there are still old and even new problems in the system. The assumption was that this "unification" of currency would bring economic stability and allow the Euro to be more like the U.S. dollar. Countries had to agree that their individual economy would grow at a certain rate and a breach in this contract would result in penalties. I believed that I would find data showing positive economic growth throughout the 12 countries. By checking the change in GDP of individual countries, I found that not all of the participants in this unification had succeeded to stay within the boundaries set by the EMU. I thought that by unifying to a common currency and spending billions of dollars to do so, there would be more stability for all countries involved with the Euro. But, that turned out to not be the case. Leaving me to ask, "How could a multi-billion dollar project end up not fulfilling all the expectations of those who designed and participated in it"?

In the beginning of 2002, the European Economic and Monetary Union (EMU) was formed and the common currency it introduced is known as the Euro. There are 12 countries participating in this currency unification and they consist of Belgium, Germany, Spain, Greece, France, Italy, Ireland, Luxembourg, The Netherlands, Finland, Austria and Portugal. In order to manage this new currency, the Eurosystem was created, which consists of a collection of Central Banks throughout Europe. One of the main reasons for the formation of the EMU is that there was fear that the Single Market would be endangered if exchange rates were not locked together.

The EMU had to collect valuable information about the European countries and what their economic status was. They collected such information as national debt, inflation rates, interest rates, exchange rates and budget deficits. One of the factors that the EMU stressed upon in order to qualify for admission was its debt to GDP ratio. This meant that countries had to have its debt less than 60% of its GDP. This posed a threat for many countries especially in the case of Italy in which they successfully met the deficit criteria but were not near the numbers to qualify as a result of its debt issues. Along with this and all the other information they were able to see which countries fulfilled the criteria and from there they would make their decision. Only one country, Greece, didn't qualify and the UK, Denmark and Sweden chose not to join.(Solomon)

In order to guarantee stability, a Growth Pact was agreed upon and it provided certain rules in which the countries involved had to obey. It consisted of a general rule that deficits should not exceed 3 percent of GDP, but if a country's GDP were to fall by 2 percent or more in a given year, it would not be penalized for a deficit greater than 3 percent of its GDP.

The twelve countries comprising the EMU have a population of about 300 million. That is ten percent more people than in the United States, however when measured in terms of GDP, it is about three-fourths that of the United States although twice that of Japan. The European Monetary Union, the United States, and Japan together are responsible for about 43 percent of world GDP and 36 percent of world exports.

There are three major differences between the Euro and the United States which are worth noting. First, government expenditures are much larger as a proportion of GDP, almost 50 percent. in Europe than in the United States, where it is about one-third of GDP. Second, unemployment is at about 10.5 percent of the labor force, compared with just over 4 percent in the United States. The third is that labor is much more mobile among the United States than it is among European countries, due to their language and cultural differences. When comparing unemployment patterns in the U.S. with those of Europe, studies have shown that differences in regional unemployment rates are smaller and less continual in the United States than are differences between national unemployment rates in the European region. The U.S. labor market has shown that regional unemployment is eliminated almost entirely by worker migration rather than by changes in regional real wages. This pattern of labor market adjustment is unlikely to be possible in Europe. Also, even within European countries, labor mobility appears limited as a result of government regulations. However others might argue that the very existence of the EMU will lead to a greater labor mobility.(Solomon)

The EMU wanted to structure the Eurosystem after that of the Federal Reserve System in the U.S. It established three interest rates, which consist of a basic "refinancing rate" which is similar to the Federal funds rate in the United States, a marginal lending rate, comparable to a discount rate, and a deposit rate paid to banks on idle funds. The basic rate was initially set at 3 percent but several months later, the Governing Council decided to lower the basic rate from 3 to 2.5 percent and also to reduce the other two rates, presumably because of the weakening in economic activity in the Euro area. This policy action was significant not only because it revealed a degree of flexibility in the Eurosystem, but also because it demonstrated that price stability is not the only policy objective of the central bank.(Lement)

The foreign exchange value of the Euro, which was set at $1.18, depreciated almost steadily, to be just below $1.06 in several months. This decline in the dollar value of the Euro was widely attributed to the strong performance of the American economy and the lower interest rates in the Euro zone than in the United States.

While the national economies of the Euro area have become integrated and have already converged in many ways, the move to a single currency is likely to have further effects. The elimination of the transaction costs of buying and selling foreign exchange and of the time and effort involved will encourage trade among the Euro countries. The elimination of uncertainty regarding future exchange rates will have a similar effect in encouraging trade and also direct investment among the countries. Also, firms that use the same currency are more likely to trade with one another. A difference between Europe and the United States is that a much larger share of finance is done through banks in Europe, while securities markets are more developed in the United States. With a larger area using the same currency and with uniform interest rates, capital markets are likely to become more important in the Euro zone.(Solomon)

If one country in the Euro area goes into recession while the rest of the area does not, there are certain ways to react. The countries own built in stabilizers will provide some offset, as tax payments decrease and unemployment benefits increase. But they are unlikely to offset the forces completely. The only other instrument available is a change in fiscal policy, a cut in tax rates or an increase in government expenditures, or a combination of both. If the countries budget has been near balance or in surplus or if its GDP declined by 2 percent or more in one year, that would be possible without running into the constraints of the Stability and Growth Pact. France and Germany currently face this dilemma and are paying heavy fines as a result of it. (Solomon)

If the shock is in the other direction, inflation in one country while price movements in the other, fiscal policy would be the only instrument available again. But the Stability and Growth Pact would not be a problem. It does not restrain countries from adopting policies that move their budgets toward surpluses.

The principal questions that have been raised regarding the international effects of the EMU deal with the international monetary system. We have to determine if the Euro can become a major reserve currency that displaces the dollar. The dollar also plays a large role as a private international asset and liability. It serves in three monetary functions, as a unit of account, a means of payment, and a store of value. If the Euro is able to take over any of these functions, then the new question that arises is when it will do so.

Moments before the introduction of the Euro, there was a good deal of debate concerning whether a single currency was appropriate for Europe. With respect to these concerns, the Euro began at a time where economic performance across its members showed wide disagreement. At the beginning of the unification, some of the Euro countries, including Ireland, Portugal, Finland, and Spain, were on the pinnacle of a rapid economic expansion.

At the same time, two of the largest countries, Germany and Italy, had stagnant economies and weak prospects for the future. The International Monetary Fund reported that 1998 GDP growth was 9% in Ireland, 5% in Finland, and almost 4% in Spain, compared to 2.8% in Germany and 1.4% in Italy. This reflected the effects of convergences in interest rates and a good example of this is Spain, which had an interest rate of 11% and it was enjoying the benefits of lower rates through convergence.(Europa)

France began to emerge from stagnation early on, recording quarterly GDP growth rates of 3.2% and 2.1%, while Germany's economy shrank by 0.7% by the end of the first quarter. Recent evidence suggests that the German economy is getting back on track, with a forecast of 2.8% real GDP growth in 2000, but this still falls short of the 3.5% growth predicted for France.

The following graph shows the countries involved with the EU and what there GDP and Employment percentages were at the beginning of this unification and what their potential growth can be.

	GDP (billion Euro)	GDP Growth (% p.a.)	Total Employment ('000)**	Annual Total employment Growth (% p.a)	
Year	**1999**	**1998 to 1999**	**1999**	**2000 -05**	**2006-10**
Austria	374	2.7	3,762	0.75	0.75
Belgium	234	3.0	4,007	1.25	1.25
Denmark	165	2.2	2692*	0.50	0.50
Finland	121	4.0	2,317	1.50	1.00
France	1,350	3.1	22,672	1.50	1.25
Germany	1,982	2.7	36,402	0.75	0.75
Greece	117	4.1	3,940	1.50	1.50
Ireland	88	5.9	1,591	2.75	2.00
Italy	1,108	2.6	20,864	1.25	1.50
Luxembourg	18	5.4	248	1.75	1.75
Netherlands	374	3.4	7398*	1.50	1.25
Portugal	107	3.5	4,837	1.00	1.00
Spain	563	3.6	13,817	2.50	1.75
Sweden	226	3.1	4,058	0.75	1.00
UK	1,353	2.8	27,442	0.75	1.00
Total	**8,180**		**145,958**		

*** Information Provided by: Eurostat**

When we look at growth, the area real GDP growth forecast by the IMF for 2003 is 2.3%, the European Commission predicts 1.8% and Consensus Economics forecasts 1.9%. Most projections for 2004 are at or slightly above the potential growth rate of the Euro area. So, it is very difficult to read any deflationary pressure in the forecasts with the data stated above.

If we look at a longer period, we can see that annual growth rates are consistently above the reference value of 4.5% since the third quarter of 2001 and even surpass 7% since the fourth quarter of 2001. The nominal money gap, which is the percent deviation of the actual money stock from the theoretical level based on a 4.5% annual growth rate is positive and close to 6% (the real money gap is still 3%) in September 2002. Thus, analysis confirms that none of these figures shows any danger of deflationary pressure.(Issing)

This set of tables presents the most relevant economic statistics concerning the euro area.

Table 1 : Output Comments

		2001	2002 FTN	2003 FTN	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03	Mar-03	
Industrial confidence FTN	Balance	-10	-12		-11	-11	-9	-10	-11	-12	
Industrial production FTN	mom % ch.	5.7	5.6		0.0	0.6	-1.6	1.1			
		2001		2002 FTN	2003 FTN	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Gross domestic product FTN	qoq % ch.				-0.2	0.4	0.4	0.4	0.2		

Table 2 : Private consumption Comments

		2001	2002 FTN	2003 FTN	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03	Mar-03
Consumer confidence FTN	Balance	-6	-11		-12	-14	-16	-18	-19	-21
Retail sales FTN	mom %	1.3	1.3		0.7	-0.5	-1.1	2.5		

	ch.									
		2001	2002 FTN	2003 FTN	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Private consumption FTN	qoq %ch.	1.8	0.6	1.7	0.1	-0.2	0.4	0.4	0.4	

Table 3 : Investment

Comments

		2001	2002 FTN	2003 FTN	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Capacity utilization FTN	%	83.5	81.2		81.8	81.1	81.2	81.0	81.5	
Gross fixed capital formation FTN	yoy % ch.	-0.3	-1.9	2.0	-0.9	-0.2	-1.3	-0.2	-0.1	
Change in stocks FTN	% of GDP	-0.2	-0.1	0.1	-0.5	-0.4	-0.3	-0.3	-0.2	

Table 4 : Labour market

Comments

		2001	2002 FTN	2003 FTN	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03	Mar-03
Unemployment FTN	%	8.0	8.2	8.3	8.4	8.5	8.5	8.6	8.7	
		2001	2002 FTN	2003 FTN	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Employment FTN	yoy % ch.	1.4	0.4	0.4	0.8	0.7	0.5	0.3		
Shortage of labour FTN	yoy % ch.	7.8	3.8		5.0	5.0	4.0	3.0	3.0	3.0
Wages FTN	yoy % ch.	2.8	2.9	2.8	3.2	3.1	3.1	2.9	2.8	

Table 5 : International transactions

Comments

		2001	2002 FTN	2003 FTN	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03	Mar-03
Export order books FTN	Balance	-14	-22		-20	-20	-19	-20	-19	-24
World trade FTN	Bn. EUR	6454	6309		523	525	504			
Exports of goods FTN	Bn. EUR	767.4	776.9	823.4	98.0	92.8	84.8	81.4		
Imports of goods FTN	Bn. EUR	802.2	781.6	828.1	89.3	83.2	77.4	82.9		
Trade balance FTN	Bn. EUR	-34.8	-4.7	-4.7	8.7	9.6	7.4	-1.5		
		2001	2002 FTN	2003 FTN	01 Q4	02 Q1	02Q2	02Q3	02Q4	03Q1
Exports of goods and services FTN	qoq % ch.	4.3	0.7	6.1	-1.1	0.2	1.7	2.1	0.0	

Imports of goods and services FTN	qoq % ch.	2.1	-1.6	6.2	-1.2	-1.0	1.5	1.8	0.6	
		2001	*2002* FTN	*2003* FTN	*Oct-02*	*Nov-02*	*Dec-02*	*Jan-03*	*Feb-03*	*Mar-03*
Current account balance FTN	Bn. EUR	-12.3	9.6	11.0	3.7	10.3	8.1	-6.4		
Direct investment (net) FTN	Bn. EUR	-104.6	-90.4		-5.0	3.9	9.6	-1.8		
Portfolio investment (net) FTN	Bn. EUR	36.5	38.0		19.4	9.7	-13.9	-14.7		

Table 6 : Prices

Comments

		2001	*2002* FTN	*2003* FTN	*Oct-02*	*Nov-02*	*Dec-02*	*Jan-03*	*Feb-03*	*Mar-03*
HICP FTN	yoy % ch.	2.5	2.2	2.0	2.2	2.3	2.3	2.2	2.4	2.4
Core HICP FTN	yoy % ch.	2.0	2.0		2.4	2.3	2.2	2.0	2.1	
Producer prices FTN	yoy % ch.	2.2	1.7		0.9	1.1	1.5	0.8		
Import prices FTN	yoy % ch.	0.4	-1.4	0.3						

Table 7 : Monetary and financial indicators

Comments

		2001	*2002* FTN	*2003* FTN	*Oct-02*	*Nov-02*	*Dec-02*	*Jan-03*	*Feb-03*	*Mar-03*
Interest rate (3 months) FTN	% p.a.	4.3	3.3		3.3	3.1	2.9	2.8	2.7	2.5
Bond yield (10 years) FTN	% p.a.	5.0	4.8		4.4	4.2	4.3	4.2	4.0	4.0
ECB repo rate FTN	% p.a.	3.25	2.75		3.25	3.25	2.75	2.75	2.75	2.50
Stock markets FTN	Index	4047	3053		2385	2559	2477	2377	2176	2089
M3 FTN	yoy % ch.	5.3	5.6		7.1	7.1	6.9	7.1	7.4	
Credit to private sector (loans) FTN	yoy % ch.	7.9	7.6		5.0	4.5	4.7	4.9	5.0	
Exchange rate USD/EUR FTN	Value	0.90	0.94	0.98	0.98	1.00	1.02	1.06	1.08	1.08
Nominal effective exchange rate FTN	Index	80.1	82.2	83.7	97.9	98.9	100.0	102.6	104.0	104.7

*** Information Provided by: The European Commission**

The first set of numbers show industrial confidence decreasing in recent months, however it shows a positive change in industrial production. Table two shows that the consumer confidence indicator decreased to -21 in March. This has been the lowest level since the recession in the early nineties. The decline is mainly attributable to the weakening of consumers' expectations about both the general economic situation and their financial situation and an expected increase in unemployment. Table three's numbers indicate little change which suggests that demand conditions can be easily met with the current existing capacity. Table four shows a steady increase in unemployment and because of it, the labor shortage is decreasing due to many firms having all positions filled. Table five shows a negative movement in almost every sector, signaling a slowing down of the European market economy. Table six indicates HICP inflation increasing to a ten-month high in February 2003. Producer prices also have been rising in past months due to the contribution of energy and manufacturing increasing. Table seven shows many changes that were influenced by recent issues concerning the U.S and Iraq. Markets fell consistently over the last few months and interest rates had to be cut once again.

The final thought in this seems to be that by unifying the countries in Europe, we have built a more stable economy for the EMU. By creating the EMU, European countries have possibly guaranteed more consistent long term stability in their economy. It's going to take a while before investors can ascertain its credibility, however when it did, the liquidity of the U.S. capital markets ensured that the dollar would still remain the currency of choice. It is hard to see successful results in the beginning of a venture such as this and along with other problems occurring in the world. In fact, it might be awhile before results are seen. But this was a way for Europe to develop a more unified system similar to that of the U.S. and good future results should come about.

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