



COMMISSION OF THE EUROPEAN COMMUNITIES

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**COMMUNICATION FROM THE COMMISSION**

**The euro area in the world economy  
– developments in the first three years –**

## COMMUNICATION FROM THE COMMISSION

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## **The euro area in the world economy – executive summary**

Stage Three of Economic and Monetary Union (EMU) started on 1 January 1999 with the 11 Member States which had achieved a high degree of nominal convergence, as mapped out in the EC Treaty. Greece was subsequently judged to have met the conditions for successful participation too, and joined the others on 1 January 2001. The introduction of notes and coins on 1 January 2002 was a difficult logistical exercise, but proceeded as smoothly as anybody could have hoped. The euro has become a tangible reality.

The benefits of the single currency, anchored in a sound institutional policy framework of responsible macro policies, and combined with structural reform, have been visible in the first three years of Stage Three of EMU. During the first two years, GDP grew at some 3 %, somewhat above potential, without creating the kind of imbalances that threaten the sustainability of growth in many parts of the world. Private savings have remained at a satisfactory level of about 15% of disposable income, budget deficits have continued to decline, albeit not at the same pace as during the 1990-98 convergence phase, increasing net public savings, and investment has been healthy, but steady, without creating an over-investment problem. As a result, the current account of the euro area has remained roughly in balance.

### **The third year of the single currency : Coping with the global slowdown**

In 2001, the global economy cooled down very rapidly, and world trade declined from a growth rate of some 12% in the preceding year to almost no growth at all. Even though the euro area is a significantly closer economic entity than its constituent Member States, trade remains important, so the appreciable decline in global trade was bound to have a significant impact. In addition, the euro area is highly integrated into the global economy, so the effects of international developments are also reflected in financial links, cross-border company ownership, and confidence. Common shocks, the increase in oil prices, the September 11th, and a correction in stock prices have all contributed to the global slowdown. But domestic factors have also played a part. GDP growth in the euro area decelerated during the year, and came to a virtual standstill in the final quarter of 2001.

Despite the slowdown in activity, employment creation held up surprisingly well, arguably a beneficial result of labour market reforms, carried out in preparation for the single currency and continued since. In the first three years of the single currency some 6 million jobs have been created in the euro area. On a slightly less positive note, inflation has increased from its very subdued level of just over 1% in the first year of Stage Three of EMU to a level of 2 ½% in 2001. This is mainly the result of a succession of special factors: two oil price hikes, the effect of which was compounded by the weakness of the euro against the currencies of major trading partners, and a series of disease and weather-related increases in food prices.

### **The euro exchange rate and external performance**

Following its launch in 1999, the euro depreciated by more than 20% against the USD. In nominal terms it had effectively lost more than 10% by spring 2001, but has remained fairly stable since<sup>1</sup>. The euro's real exchange rate in terms of unit labour cost is far below its long-term (1980-2000) average.

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<sup>1</sup> The cut-off date of this Communication was 21 March 2002.

As a result, the euro area's producers enjoy a favourable position when competing with third countries' suppliers. The competitive edge of domestic production over foreign supply helps to explain why net exports could make a positive contribution to GDP in 2001, despite the sharp decline in world trade. At the same time the failure of the euro to appreciate towards a level more in line with economic fundamentals, was of little help in containing inflation.

From a global point of view there are still substantial external imbalances. A large current account deficit the US economy is matched by a large current account surplus in Japan and some other Asian countries, while the euro area as a whole registered a current account close to balance. How far cyclical factors contribute to global imbalances is open to question, but they should unwind as economic growth in the respective areas returns to trend.

### **Fiscal and monetary policies**

Starting from an unbalanced budgetary situation, the last six years have seen a great deal of progress towards achieving greater fiscal consolidation. Since the beginning of 1999, fiscal policies have been under of the Stability and Growth Pact (SGP) and have complied in full with the 3 % reference value. "Fiscal adjustment has continued in a majority of countries, although it is slowing down. Tax cuts already decided upon and the cyclical slowdown in 2001 have widened actual budget deficits, but the structural deficits have remained broadly unchanged. Automatic stabilisers have been allowed to cushion the effects of the slowdown in most Member States.

Notwithstanding the progress made, there are still appreciable budget deficits in Germany, France, Italy and Portugal. Further consolidation efforts are necessary to reach positions that are close to balance in 2004. Commitments to this end were made in the 2001 round of updated stability programmes. Member States' commitment to this medium-term target were confirmed by the European Council in Barcelona. As a result of the discussion in Council on the Commission's draft recommendations for an early warning, Germany and Portugal gave firm political commitments which responded to the substance of the Commissions concerns.

Monetary policy has continued to focus on its primary objective of price stability in the euro area, defined by the ECB as an HICP inflation rate of below 2%, to be achieved in the medium run. The forward-looking, medium-run orientation of the ECB allowed interest rates to be lowered four times in 2001 by a cumulative 150 basis points to a level of 3¼ %, against the background of a slowing economy exerting downward pressure on inflation. Financing conditions have continued to be conducive to growth. At the same time, inflation expectations have remained compatible with the ECB's quantitative definition of price stability. As inflation rates continue to differ across Member States, and monetary conditions tend to be too tight where inflationary pressures are low, and too accommodative where final demand exceeds potential output. Fiscal policy can be one possible instrument, but could become overburdened without a more flexible wage and price system.

### **Policy coordination**

A sound economic policy framework has prevailed during the first three years of EMU. It is characterised by a number of principles enshrined in the Treaty - commitment to an open market economy with free competition, stable prices and sound public finances -, which are conducive to sustainable growth and high employment. The single monetary policy is entrusted to the independent ECB. Its primary objective is to maintain price stability. Responsibility for most economic policies,

i.e. national budgetary policy and structural policies, remains with the Member States.

The Treaty provides for a system of economic policies' coordination, fostering positive spill-over effects and taking into account possible negative externalities that could occur when decision-making is not coordinated. The Broad Economic Policy Guidelines of the Member States and the Community (BEPGs) are the central element in this system. The vigorous job creation witnessed since 1997 also reflects the labour market reforms undertaken by Member States, inter alia in the context of the European Employment Strategy. The annual Employment Guidelines are the Treaty-based instrument for employment policy coordination. Another important element, based on the Treaty, is multilateral surveillance of economic policies.

Strengthened economic (i.e. fiscal and structural) policy coordination could be improved by streamlining processes where appropriate and by implementing the measures suggested by the Commission and endorsed by the Barcelona European Council. For better common assessment of the economic situation, there needs to be more work on EMU statistical requirements. And for more universal understanding of what constitute good economic policies in EMU, the Commission intends to propose a set of common standards for the conduct of economic policies to help achieve more consensus, better economic governance, and increase transparency.

### **Wage formation under EMU**

Monetary Union has in many ways changed the macro-economic environment for wage and price setting in the euro area. Wage bargaining needs to be adapted to the new policy framework, which requires a higher degree of nominal wage flexibility in order to guarantee the euro area competitiveness. At the same time, wage increases at the national level need to take into account the impact on area wide inflation.

In the euro area as a whole the last decade has seen impressive progress on nominal stabilisation of both prices and wages. Indeed, the 1990s saw a remarkable disinflation process, and by 1997 the inflation rate had fallen below the 2% mark. Despite an increase in 2001, nominal unit labour cost inflation in the euro area has fallen rapidly. Moreover, despite a marked reduction in unemployment over the past few years, there have been few signs of a significant re-acceleration of nominal unit labour cost growth. All in all, there can be little doubt that in the early years of EMU, and even in some of the preceding years, there was an impressive amount of nominal wage moderation, which is difficult to attribute to anything other than changes in underlying behavioural relations.

Real wage moderation has borne fruit and contributed to the dynamism in job creation in recent years. Estimates indicate that the NAIRU for the euro area has fallen by about 1½percentage points, suggesting that about half of the improvement in actual unemployment can be considered structural in nature. The wage discipline reflected in the fall of the NAIRU is explained by the relatively widespread product and labour market reforms in most euro area countries, which spurred competition in goods and services markets and tackled insider-outsider divisions in the labour markets during the second half of the 1990s.

However, it must also be acknowledged that progress on reform has been fairly uneven across countries, with all the major economies of the euro area still plagued by relatively high structural unemployment. Reforms have also been rather piecemeal, suggesting that further reforms are needed if the fall in the NAIRU is to continue.

Thus, it is difficult to explain this widespread wage moderation without considering the role of income policies in a number of countries. The task is to reconcile the need for area-wide wages to remain compatible with the ECB price stability objective with the need for more flexibility, reflecting differences in the level and growth rates of productivity, so as to react appropriately to changes in demand specific to regions or sectors and improve prospects for profitable jobs.

### **Investment and growth potential in the euro area**

Public and private Investment are crucial for the development of the euro area's growth potential in the medium and longer term. EMU and the policy framework in which it is embedded is likely to positively affect major determinants of investment such as profitability and real interest rates: greater financial integration will improve financing conditions and reduced exchange rate risks will allow investment to be allocated more efficiently. Finally, with fiscal discipline there will be less crowding out of private investment.

It is too early to reach definite conclusions on the impact of EMU on investment given the time elapsed since the introduction of the euro. Nevertheless, some encouraging signs point in the right direction. If one includes the run-up to EMU since the mid-1990s, real interest rates as well as real exchange rate variation have declined and post-tax profitability is sustained at a relatively high level. Equally, the economies of the euro area show considerable convergence of investment rates, accompanied by convergence of economic conditions such as profitability and interest rates, which are the result of both deeper market integration and a more harmonised institutional framework. The evidence from FDI flows is less conclusive. M&A activities, perhaps reflecting the longer-term strategic objectives of companies have dominated FDI flows in recent years.

### **The euro and the euro area financial system**

The pace of integration of euro area financial markets has clearly accelerated since the changeover to the euro in January 1999. Of course the euro is not the only factor behind this acceleration: globalisation, fostered by the liberalisation of international capital movements, financial deregulation and advances in technology, and progress in creating a common regulatory framework across the EU (as part of the effort to complete the internal market in financial services) have also been crucial, as have the financial reforms undertaken at Member State level.

The euro has eliminated exchange risk as a source of fragmentation in the euro area financial system and at the same time it has fully exposed the opportunity costs of the remaining barriers to integration. Deeper integration due to the euro is reflected in more homogenous markets, a wave of consolidation among intermediaries and exchanges and the emergence of new and innovative products and techniques.

As market operators have adopted more pan-European strategies, policymakers at EU level have responded by elaborating a coherent policy strategy for the completion of the internal market for financial services and committing themselves to its rapid implementation (see, for instance, the Conclusions of the Barcelona European Council in March 2002). First, and most importantly, the EU has set an ambitious deadline, the year 2005, for the implementation of the Financial Services Action Plan (FSAP) - a package of 42 policy initiatives aimed at improving the functioning of the EU financial system. An even tighter deadline, 2003, has been set for actions relating to securities markets and for the Risk Capital Action Plan (RCAP). The latter is the blueprint for developing an integrated

and efficient market for equity financing of young and innovative businesses. Second, implementation of the FSAP is to be consistent across all of the Member States so that there is effective – rather than just nominal - integration of national financial markets. The new decision-making framework for securities legislation, adopted on the basis of the proposals by the Lamfalussy Committee should contribute to this objective and ensure that legislation is more swiftly adapted to the evolving financial markets. Third, competition policy is to be pro-active as financial integration proceeds, so as to ensure that economic benefits are fully exploited. Fourth, consumers and investors are to be adequately protected so that they have the confidence to operate in - and so enjoy the full benefits of – a single market extending across the Union.

### **The euro as an international currency**

The US dollar is still the main international currency, but the euro became the world's second leading currency after its launch. There are a number of factors that support use of the euro as an international currency. The first is the large size of the euro-area economy. It accounts for approximately 16% of world GDP, making it somewhat smaller than the US (21%), but much larger than Japan (8%). Figures for the share of the three areas of total world trade in goods and services are similar. The second factor which makes the euro attractive as an international currency is its stability, which reflects the sound economic fundamentals of the euro area, underpinned by the stability-oriented economic-policy framework under EMU. The third factor is the ongoing integration of national financial markets in Europe into broad, deep and liquid pan-European financial markets, which will enhance the role of the euro in international borrowing and lending activity. Nevertheless, because of network and scale effects the US dollar is likely to remain the dominant currency. In any event, internationalisation of the euro is a process driven by the private sector, and the Eurosystem neither hinders nor actively promote internationalisation of the euro as a policy objective.

The euro area, and no longer its Member States, are now considered by the rest of the world when international macro-economic issues are discussed. International institutions in charge of multilateral surveillance, such as the IMF and the OECD, have started to acknowledge the implications of these changes by assessing on a regular basis the overall macro-economic stance of the euro area. The change is also reflected in G7 Finance Ministers' statements that no longer refer to the macro-economic stance of specific euro area Member States but to the overall euro area position.

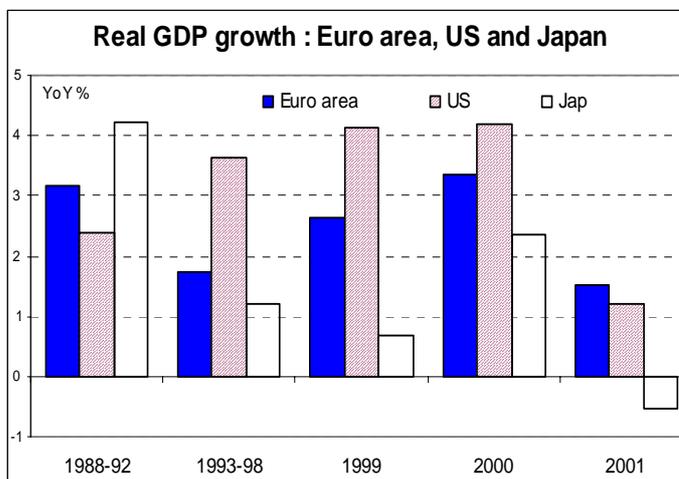
EMU has fostered, a process to develop common European positions, allowing the Community to start playing an international role commensurate with its financial and economic weight. This needs to be complemented by further progress on representation.

# 1. ECONOMIC SITUATION AND POLICY ACHIEVEMENTS

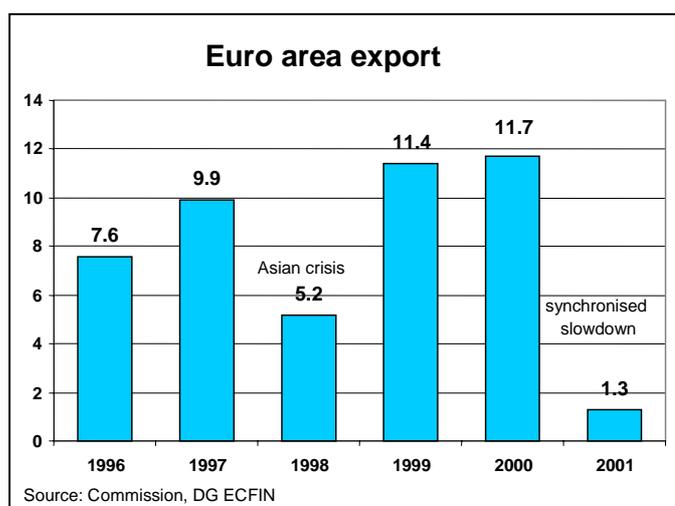
## 1.1 The third year of the single currency: Coping with the global slowdown

In the first two years of Stage Three of EMU, GDP grew above potential, averaging 3% per annum, followed by a sharp but short-lived downturn in the third year. In 2001, GDP growth decelerated, and is likely to remain subdued in the first part of 2002. There were domestic and external reasons for the slowdown. Private consumption has been sluggish since Autumn 2000, as the purchasing power of euro area households was weakened by the surge in energy and food prices as well as the appreciation of the US dollar against the euro. In addition, consumer confidence deteriorated with increased uncertainties about income prospects and falling stock prices. Investment contracted as profits declined, and demand prospects deteriorated.

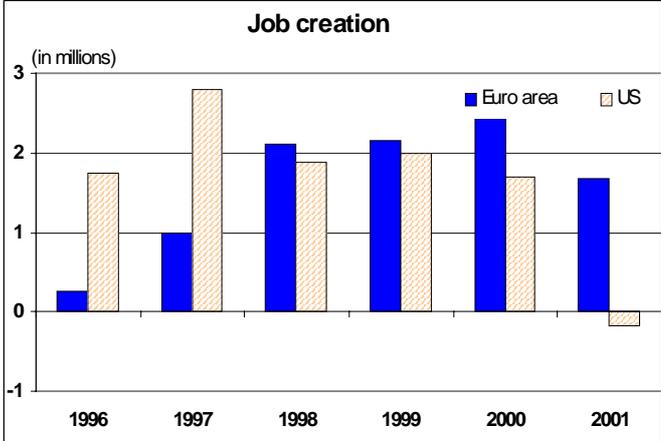
There has been increasing synchronisation with the global economy. Since the start of the single currency, the euro area GDP growth rate has narrowed the gap with the US, while at the same time the cyclical pattern has become highly synchronised with other major economies. This contrasts with the convergence period (1990-98). The high degree of synchronisation during last years recession was explained by common shocks – the hike in oil prices, the burst of the IT bubble, and the September 11 events. But it can also be seen as a sign that the euro has started to behave more like one would expect from an economy which is as deeply integrated into the global economy as the euro area.



On the external side, foreign demand plunged, because of the sharp decline in global activity. World trade growth had steeply decelerated and despite the weak euro, real export growth from the euro area dropped sharply from 12½ % in 2000 to slightly above 2% last year. Nevertheless, as imports contracted at a faster pace than exports, the external sector made a positive contribution to growth. Recovery of activity might be driven by improving consumer confidence, accompanied by gains in real disposable income, depleted inventories, growth-supportive monetary conditions, and a more favourable external environment.

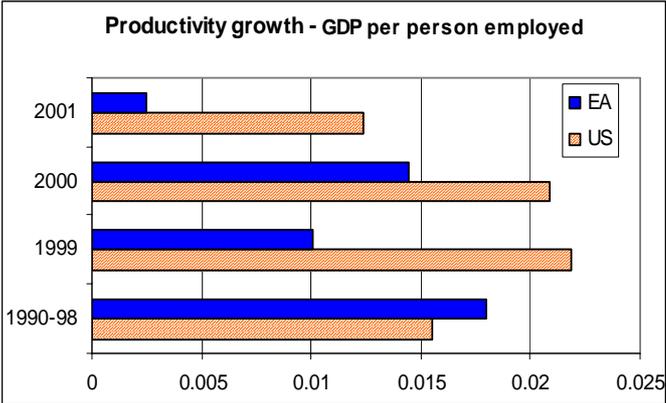


The acceleration in economic activity during the first two years had a beneficial impact on employment. But interestingly job creation held up reasonably well, even during the downswing. In the first three years of the single currency some 6 million jobs have been created in the euro area as against 3.5 millions in the US. The unemployment rate decreased from 11.3% in 1997 to 8.3% in 2001. Thus GDP growth has translated into higher employment growth.

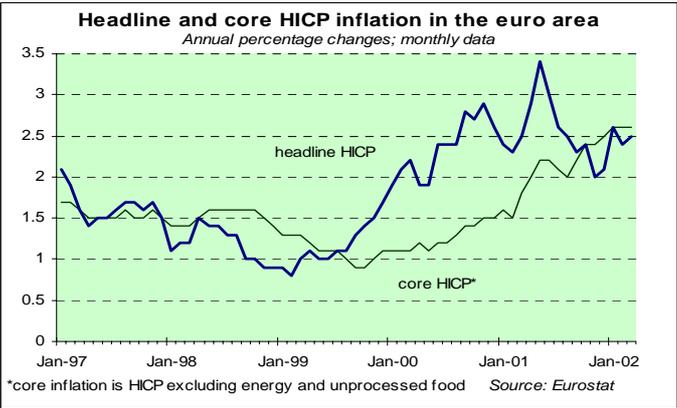


The explanations for this job-rich growth lie in structural changes in the labour market. A protracted period of wage moderation has reversed the capital-labour substitution trend that was detrimental to employment in the first part of the 90s. On the supply side the participation rate of women in particular has increased appreciably along with the share of part-time jobs and temporary contracts in total employment. Average participation rates are nevertheless still below those of the US or Scandinavian countries.

Productivity growth in the euro area and in the US was roughly equal on average during the first half of the 1990s. However, since the second half of the 1990s productivity in the US has been significantly stronger than usual at the mature state of the cycle, while productivity in the euro area has maintained a more conventional pace and pro-cyclical pattern. Another major difference has been stronger US labour supply growth, to some extent due to migration, and the ability of the US economy to absorb a growing work force. Both factors explain why GDP growth has been higher in the US than in the euro area.



Following very subdued inflation at the start of Stage Three of EMU, since the beginning of 2000, increases in consumer prices have remained above the ECB's 2% threshold. The headline HICP inflation rate increased from just 1.1% in 1999, to 2.3% in 2000 and 2.5% in 2001. The increase can be explained to a large extent by a succession of special cost push factors, while the output gap has been mostly negative since the mid-1990s.

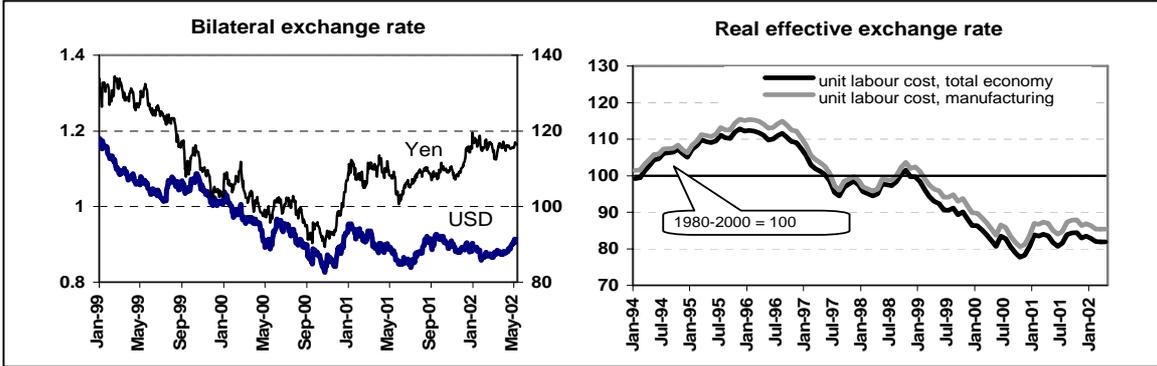


Two main cost-push factors have dominated developments in consumer price inflation: surges in import prices and domestic food prices. Higher import prices, mainly a combination of higher world oil prices and a weaker euro, were the main driving force behind the rise in inflation during 1999 and most of 2000. By the end of 2000, the BSE scare, the foot-and-mouth outbreak, and unusually bad weather had taken over and were helping to keep HICP inflation accelerating until mid-spring 2001. Finally, as 2002 began, further rises in fresh food prices, owing to unusually cold weather in some parts of Europe, as well as less favourable developments in energy prices, again pushed headline inflation in the upward direction.

**1.2 The euro exchange rate and the external accounts**

*Euro area*

Following its launch in 1999, the euro depreciated by more than 20% against the USD, but has regained some 10% from its low point in October 2000. In nominal effective terms it had lost more than 10% by spring 2001, but has remained fairly stable since. The more recent stability is a result of the USD and the GBP fluctuating without clear direction in a broader range vis-à-vis the euro, while the depreciation of the euro against the CHF was broadly offset by gains against JPY. The relative stability of the effective exchange rate over this period is surprising, given the dramatic swings which have taken place in the world economy, and the general perception that the euro is fundamentally undervalued.



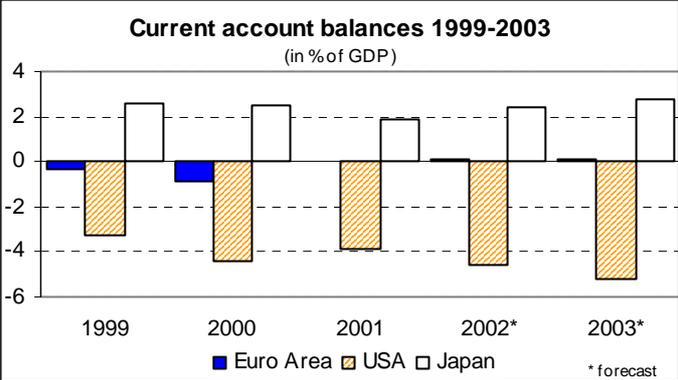
The euro’s real effective exchange rate in terms of unit labour cost is far below its long-term (1980-2000) average. The euro area’s producers have a favourable strong position in competing with third country suppliers. The competitive edge of domestic production over foreign supply helps explaining why net exports could make a positive contribution to GDP in 2001, despite the sharp decline in world trade . At the same time the failure of the euro to appreciate towards a level more in line with economic fundamentals, was of little help in containing inflation.

The real effective exchange rate is a major determinant of cross-border trade flows. Changes in direct taxes, wage settlements and country-specific cost factors influence the position of domestic producers in world markets<sup>2</sup>. A real depreciation tends to improve the competitive position of domestic producers but at the same time means a loss in purchasing power for consumers. It also has an unfavourable effect on inflationary pressures. Which level of ‘competitiveness’ is appropriate will depend on economic circumstances at the time.

The euro area current account continued to improve throughout 2001. The annual aggregate displayed

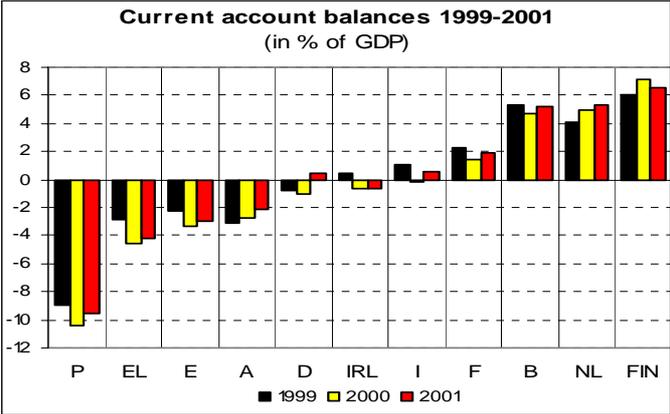
<sup>2</sup> Price competitiveness is a narrow concept, other factors such as product quality, services and punctuality also influence the strength of a country’s export sector. The World Economic Forum’s Global Competitiveness Report ranks countries by their “current competitiveness” and “growth competitiveness”. The European Commission also publishes a report every year on competitiveness of enterprises. See also “Competitiveness: A Dangerous Obsession” by P. Krugman, Foreign Affairs, March-April 1994.

a very small surplus, and according to most recent forecasts it is expected to show a small surplus until 2003. From a global point of view substantial external imbalances remained unabated. The large current account deficit of the US economy is partly offset by a large current account surplus in Japan and some other countries in Asia, while the euro area as a whole registered a current account close to balance. How far cyclical factors contribute to global imbalances is open to question, but they should unwind as economic growth in the respective areas returns to trend. Ceteris paribus, cyclical factors would imply current account deficits in periods of above-average income growth and surpluses in times of below-average income growth.



*Member States*

While the euro area current account has shown no significant imbalance during its first three years, there have been differences in developments in the Member States. External imbalances within the euro area raise questions about the appropriateness and sustainability of external imbalances in EMU. In general, although there have always been current account imbalances at Member State level in the past, the euro has significantly changed the situation as: the single financial market makes it easier to finance deficits. Indeed, countries could run imbalances for a long time thus accumulating large net external positions. This is not inherently inappropriate. There can be good reasons for current account deficits (e.g. in the context of catching up) reflecting private sector activity. However, an imbalance in a Member State's international account will ultimately imply a change in its net external position.



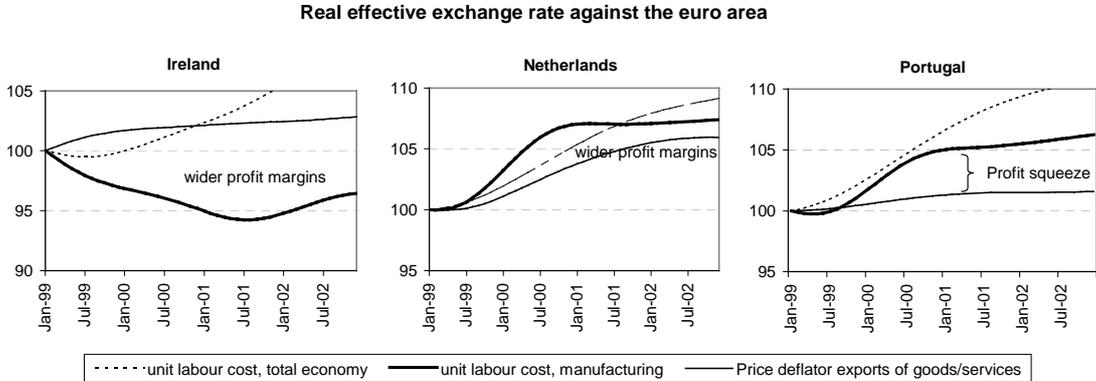
And even without discussing the theoretical foundations of current account sustainability, the accumulation of external debt will be subject to ceilings, at some level. Because corrections can no longer take the form of nominal exchange rate changes, other channels affecting competitiveness have become more important. For a country, which has to improve price competitiveness, wage moderation or structural reform to raise productivity are the only means. Structural reform has become particularly urgent as relative wage moderation is more difficult in the low-inflation environment of the euro area.

The competitiveness situation varies across Member States, both with respect to level and its recent developments. In the individual Member States the following developments have taken place since the start of EMU compared with the euro area average<sup>3</sup>: in some, cost competitiveness declined - Portugal (down by 10%), the Netherlands (-8%), Ireland (-6%) and Spain (-3%) others improved their cost competitiveness; Germany (up by +5%), Greece (+5%) and Austria (+2%); while in others cost competitiveness remained broadly stable: France (+0.6%), Belgium-Luxembourg (-0.4%), Italy (-1%) and Finland (-1%).

<sup>3</sup> As measured by the real effective exchange rate in terms of unit labour cost in manufacturing.

The trends observed since the beginning of the single currency do not necessarily indicate movements away from the appropriate level of competitiveness, as the starting positions might not have reflected a position of equilibrium. Divergent real effective exchange rate paths in the Member States can be explained in terms of different rates of productivity growth, different inflation rates, and structural factors such as the openness of the economy and the composition of trade. So an in-depth assessment of movements in real exchange rates requires a comprehensive analysis of the economic situation in each country.

One way to assess the potential implications would be to look at the variation in export prices minus the variation in unit cost in unit cost of manufacturing labour as a proxy for developments in profit margins. If cost increases can not be passed on to export prices, because producers have little pricing power in their export markets, then profit margins will increasingly come under pressure. Taking the three countries with the largest loss in competitiveness against the euro area as an example, Portugal and the Netherlands have a similar geographical breakdown in external trade -, about 1/3 is with the world outside the euro area and 2/3 within the area -, while for Ireland the weight is 55% outside versus 45% inside. This implies that Ireland’s loss within the euro area is less important and its gain from the euro weakness larger than for the other two countries.

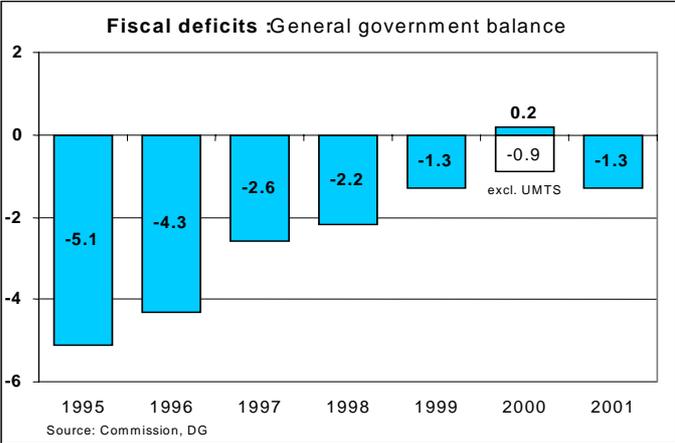


From a policy perspective, it is important to monitor Member State’s current account balances within the euro area in addition to the area-wide balance, as they may give indications of country specific problems. Price competitiveness may be worsening as a move towards or away from equilibrium. Monetary policy is oriented towards the euro area, and is therefore ineffective in dealing with country specific excess demand or supply situations. Fiscal policy, and in particular structural reform, aimed at increasing supply is needed to prevent external imbalances from accumulating, which might ultimately threaten financial stability.

**1.3 Macro economic policies in the euro area**

*Achievements*

As regards *fiscal policy*, the Stability and Growth Pact (SGP) established a comprehensive surveillance procedure to monitor budgetary policies in EMU. The aim is to ensure budgetary discipline, thus helping the ECB to maintain price stability. Since a single currency implies a greater role for national fiscal policies in adjusting to country-specific developments, the SGP establishes the “medium-term budgetary objective of positions close to balance or in surplus” which “will allow all Member States to deal with normal cyclical



fluctuations while keeping the government deficit within the reference value" of 3% of GDP. Under the SGP, euro-area Member States must update their medium-term fiscal strategy every year through Stability Programmes<sup>4</sup>. The Stability Programmes are the main instruments of budgetary surveillance in EMU and are assessed by the Commission and the Council.

Starting from an unbalanced budgetary situation, the last six years have seen a great deal of progress towards achieving greater fiscal discipline. Actual budget balances in the euro area improved up to 1999, in part due to vigorous consolidation efforts, and many Member States are now running a surplus. Since then, the favourable performance of some countries was largely due to strong growth, improvement in underlying fiscal positions being very modest. In 2001 budget deficits have increased due to tax cuts that were not fully offset by expenditure reductions and the operation of automatic stabilisers in the cyclical slowdown.

Since the beginning of 1999, fiscal policies have been set in the framework of the SGP. The 3% reference value has de facto become a "hard ceiling". No Member State has breached it. Fiscal adjustment has continued in the majority of countries, albeit at a slowing pace. In 2001, most Member States had reached budgetary positions fulfilling the "close to balance or in surplus" requirement of the SGP.

Obviously, the SGP played a significant role in this achievement. Notwithstanding, these steps forward budget deficits are still too large in Germany, France, Italy and Portugal, impacting on the euro-area-wide aggregates. Further consolidation efforts are necessary to reach positions that are close to balance in 2004 at the latest. Commitments to this end have been made in the context of the 2001 round of updated stability programmes. As budget deficits in 2001 in Germany and Portugal exceeded by a wide margin, the targets set in their respective Stability Programmes, approaching the 3% of GDP reference value, the Commission made a recommendation to the Council to issue an "early warning under the Stability and Growth Pact regulation. As a result of the discussion in Council on the Commission's draft recommendations for an early warning, Germany and Portugal gave firm political commitments which responded to the substance of the Commission's concerns.

Overall, a favourable feature of the improvement in fiscal positions is the composition of budgetary adjustment. Reducing the tax burden, where appropriate (especially marginal tax rates on labour) eliminating tax distortions and restraining current expenditure is the most effective way to ensure durable fiscal adjustment. Recent budgetary developments show that most countries are moving in this direction. The present adjustment mainly relies on expenditure restraint, while the overall tax burden has fallen as a share of GDP. Ongoing tax reforms should help to reduce the historically high tax burdens which still prevail in many EU countries. Lowering the tax burden on both capital and labour, and especially low-cost labour, should enhance physical and human capital accumulation, increase labour-market participation and boost the demand for labour.

Nevertheless, the euro area faces two main challenges in relation to future fiscal policy:

- *Eliminating remaining imbalances and maintaining a neutral fiscal stance:* If the euro area is to enjoy favourable growth and low inflation, it is essential to eliminate the remaining imbalances and maintain a neutral fiscal stance. Continued fiscal discipline will also facilitate the ECB's task of achieving price stability. By ensuring that budgetary positions meet the medium-term objective set out by the SGP of being "close to balance or in surplus", Member States will also be able to cope with normal cyclical fluctuations, responding to country-specific developments, and providing budgetary room for manoeuvre to make the necessary structural reforms.

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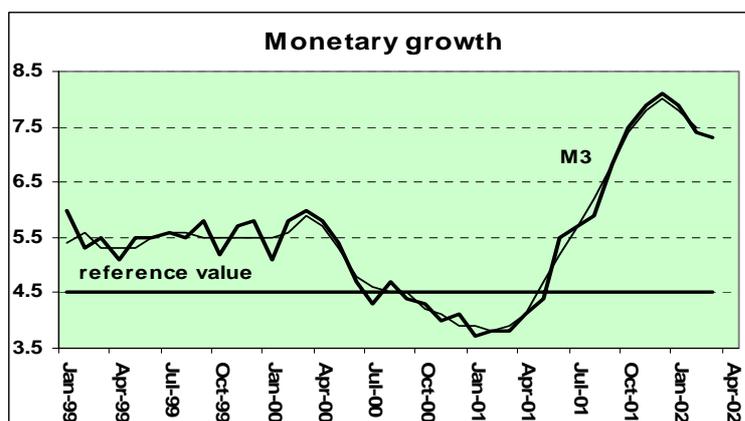
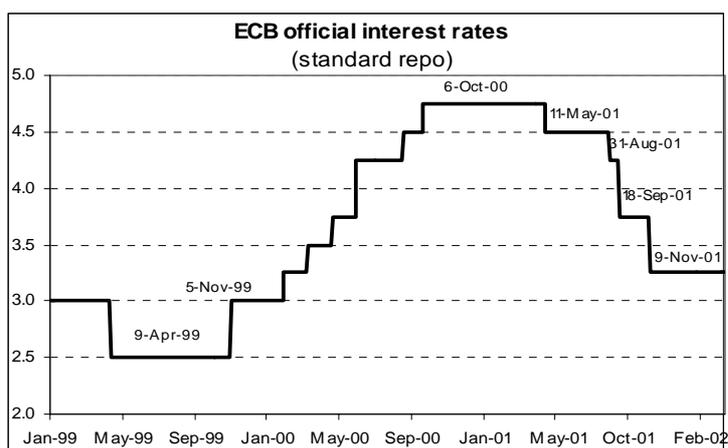
<sup>4</sup> Non euro area Member States continue to present Convergence Programmes.

- *Preparing for population ageing*: Sustainability of public finances is now part of surveillance in the Stability and Growth Pact framework. Risks have been identified in several Member States. This may require setting more ambitious medium-term budgetary targets in order to smooth future debt developments.

As regards *monetary policy*, the Treaty makes price stability the primary objective of the ECB. Monetary policy should also support the economic policies of the euro area, without prejudice to the goal of price stability. The ECB's monetary policy strategy consisting of three elements: a quantitative definition of price stability and "two pillars" used to assess risks to price stability. Price stability was defined by the ECB as a year-on-year increase in the HICP for the euro area of below 2%, to be maintained over the medium term. The definition of price stability provides a yardstick against which the ECB's monetary policy can be assessed for the achievement of its primary objective. Furthermore, the ECB stated that the single monetary policy would adopt a euro-area-wide perspective and so, it would not react to specific regional or national developments. The first pillar of the ECB's monetary policy strategy attaches a prominent role for money, signalled by the announcement of a reference value for the expansion of broad money, M3. Since December 1998, the ECB's reference value has been set at a growth rate of 4½%. The second pillar consists of an analysis of a wide range of other economic indicators such as cost and price indices, the exchange rate, real economy indicators, and financial market indicators, in order to arrive at a broad based assessment of the inflation outlook and the risks to price stability.

In spring 1999, the ECB cut interest rates against the background of declining inflation and uncertain global growth prospects in the aftermath of the financial crises in South-East Asia, Russia and Brazil. As growth picked up later in the year, and inflationary pressures rising were the ECB reversed the initial move by raising policy rates. During the year 2000, the significant increase in oil prices coupled with a depreciating euro shifted the balance of risks to price stability upwards. Meanwhile, money growth remained above the ½% reference value and credit to the private sector continued to grow strongly. The ECB responded to increased inflationary pressures by raising interest rates in a number of steps. The deteriorating economic outlook in the world economy, and in particular the US, triggered a series of interest rate cuts in major economies throughout 2001. The ECB lowered interest rates four times last year, by a cumulative 150 basis points, to a level of 3 ¼%. This was done despite an inflation rate above its upper limit of 2%, because a good part of the price increases were of a transitory nature, while the weakening economy was exerting downward pressure on inflation. Prospects that a temporary higher rate of inflation would not feed into inflation expectations, were conducive of continued wage restraint.

For most of the time during the first three years of the single currency monetary growth was above the ECB's reference value and in the last quarter of 2001 and the first quarter of this year outstripped it. However, the recent strong monetary growth was not considered a risk to price stability by the ECB, as it was seen as mainly caused by portfolio shifts into monetary assets in an environment of



increased uncertainty. In this context, the growth of M3 above the reference value did not prevent from reducing further key ECB interest rates following the terrorist attacks in the US in late 2001.

Whilst it is of paramount importance that the ECB bases its interest-rate decisions on the economic conditions of the euro area as a whole, differences in inflation rates among the Member States persist. This, however, is also the case, for example, across single States in the United States. Economic policies need to be adapted in order to address domestic imbalances in individual euro area countries.

#### **1.4 Coordination of economic policies in EMU**

A sound economic policy architecture is enshrined in the Treaty. It comprises a commitment to an open market economy with free competition, stable prices and sound public finances which are conducive to sustainable growth and high employment. It assigns tasks to the various policy-makers but leaves them independent (combination of the principles of subsidiarity and coordination). The single monetary policy is entrusted to the independent ECB. Its primary objective is to maintain price stability. Responsibility for most other economic policies, i.e. national budgetary policy and structural policies, remains with the Member States.

The Treaty provides for a system of economic policies' coordination, fostering positive spill-over effects and taking account of any possible negative externalities that could occur when decision-making is not coordinated. The Broad Economic Policy Guidelines of the Member States and the Community (BEPGs) are the central element in this system. The annual Employment Guidelines are the Treaty-based instrument for employment policy coordination. Another important element based on the Treaty is multilateral surveillance of economic policies.

The BEPGs provide guidance to the relevant policy makers with regard to both the macroeconomic and structural spheres. And because they are comprehensive, these guidelines seek to ensure consistency in policy stance, across policy fields and in geographical terms. Multilateral surveillance has been put into practice in the form of procedures and processes that aim to establish sound budgetary policy (Stability and Growth Pact) to advance the process of structural reform in labour, product and capital markets (the Luxembourg and Cardiff processes). In June 1999, the Cologne European Council initiated the Macroeconomic Dialogue. It brings together both policy makers and representatives of the social partners for an exchange of views on economic trends and policy requirements in the EMU framework. In March 2000 the Lisbon European Council integrated economic and social reform objectives into a ten-year agenda aimed at becoming the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.

Both the degree of economic policy coordination and the form it takes vary considerably across policy areas. In any case, successful coordination rests on three elements: (i) a common assessment of the current economic situation and the outlook; (ii) better understanding of the working of EMU and the economies of its member states and (iii) the willingness of policy-makers to give and take open and frank advice, to accept the principle of peer pressure and to adjust policies when necessary.

Assessments of economic policy coordination in EMU, endorsed by the Helsinki and Lisbon European Councils, have concluded that there is no need for new processes. Moreover, the Barcelona European Council stressed that the focus must be on implementation. Emphasis has been put on learning-by-doing to make gradual improvements. In the first three years, notable progress has been made in the following three areas:

##### *The Broad Economic Policy Guidelines*

The BEPGs continue to contribute to convergence in EMU and, in line with the Lisbon objectives, they give priority to improving the EU's growth potential through economic reform. The BEPGs have been enhanced in several ways. They have become more operational through the use of more concrete

and specific recommendations in both the general and country specific parts. Increased attention is also devoted to implementation. To this end the Commission has introduced a comprehensive implementation report that assesses the extent to which Member States have followed the policy recommendations.

The significance of the BEPGs has been further enhanced through the greater involvement of the European Council, as decided in Lisbon. The annual spring meeting of the European Council devoted to economic and social questions is providing additional political guidance. Moreover, the BEPGs are now oriented towards, and draw on, work in other relevant Council formations which assume responsibility for implementation in their respective areas and contribute to subsequent BEPGs.

#### *The Stability and Growth Pact*

The Pact designed to bring about sound budgetary positions in the Member States, a condition for the smooth functioning of EMU. Implementing the Pact has been helped by the adoption of a new code of conduct in 2001 governing the format and contents of the Stability Programmes submitted by euro-area Member States. The new code makes it easier to compare programmes through the use of common external assumptions for projections and by having all national programmes submitted within a short period every autumn. In addition the set of information which has to be provided has been increased to allow better analysis of issues relating to the long-term sustainability of public finances.

#### *The Eurogroup*

The Eurogroup brings together Ministers from Member States that have adopted the euro. The Commission, and where appropriate the ECB, are invited to participate. The group serves as an informal forum for frank and free discussions on EMU-related issues. This informal forum has facilitated the establishment of common views among Ministers on matters of mutual concern. The range of subjects covered has expanded from topics such as cyclical positions, budgetary stances, exchange rate and capital market developments, to structural issues that have an impact on growth and public finances. Furthermore, the effectiveness of the Eurogroup has been enhanced by improving its working procedures and giving it more visibility.

Whilst progress has been made in the first three years of the single currency, there is a need to further strengthen policy coordination. To this end the Barcelona European Council endorsed measures to improve the common assessment of the economic situation. Work need to be intensified on EMU statistical requirements. Moreover, in March 2002, the Commission started issuing a regular quarterly report presenting ongoing analytical work. And with the aim of enhancing the common understanding of what constitutes good economic policies in EMU, the Commission intends shortly to propose a set of common standards for conducting economic policies.

## **2. MONITORING WAGE DEVELOPMENTS IN EMU**

### **2.1 Introduction**

The formation of EMU was expected to exert a profound impact on the market players, in particular affecting price setting and wage bargaining behaviour. Economic and Monetary Union has in important ways changed the macro-economic environment, which is now characterised by a single, stability-oriented monetary policy for the euro area, and sound national fiscal policies. The debate about the likely impact of EMU on wage formation has centred around three different, though interconnected, aspects: (i) the necessary degree of nominal wage flexibility to take account of the now more direct effects of wage on price competitiveness (ii) the direct impact on real wage aspirations (the wage-setting curve) and, thus, on equilibrium unemployment; and (iii) the impact on labour market institutions, in particular wage bargaining mechanisms.

It has been widely held that, in general, EMU should provide improved framework conditions for employment-compatible wage bargaining behaviour as the link between wage and employment trends becomes more evident and stringent. With the bailout option of nominal exchange rate devaluation no longer available, any substantial error in wage setting would ultimately translate into a loss of competitiveness, deteriorating labour market conditions and painful adjustment thereafter.

In EMU it is therefore even more important than in the past for wage developments to be in line with both the macro-economic framework set at the Community level and the individual country-specific requirements. Thus, wage bargaining behaviour shows that:

- If overall nominal wage developments are not consistent with price stability, excessive nominal wage increases pose inflationary risks for the euro-zone as a whole with adverse effects on growth and employment in the entire monetary union.
- Real wage developments that are in line with labour productivity growth and, take into account, where necessary, the need to strengthen the profitability of capacity-enhancing and employment-creating investment avoid deterioration in competitiveness and labour market conditions.
- The single currency increases transparency and facilitates wage comparisons which may lead to “wage imitation”. While convergence in living standards is an aim of the EU and is likely to happen over time, premature wage level catching-up might actually slow down or even stop the process of real convergence.
- Wage agreements that take into account productivity differentials according to qualifications, skills and geographical areas not only help to avoid job destruction and enhance job creation in general, but also improve the employment prospects for groups such as the young, low-skilled or long-term unemployed and contribute to the efficient reallocation of labour across occupations, sectors and regions.

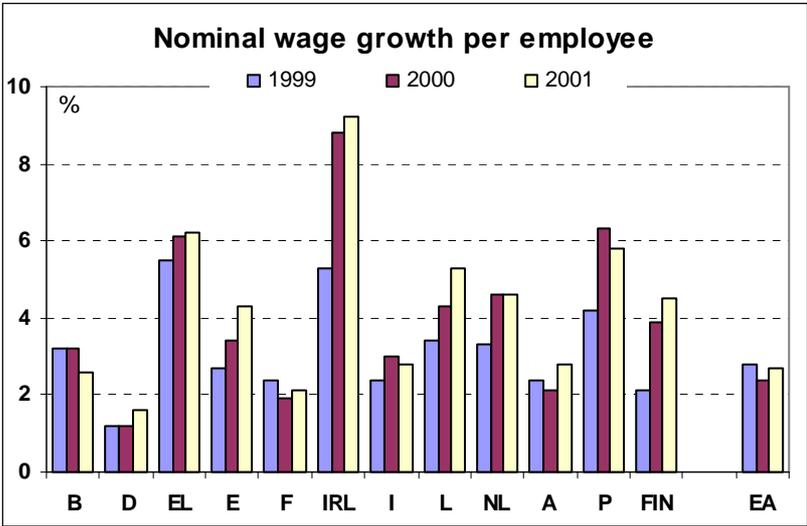
The responsibility for wage setting procedures and outcomes compatible with the achievement and maintenance of high employment continues to fall primarily in the domain of the private sector. As indicated above, inappropriate wage developments - or, more generally speaking, inadequate labour market structures - in specific countries or regions, particularly when they are big enough to require an

offsetting monetary policy response, may have harmful consequences for other members of EMU as well. Strengthened economic policy coordination could help internalising these effects.

**2.2 Aggregate wage developments: some stylised facts**

The last decade has seen a remarkable disinflation process. While the lacklustre overall economic performance over that period has contributed to a reduction in inflationary pressures, there is evidence that the achieved high degree of price stability has also been the result of the systemic changes associated with the run-up to Stage Three of EMU. With price stability and a high degree of sustainable convergence being key requirements for adopting the euro, differences between national inflation rates also narrowed drastically in this process. For the euro area as a whole, nominal wage growth per employee declined almost in parallel with price stabilisation, with nominal compensation per worker now set to increase on average by about 3 % annually at the present point in time. At first glance, therefore, the players in the wage bargaining process appear, in general, to have taken on board the need for compatibility with price stability.

As a by-product of nominal stabilisation, the absolute dispersion of nominal wage growth across countries has also diminished significantly over the past decade, resulting in fairly similar nominal wage developments in the recent past. However, in 2001 the absolute dispersion of nominal wage growth per worker among the "big four" euro countries still amounted to 2.7 percentage points (ranging from 1.6 % in Germany to 4.3 % in Spain). Money wages increased somewhat faster in Finland and the Netherlands, reflecting different cyclical positions; the highest rates of nominal wage growth were in Ireland, Portugal and Greece. As a result, there still remains a significant dispersion of rates of growth in money wages in the euro area.<sup>5</sup>



While convergence to a wage behaviour, that keeps in mind its impact on overall price inflation, is warranted, cross-country differences in productivity levels and rates of growth actually limit the degree of appropriate wage synchronisation. Allowing wages to reflect country, regional or sectoral differences is a means to allow real wage levels to converge over time at sustained or improved employment levels. Thus, stronger nominal wage increases in some countries enjoying faster growth of labour productivity need not be a particular cause for concern.

<sup>5</sup> When the coefficient of variation in nominal wage growth rates is taken as a yardstick, the relative dispersion of nominal wage increases appears to have somewhat increased over time. However, the evidence of more closely synchronised nominal wage behaviour is preserved when looking at measures of relative dispersion.

The stabilisation in nominal unit labour cost developments, was accompanied by a decline in the cross-country dispersion in nominal unit labour cost increases across Member States. However, in 2001 some slippage in nominal unit labour cost growth occurred, and there is similarly clear evidence of overshooting nominal unit labour cost growth in a number of smaller countries.

The slowdown in economic activity in 2001 was accompanied by a pick-up in nominal unit labour cost growth. For the euro area as a whole, nominal unit labour cost have risen by about 2.5 % last year. While this is to some extent a reflection of weaker than expected labour productivity growth, several countries – mainly in the euro area periphery – have undoubtedly shown signs of overheating. Nevertheless, for the area as a whole current expectations are for a deceleration of nominal unit labour cost growth, currently forecasted to return below 2 % in 2002.

In summary, despite an increase in 2001 nominal unit labour cost inflation in the euro area as a whole has fallen. Moreover, despite a marked reduction of unemployment over the past few years, up to date there have been few signs of a significant re-acceleration of nominal unit labour cost growth in the area as a whole. Admittedly, several countries which have experienced a few years of sustained growth and where the labour market has become relatively tight (Ireland, the Netherlands and Portugal), appear to be relatively more exposed to eventual wage pressures. Furthermore, the labour cost impact of the reduced working week in France may be felt more strongly, once compensating productivity increases start abating. However, all in all, the early years of EMU, including several years of the run-up to monetary union, have seen an impressive amount of nominal wage moderation, which can hardly be explained without recourse to changes in underlying behavioural relations.<sup>6</sup>

Corroborating evidence for overall wage moderation is to be found in the evolution of real product wages adjusted for productivity. Obviously, in its simplest form, this boils down to the analysis of real unit labour cost developments, mirroring changes in the share of labour in total income. Indeed, for the euro area as a whole, the labour income share remained broadly constant in the first three years of EMU, after having fallen continuously in the preceding five years.

A somewhat closer look at real unit labour cost developments over the last three years reveals the following pattern:

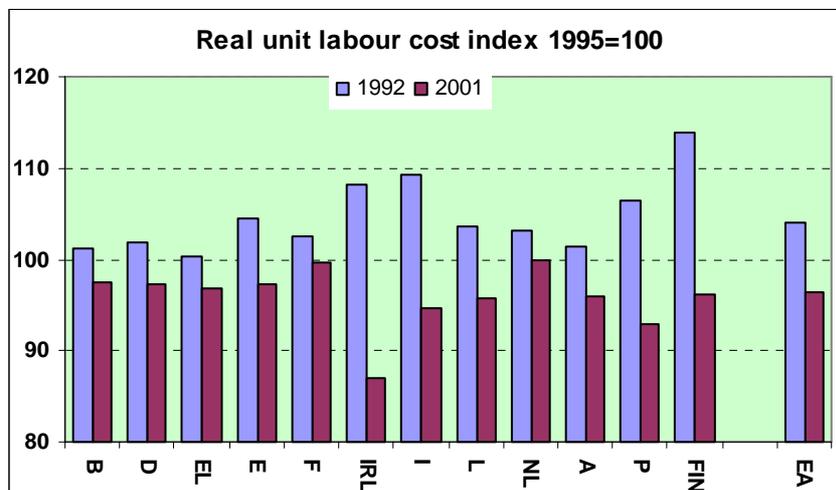
- Real wage moderation has prevailed in almost all countries of the euro area. Only in France, Luxembourg and Portugal real unit labour cost were higher in 2001 than three years previously.
- In the countries of the former DM-bloc, plus Italy real unit labour cost growth has basically been flat over the past three years; and 1st year Spain saw a pause in the trend decrease of the wage share.
- In Ireland and Finland, which had both seen significant declines in real unit labour costs in the pre-EMU years, the fall in labour's share of income came to a halt and the real unit labour cost started to increase.

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<sup>6</sup> Put more formally, out-of-sample predictions of wage equations estimated up to the early 1990s generally tend to over-predict wage developments in subsequent years (OECD 2000).

- Late comer Greece has, over the past three years, registered a pronounced fall in real unit labour cost, compensating for the real wage push experienced in the pre-EMU years.

Evidently, real wage moderation has borne fruit and contributed to the dynamism in job creation in recent years. The unemployment rate of the area has decreased significantly from its peak of 11.5 % to below 8.5 %, yet wage developments have remained subdued. Thus, the NAIRU of the euro area might have declined by about 1 ½ percentage points, and continues to be on a



downward path, suggesting that about half of the improvement in actual unemployment could be considered structural in nature. By and large, other international bodies such as the OECD and the IMF have arrived at very similar conclusions. Obviously, we need to understand the underlying mechanisms behind the wage moderation, before we can say whether or not this process of wage moderation can be sustained.

### 2.3 Factors behind the wage moderation observed in recent years

To better understand the nature of the wage moderation, as reflected in the fall of the NAIRU, reference should be made to relatively widespread product and labour market reforms in most euro area countries, spurring competition in goods and services markets and cracking down on insider-outsider divisions in the labour markets during the second half of the 1990s. Employment stimulating reform efforts<sup>7</sup> have addressed, inter alia, tax and benefit systems, for example in the form of cuts in payroll taxes for targeted groups or in-work financial support for low-wage earners, and a modernisation of work organisation, including the facilitation of part-time work and more flexible work contract arrangements.

Moreover, the introduction of the single currency is bound to increase the degree of competition in product and services markets by enhancing price transparency across EMU Member States.<sup>8</sup> Thus, EMU provides an additional impetus to ongoing efforts in the context of the Single Market Programme to improve the functioning of product and service markets. As a result, the potential for rent sharing behaviour between workers and firms will be strongly reduced.

<sup>7</sup> While more active and preventive labour market policies may have helped to improve the employment situation, their effect on wage moderation and the NAIRU is ambiguous.

<sup>8</sup> Note, however, the more sceptical view of several observers that integration may not necessarily imply intensified competition, because integration also facilitates the strategies of transnational firms potentially enabling them to establish product market domination across Europe.

***Box: Centralisation, coordination and macroeconomic outcomes.***

The discussion of how wage bargaining structures affect wage developments has to a large extent been shaped by the Calmfors and Driffill hypothesis. It predicts an 'inverted U' relationship between unemployment and the degree of centralisation of wage bargaining. Fully centralised and fully decentralised bargaining produce the most employment-friendly outcomes, essentially because firm-level bargaining takes the competitiveness of the firm into account and economy-wide bargaining is concerned with the macroeconomic employment effects. In between the two extremes, the externality implications of wage increases on employment are not fully taken into account, which leads to inferior outcomes. Empirical evidence for the inverted U relationship is, however, weak. Successful coordination, whether formal (e.g. through wage norms agreed with government involvement) or informal (e.g. through pattern bargaining) can be understood as a way of overcoming the potential disadvantage of bargaining at an intermediate level.

While it is difficult to establish precisely the contribution of the various reform efforts, there can be little doubt that they have had some effect in reducing the NAIRU by helping to keep a lid on wage demands. However, it must also be acknowledged that the progress on reform has been fairly uneven across countries. All the major economies of the euro area still have relatively high structural unemployment.

Thus, it is difficult to account for the widespread wage moderation without considering the role of informal incomes policies in a number of countries<sup>9</sup>. In the past few years bi- and tripartite agreements on wage policy have been concluded in Belgium, Denmark, Finland, Germany, Greece, Spain, Ireland, Italy, the Netherlands and Portugal typically committing the parties involved in collective bargaining to some form of wage moderation compatible with price stability and to improve competitiveness. Governments' involvement in tripartite "social pacts" may take various forms, for example trading tax cuts and/or specific labour market policy measures against wage restraint, as has recently been the case in Finland and Ireland. Finland has also made an attempt to increase nominal wage flexibility by the introduction of so-called "EMU buffer funds",<sup>10</sup> but their impact will probably remain fairly limited.

Belgium provides probably the clearest instance of explicitly taking competitiveness into account. In 1996 the government enacted an "employment and competitiveness" law which included a legal wage norm for 1997-98, whereby pay increases were not to exceed average increases in Belgium's neighbouring countries, France, Germany and the Netherlands. Indeed, the social partners concluded new inter-sectoral agreements in 1998 and 2000, again incorporating the concept of a wage norm related to wage trends in neighbouring countries as the key reference for average Belgian wage increases.<sup>11</sup>

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<sup>9</sup> For a detailed discussion see for example the European Industrial Relations Observatory (EIRO), EIROonline (2000) .

<sup>10</sup> In periods of economic upturn social security contributions are levied at a slightly higher rate than necessary. During cyclical downturns the accumulated funds can then be used to pay for additional social security costs.

<sup>11</sup> The most recent framework agreement, concluded in December 2000, caps increases in nominal wages per employee to a total of 6.4 % for the period 2001-2002.

***Box: Social Pacts.***

In the 1980s and 1990s, tripartite social pacts (re-) emerged in a number of Member States; most often this corporatist approach was chosen against a backdrop of high unemployment and rigid labour market structures. For the government, tripartite negotiations on structural reforms offer the advantage of indicating what is politically feasible at an early stage and ultimately winning the social partners' active support for the implementation of an agreement. Furthermore, tripartite negotiations offer the possibility of concluding package deals whereby every participant can claim at least partial achievement of his goals. Often, governments encourage package deals by offering rewards (e.g. in the form of tax cuts) in the case of success. For the social partners, tripartite negotiation holds out the possibility of being able to influence policies at an early stage and of gaining legitimacy.

The run-up to Stage Three of EMU brought additional dimensions into the coordination process: on the fiscal side the need to fulfil the Maastricht criteria and the disinflation process on the monetary side; the latter also strengthened the focus on wage developments. However, the pressure that had favoured social pacts in the first place might have eased with the launch of the single currency and the favourable growth conditions in 1999/2000.

Coordinated wage bargaining at the national level has helped to sustain wage moderation. However, such arrangements face a fundamental problem of time consistency, making it difficult to lock in the bargain. In particular, with free capital mobility the effectiveness of mechanisms to bind employers to policies of high investment is fairly limited. In turn, this reduces the incentives for labour to exercise wage restraint in anticipation of future investment. Governments may hence find it increasingly difficult to design supportive policies deemed acceptable by the main actors in wage bargaining.

At the same time, with inflation in the euro area converging at fairly low levels, the role of generalised wage restraint has become less important, while the importance of greater nominal wage flexibility for the smooth functioning of EMU has increased. Experience suggests that co-ordinated wage bargaining at the national level tends to produce results orientated towards certain general economy-wide indicators, instead of regional, company and skill specific needs. Provided that it allows for flexible adjustment at lower bargaining levels, co-ordinated bargaining itself may deliver fairly differentiated outcomes. In recent years there has been a move in several countries towards "centralised decentralisation" in wage bargaining, for example in the form of "opening clauses", which allow for some degree of firm-level differentiation. However, centralised bargaining was sometimes unable to quickly correct wage developments out of line with productivity. In such cases, the ensuing loss of competitiveness may build up over quite some time, before the inevitable, and painful adjustment kicks in.

With labour market policies geared towards mobilising the labour force potential, by means of comprehensive structural reforms aimed at increasing participation rates, overall wage pressures may indeed remain subdued. Accompanying structural reform also facilitates the transition towards a higher degree of in-built wage differentiation.

So far progress has been made in reforming labour market institutions in the euro area, and there can be little doubt that in general wage bargaining institutions and wage setting practices have responded, quite favourably to the new economic environment, both in the run-up to Stage Three of EMU and during its first three years. Over the medium term, the driving forces of price transparency, increasing capital mobility, trade integration and competition are likely to increase the real wage elasticity of

demand for labour. This should foster employment-compatible wage bargaining behaviour as the link between wage and employment trends ultimately become much more evident and stringent.

### 3. INVESTMENT AND THE EURO AREA GROWTH POTENTIAL

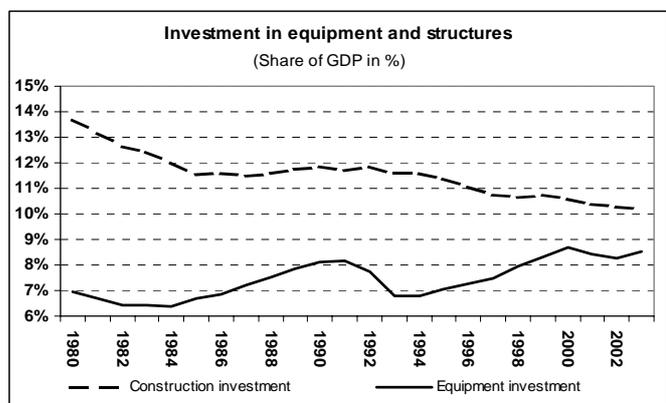
#### 3.1. Investment trends in the euro area in the 1990s

Public and private investments are crucial to the development of the euro area's growth potential over the medium and longer term since it determines the structure and size of the capital stock and acts as a conduit for the penetration of new technologies. While the empirical evidence is still inconclusive<sup>12</sup>, it is nevertheless clear that EMU offers significant upside potential for investment in the euro area for three reasons:

- By acting as a complement to the single market programme, the euro fosters competition and reduces exchange rate risks.
- As the drive towards greater financial market integration deepens, financing conditions for firms are expected to improve in general and cross border investments will become easier.
- At the level of economic policies, it is expected that EMU will act as a catalyst for structural reforms, in particular in labour markets. On the fiscal side, lower deficits and falling debt ratios will have an impact on interest rates, and create room for private sector activity.

While the upside investment potential provided by the EMU framework is clear, it should be underlined that realising that potential will require significant policy efforts in both the macro and microeconomic arenas over the coming years. The extent of the challenge is revealed by an analysis of historical trends. The euro area's lacklustre investment performance during the 1990s is widely considered to be a major factor behind the area's relatively poor actual and potential growth performance. This chapter tries to isolate factors, which are crucial in determining investment trends, with particular emphasis on those on which EMU is likely to impact directly or indirectly.

During most of the 1990s, the euro area's investment performance was poor. The investment recovery of the late 1990s appears slow compared with the previous investment cycle, which began in 1986, lasted 5 years and reached peak growth rates for total investment of 7%. In contrast, the recovery of the late 1990s was both shorter and less pronounced, with annual growth rates not exceeding 5%. Investment shares show a similar picture of a more muted

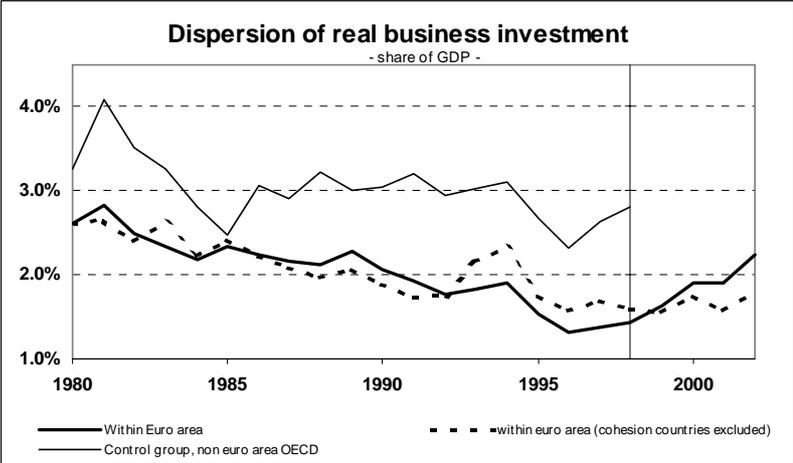


<sup>12</sup> Given the short time that has elapsed since the start of the EMU process, it is clearly too early to attempt an empirically comprehensive assessment of its impact on investment in the euro area.

recovery in the 1990s, progressing steadily between 1997 and 2000 but still remaining below its peak of the late 1980s. Investment growth was unusually buoyant in the second half of the 1980s<sup>13</sup>.

The overall investment trend can be disaggregated into construction and equipment investment or, alternatively, into public and private investment. The construction sector, accounting for more than half of total investment, played an important role in the subdued investment performance of the euro area after the 1992-93 recession. In contrast, the expansion phases of the equipment investment cycles in the 1980s and 1990s seem rather similar both in terms of duration and growth rates. Average growth rates were slightly slower during the expansion of the 1990s but, in 2000, real equipment investment was significantly higher as a share of GDP than at the peak of the previous investment cycle. Approximately three quarters of total corporate investment spending is on equipment, as witnessed by a sustained growth pattern during most of the second half of the 1990s. Also, the share of ICT expenditure in total GDP has increased in recent years.<sup>14</sup> Contrary to business investment, government investment (partly as a result of privatisation) saw its share in GDP decline continuously between 1991 and 1998, after which it remained broadly stable. Consequently if we exclude construction and public investment the picture from the 1990's in terms of equipment investment is encouraging with business investment in this area having accelerated since the mid 1990s, especially in real terms, and prices in the ICT sector declining sharply. Business investment (as a share of GDP) has reached levels similar to the peak in the late 1980s.

Over the 1990s there was a considerable reduction in the cross country variation of investment rates, while the dispersion of investment rates over the rest of the OECD<sup>15</sup> countries, remained fairly stable. This foreshadowed the convergence in economic conditions and stricter synchronisation of policies in the run-up to Stage Three of EMU. Surprisingly, the trend of real convergence was even more marked for more advanced economies than for the cohesion countries. Since 1999, however, dispersion in rates of business investment has not declined any further, and in more recent years there has even been a slight increase caused to some extent by more buoyant investment in the countries catching up.



<sup>13</sup> This buoyancy reflected, at least partly, anticipation of completion of the Single Market.

<sup>14</sup> In a recent study the ECB (ECB WP 122, New Technologies and Productivity Growth in the euro area, Vijselaar and Albers) estimates that the contribution of ICT investment to output growth in the Euro Area has increased from 0.37 percentage points over the period 1991-95 to 0.74 percentage points in 1996-99.

<sup>15</sup> Including Denmark, Sweden and the UK.

**Box: Foreign direct investment**

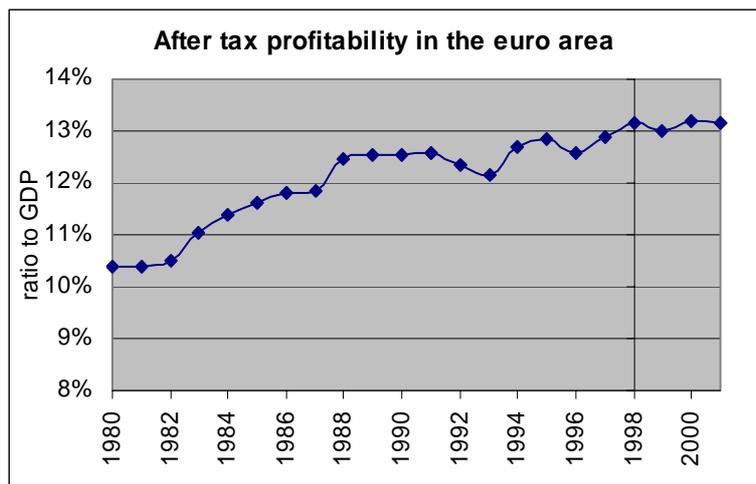
Throughout the 1990's European integration gradually removed barriers to foreign direct investment (FDI) and to direct ownership by foreign companies. The introduction of the euro has further reduced barriers to intra-euro area investment flows arising from the potential variability of exchange rates, and from likely reductions in the home-country bias in private sector portfolios. At the same time trade barriers have been lowered and consequently to the extent that FDI is a substitute for trade flows the overall impact of integration is ambiguous.

Both outflows of FDI from the euro area and inflows into the region increased significantly during the second half of the 1990s. Some comment seems necessary regarding the high level of net FDI outflows in recent years appear necessary. Net FDI outflows from the euro area surged during the second half of the 1990s, averaging more than 1 % of GDP between 1996 and 1999. FDI data indicate that investment by companies based in the Euro Area actually recovered much more strongly during the second half of the 1990s, than shown by national accounts data on business investment. Analysis of geographical and sectoral data confirms that the surge in net FDI flows in recent years was largely driven by the strategic decisions of multinational corporations in a limited number of sectors and geographical areas, probably more linked to global expansion than motivated by differences in expected profitability. Data for 2000 reflect large inflows to Germany and large outflows from the UK, to M&A activities in the telecom sector. There is no convincing empirical evidence so far that FDI flows have responded strongly to differences in competitiveness within the euro area.

### 3.2 Determinants of investment in the euro area

Economic theory points to three main macroeconomic factors in determining investment: aggregate demand, the cost of capital and profitability. Given the particular significance of productivity and potential growth, a simple and direct test of the relative importance of the key macroeconomic variables was carried out using profitability, relative investment prices and real interest rates as variables to explain investment in equipment. As anticipated research results show the positive impact of higher profits, relative investment prices, lower real interest rates and lower taxes. A sustained increase in profitability of 1 percentage point increases the investment in equipment share in GDP by 0.10 to 0.15 of a percentage point. A similar fall in relative investment prices or real interest rates would raise the equipment share by about 0.05 of a percentage point.

Since the early 1990s, there has been a noticeable, continuing upward shift in after-tax profitability<sup>16</sup> in the euro area. At the same time, growth has become more labour-intensive, implying a significant decline in capital for labour

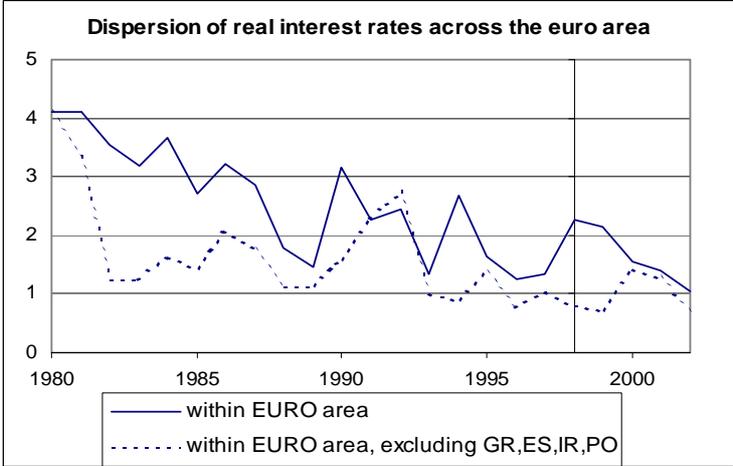
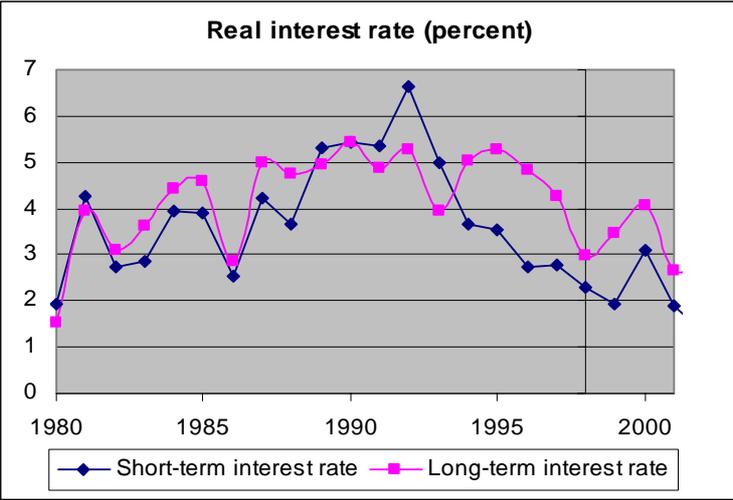


<sup>16</sup> Measured as GDP at market prices minus labour income (excl. self employed), times one minus effective corporate tax rate, all in percent of capital.

substitution. This trend reflects both the secular movement towards a more service sector dominated economy and the long period of sustained wage moderation. Unfortunately, so far the relatively large increase in profitability does not appear to be translating into an equally strong overall investment performance. More encouragingly, EMU has had positive effects on investment by reducing uncertainty, as volatile exchange rates between euro area member states are a thing of the past, as are lower short and long-term interest rates as a result of EMU's sound fiscal policy framework.

As expected, fundamental macroeconomic determinants of investment have also shown a considerable degree of convergence in recent years. The dispersion of after-tax profitability, measured by its standard deviation, has nearly halved since the end of the 1980s with especially marked decline in the early 90s. Similarly, real interest rates have shown signs of convergence as well. Convergence of profitability reflects increased product market, and labour market competition, but also higher capital mobility due to financial

liberalisation. This, together with increased synchronisation of fiscal and monetary conditions within the euro area explains the convergence of real interest rates. Nevertheless, country specific factors continue to play a role. The exceptional increase in Irish investment has been accompanied by a substantial increase in after-tax profitability. Portugal is the only country where profitability has been declining over the last three years, but as real interest rates have fallen too, the investment rate has changed very little.



While the traditional macroeconomic variables appear to explain investment behaviour in the euro area to some extent, macro-economic factors are also important. It is clear that structural rigidities in the financial, labour and product markets need to be addressed if EMU is to achieve its full potential in terms of enhancing the economic environment for investment. Stock market variables are positively correlated with investment growth in cross-country comparisons. Similar linkages exist for indicators of stock market size, liquidity and prices. This is not surprising as firms invest to increase profits and shareholders assess the value of firms according to expected future profits. The evidence available so far suggests that stock markets as a source of financing are particularly important for enterprises in the ICT sector, which have been a main driver of investment growth in the US. Product market regulation seems to be another structural determinant that has a significant effect on investment behaviour. Indicators constructed by the OECD to gauge differences in regulatory patterns across countries,

consistently show that more restrictive regulation goes hand in hand with lower rates of investment growth. In particular, indicators linked to the extent of public ownership (size, scope of public enterprises and their corporate control), the state's involvement in business operations (price controls, use of command and control regulations) and barriers to entrepreneurship (regulatory opacity, large administrative burdens on start-ups and barriers to competition) are negatively linked with investment activity. Finally, labour market rigidities may have held back investment in the euro area. Indeed, the OECD Employment Protection Legislation Indicator is negatively related to real investment growth. Other quantitative structural labour market variables point in the same direction, e.g. the "tax rate on low wage earners" and the "duration of unemployment benefits".

From the evidence presented, there seems to be both a need and scope for improving the investment environment in the euro area, with EMU providing the potential for that to happen. A sustained increase in the rate of fixed capital formation would move the euro area onto a path of permanently higher living standards. An increase in the share of investment in GDP would raise the area's growth potential in the very short term – and in the longer term too if technological progress is incorporated into a more modern capital stock. Evidence on the determinants of investment point to the need to address a series of structural rigidities in the euro area with the objective of improving the investment climate. In this regard a wide range of possible structural reform measures are under consideration, covering labour market reforms, reductions in corporate taxes, and product and financial market reforms that increase competition and reduce monopoly rents.

To conclude, EMU has the potential to significantly improve the investment environment in the euro area and to act as a powerful counterweight to the negative impact on growth of factors such as declining populations. EMU is expected to play this positive role (a) by fostering competition and reducing exchange rate risks, thus impacting on a range of investment determinants; (b) by acting as a catalyst for financial market development; and (c) by encouraging a range of macro- and micro-economic reforms which will promote investment.

## 4 THE EURO AREA FINANCIAL SYSTEM

### 4.1 Overall developments in the EU financial system

In recent years, there has been a visible acceleration in the process of development and integration of EU financial markets. There are three main, interrelated factors behind this acceleration: (i) globalisation, fostered by the liberalisation of international capital movements, financial deregulation and advances in technology; (ii) progress in creating a common regulatory framework across the EU (as part of the effort to complete the Internal Market in financial services), accompanied by financial reforms in the Member States; and (iii) the changeover to the euro.

Before January 1999, the need to operate in many national currencies was a major obstacle to financial integration in the Union. The presence of an exchange rate risk limited the attractiveness of cross-border investment, reduced the incentive to proceed with regulatory harmonisation at the EU level, and dampened competitive pressures on the Member States' home markets. The changeover to the euro as the single currency of twelve Member States has altered this situation. The euro has eliminated exchange risk as a source of fragmentation in the euro area financial system and at the same time it has highlighted the opportunity costs of the remaining sources of fragmentation in the system. Deeper integration due to the euro is reflected in more homogeneous markets, a wave of consolidation among intermediaries and exchanges and the emergence of new and innovative products and techniques. Market operators have adopted more pan-European strategies, and policy-makers have responded by assigning a high political priority to the completion of the internal market for financial services. In addition, there is now a greater incentive to intensify domestic reforms as a means of preserving the competitiveness of previously protected national financial systems.

Financial structures in the euro area and the US (end-2001, in % of GDP)

	euro area	US
Bank deposits	64.3	60.6
Bank loans	108.2	50.7
– to corporation	42.7	16.1
– to households	45.7	34.6
– general government	12.4	0.0
Outstanding debt securities	90.6	148.6
Issued by		
– corporations	5.8	24.2
– financial Institutions	28.7	43.1
– public sector	52.7	84.4
Stock market capitalisation	73.3	138.7

Sources: ECB (euro area bank deposits and loans), Federal Reserve (US bank deposits and loans), Eurostat (euro area and US GDP, stock market capitalisation), BIS (debt securities). For the US, bank deposits and loans are aggregates for commercial banks, credit unions and saving institutions (data from Fed, Flow of Funds). For the US, public sector outstanding debt securities include those issued by Government-Sponsored Enterprises or Federally Related Mortgage Pools

US financial systems are seen as predominantly market-based and the euro area system as predominantly bank-based.<sup>17</sup> This is still valid. In particular, bank financing plays a much bigger role in business financing in the euro area than in the US. In the US, direct issuance of securities is the dominant means of business financing, as reflected in the large outstanding amounts of debt securities and stock market capitalisation. In spite of these differences, it is noticeable that in both economic areas the whole range of instruments and intermediaries play an important role.

In the euro area, advances in information processing, liberalisation and market integration (including through the removal of twelve different currencies), are to favouring the development of capital markets relative to bank finance. However, there is no theoretical or empirical evidence to suggest that a more securitised financial system would be superior to the current bank-oriented system. Other characteristics have come to be regarded as more relevant for the overall efficiency of a financial system - for instance, its completeness and adaptability<sup>18</sup>.

The euro area financial sector is experiencing a phase of rapid structural change, in which deeper integration of national markets is accompanied by a general expansion of the financial sector and heightened competition between the available instruments and intermediaries. Due to the specific characteristics of the various components of the financial industry, developments, in particular in respect to integration, have been rather uneven across markets.

## **4.2 Money and derivatives markets**

From 1 January 1999, the ECB monetary policy operations have been implemented in euro on the basis of the area-wide demand for liquidity, without discrimination between the individual liquidity needs of national banking systems. Some problems with the ECB's liquidity allotment procedures in the initial period were effectively addressed by the move to floating rate tenders in June 2000. While, from then onwards, the euro-denominated money market has functioned smoothly, the degree of integration varies across its different segments..

In the *market for unsecured inter-bank deposits*, integration is virtually complete and there is practically full convergence in very short-term interest rates across the euro area. Such convergence in interest rates is also reflected in the full acceptance by market operators of EONIA (Euro Overnight Index Average) and EURIBOR (Euro-Inter-Bank Offered Rate) as uniform price references. Interest rate convergence has also been helped by the efficient distribution of liquidity area-wide: cross-border transactions account for a large part (about 60 %) of total inter-bank activity of the largest market participants. There are indications that the inter-bank market has developed a two-tier structure in distributing liquidity, with relatively large banks dominating cross-border transactions and smaller banks relying on domestic transactions with larger banks for their funding. Interest-rate convergence is also evident at somewhat longer maturities in the money market. Analysis by the BIS<sup>19</sup> has pointed to

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<sup>17</sup> In comparing the euro area financial market to the US, it should be stressed that the euro area is fundamentally different from the US because it is a union of countries and not one single country. Despite much progress in financial integration, the euro area financial sector is still characterised by different national legal and regulatory systems, markets conventions, etc..

<sup>18</sup> A complete financial structure offers a company the financing through markets and intermediaries which best corresponds to its needs at the different stages of its life. An adaptive structure provides leeway for the evolution of new forms of financial intermediaries or contract forms, if the business environment changes.

<sup>19</sup> Bank for International Settlements (2000), 70<sup>th</sup> Annual Report.

the decline of 40 % in bid-ask spreads on 3-month euro-currency deposit rates in 2000 relative to 1996 as further evidence of integration in the euro unsecured money market.

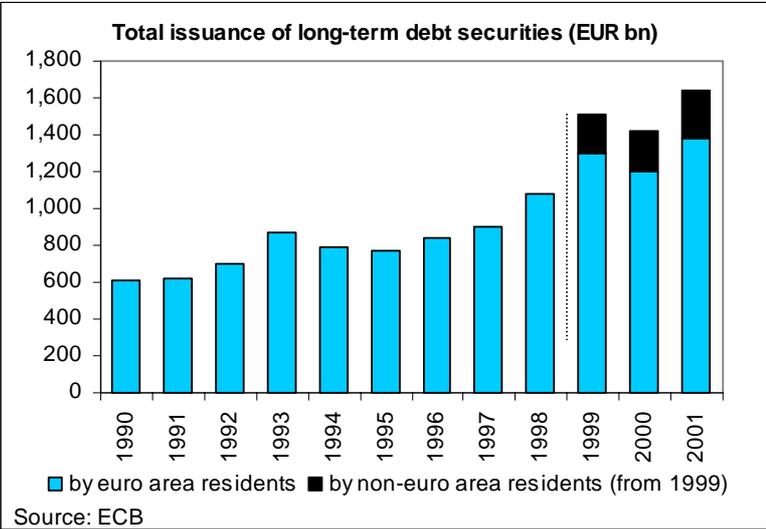
In parallel with developments on the unsecured money market, the euro-area *derivatives market* is also highly integrated. The cross-border market for euro interest rate swaps has expanded sharply since the introduction of the euro, and the high degree of market integration is reflected in very narrow bid-ask spreads and relatively large outstanding amounts. Activity in other derivatives markets has also increased, with EURIBOR-based futures contracts displacing all futures contracts in legacy currencies that existed before EMU.

The *secured money market* segments (e.g. private repurchase agreements, Treasury bills, commercial paper and certificates of deposit, which involve the exchange of liquidity for collateral) remain considerably less integrated. This state of affairs reflects difficulties in the cross-border use of collateral, mainly due to national differences in market practices, regulations and the tax/legal treatments that apply to the securities used as collateral. These national differences are reflected in segmented national-based market infrastructures and can create important practical difficulties in cross-border clearing and settlement, as stressed in a recent report by the Giovannini Group<sup>20</sup>. The collateral directive, which is to be fully implemented by 2003, will address present difficulties in the cross-border use of collateral and help to integrate EU financial markets further, e.g. by determining which law governs cross-border collateral arrangements.

**4.3 Bond markets**

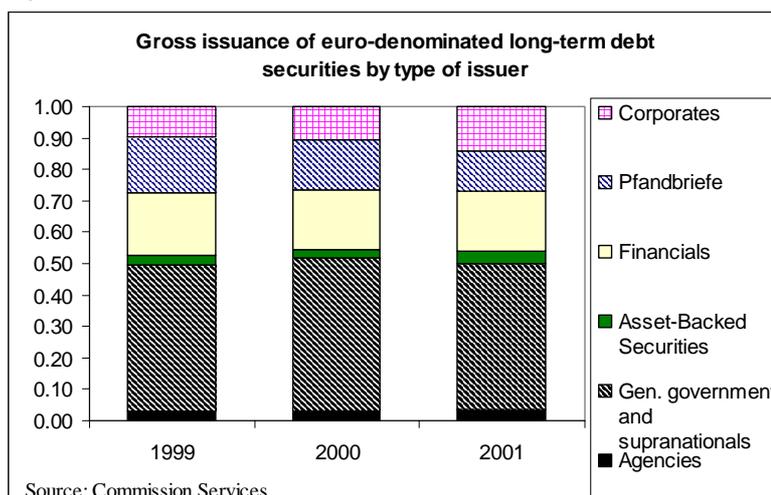
The introduction of the euro has integrated the national bond markets of the participating Member States, resulting in a substantially more homogenous euro-denominated bond market. The effects of integration are evident in many aspects of market activity.

First, the greater liquidity and depth of the euro-denominated market has been reflected in higher issuance volumes. Total domestic issuance in euro since January 1999 has exceeded the combined issuance in legacy currencies during the years immediately preceding EMU. Euro issuance was particularly strong in 1999, rising by 20 % relative to 1998. This surge in issuance reflected the



<sup>20</sup> The Giovannini Group is a group of market participants, under the chairmanship of Alberto Giovannini, established to advise the Commission on the financial market. In November 2001, the Group issued a Report on “Cross Border Clearing and Settlement Arrangements in the European Union”. The Report, published as European Commission Economic Paper No.163, is available at [http://europa.eu.int/comm/economy\\_finance/giovannini/clearing\\_settlement\\_en.htm](http://europa.eu.int/comm/economy_finance/giovannini/clearing_settlement_en.htm).

release of pent-up demand on the part of both issuers and investors, who had delayed their entry into the market because of turbulence in the international financial system and uncertainty surrounding the changeover to the euro. Corporate issuers were particularly active in the early months of 1999, as many endeavoured to establish a position in the new and potentially more liquid market. In 2000, however, euro issuance declined by 6 % (including issuance by non euro area residents for which data are available only since 1999), with the return to a more normal rhythm of issuing activity, reduced government borrowing needs and a progressive deterioration in market sentiment as interest rates and oil prices moved steadily higher. The trend in euro issuance showed a sharp upturn at the beginning of 2001. Despite a deceleration in the later part of the year, total issuance in 2001 was 16 % up from the previous year. The strength of euro issuance in 2001 can be traced to the corporate and financial issuers, who responded to the improved bond market conditions and weakness in global equity markets.



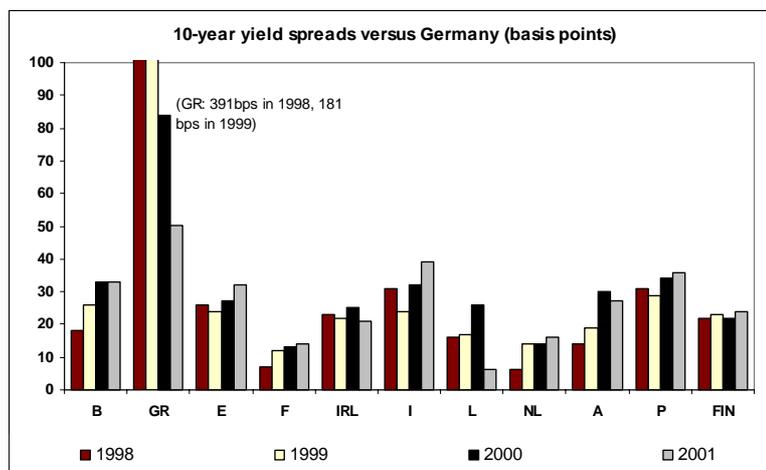
Second, relative to the pre-EMU situation, there has been a sharp rise in the share of private sector

relative to sovereign issuance. This shift in the composition of bond issuance is the result of both reduced financing needs of the euro area governments following the 1990s fiscal retrenchment, and a surge in issuance by financial and non-financial corporations. In particular, the relatively underdeveloped market in non-financial corporate bonds has recorded exceptionally rapid growth rates, with total issuance rising from €27 billion in 1998 to €97 billion in 2001. Further evidence of increased liquidity in the corporate and financial segments of the market is to be found in the progressively larger size of individual issues, with tranches above €1 billion now commonplace.<sup>21</sup> In the non-financial corporate market segment, the rise of issues by lower-rated corporations is also an indication of a relatively liquid market, although the share of high-yielding issues remains relatively small. The trend toward greater securitisation undoubtedly reflects higher investor demand in the more liquid euro-denominated bond market, as well other factors not directly related to euro, such as the need to finance increased M&A activity and UMTS auctions that have stimulated the supply of corporate and financial bonds.

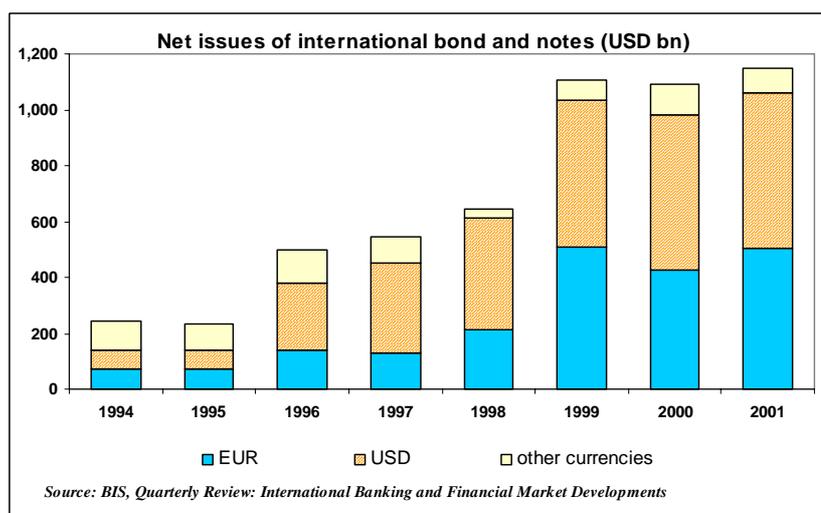
Despite its lower share in total issuance, sovereign issuance remains a dominant source of supply to the euro-denominated bond market. In 2001, it still represented more than 40% of total issuance in euro. The homogeneity of the euro-area government bond market is evident in highly convergent yields across the Member States, which is in marked contrast to the situation that existed as recently as the mid-1990s. The convergence in yields can be attributed to the elimination of exchange risk and to the relative improvement in budgetary conditions in several of the Member States. However, there is still evidence of fragmentation of liquidity in this market segment, as government bonds are issued by

<sup>21</sup> Freddie Mac, the US quasi-governmental mortgage agency, began a significant euro issuance programme in September 2000, planning to issue of EUR 5 billion per quarter in varying maturities.

twelve separate agencies with different borrowing requirements, issuance, strategies, procedures and instruments. Liquidity premiums seem to have emerged as an important determinant of euro-area government yield spreads - especially for smaller-issuing Member States, several of which would be expected to enjoy relatively low credit risk due to their favourable budgetary positions. It shows that for most countries ten-year spreads versus Germany were somewhat wider in 2001 than in 1998. The preference enjoyed by the German ten-year Bund also reflects the fact that the Bund is deliverable into the future contract in Eurex, which has become predominant in the euro area. An active derivative market ultimately promotes better liquidity of the underlying security.



Third, as issuance volumes have risen, the euro has emerged as the second most important currency for international bond issuance. The US dollar and euro now dominate international issuance, representing more than 90 % total<sup>22</sup>. The euro's share of international issuance almost matched that of the US dollar in 1999, but fell back sharply in 2000. In 2001, the euro's share was 44 %, compared to 48 % for the US dollar.



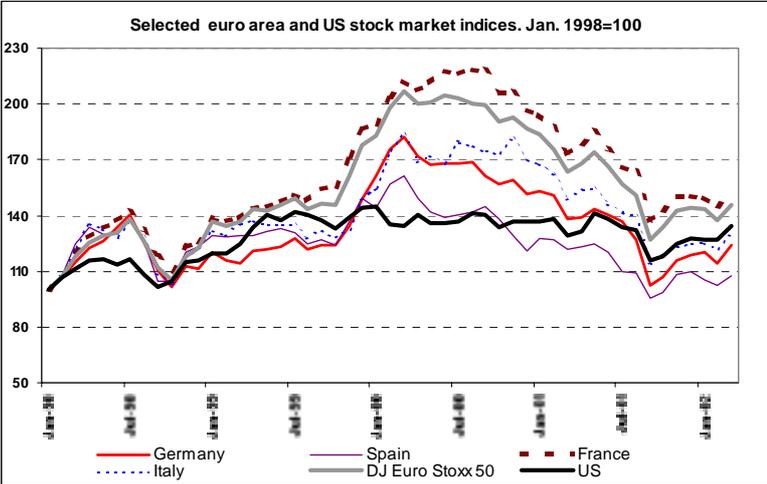
#### 4.4 Equity markets

The euro, by eliminating exchange risk, has stimulated demand for cross-border equity investment. Other forces have contributed to the trend toward cross-border trade, such as the growing

<sup>22</sup> The BIS international debt securities database covers three types of instruments: securities denominated in a currency other than that of the market in which they are issued ("eurobonds"); securities denominated in the currency of the market in which they are issued, but issued by non-residents (foreign bonds, such as "Yankee" bonds in the US market); and securities denominated in the currency of the market in which they are issued, issued by residents, but targeted at non-residents (BIS Quarterly Review, March 2002).

internationalisation of equity issuance, more mergers and acquisitions across borders and the consolidation of formal stock exchanges.

Apart from these structural developments, the integration in EU equity markets has been evident mainly in a more sectorally correlated movement in equity prices across the various Member State markets. This indicates a change in investor behaviour away from country-based investments and toward sector-based investments, with divergence in the evolution of indices explained mainly by differences in composition. The use of equity related derivatives has also significantly increased in recent years, enhancing primary equity market liquidity.



The effect of the euro in encouraging cross-border equity investment has been a factor in stimulating activity in the new-economy stock markets of the EU which – in line with US developments – have exhibited rather extreme behaviour in recent years, reflecting the ups and downs of demand for TMT (technology, media and telecommunications) securities.

The response of formal stock exchanges to increased competition, including from the many electronic trading networks established in recent years, has been to consolidate. While consolidation has been a global rather than Europe-specific phenomenon, there have been several high-profile consolidation efforts in Europe. The most notable of these has been the creation of Euronext, which merged the Amsterdam, Brussels and Paris exchanges in mid-2000 and subsequently expanded to include the Lisbon exchange in 2002. Not all consolidation efforts have been successful, however, with the failed merger of Deutsche Börse and the London stock exchange a prominent example.

As trading exchanges consolidate, EU post-trading infrastructure is also slowly being transformed. Historically, the pattern of European securities trading has followed national lines, resulting in efficient structures for securities transactions at the national level, usually with the vertical integration of the trading, clearing, settlement and depository functions.<sup>23</sup> These nationally based structures – offering only very limited scope for cross-border trading - have by and large survived until today. The various national systems use specific market practices and are subject to different frameworks for the regulatory, legal and fiscal treatment of securities. This state of affairs causes additional costs for cross-border securities trading in the European Union, both direct costs in the form of higher prices for the services provided and indirect costs relating to of inefficiencies in the functioning of the financial system, e.g. additional costs for back-office to reach several markets. The limited consolidation which

<sup>23</sup> See Giovannini Group Report on “Cross Border Clearing and Settlement Arrangements in the European Union”, *op. cit.*.

has taken place so far has mainly concerned clearing houses, whereas the configuration of security settlement systems has not changed much compared to the pre-euro situation.<sup>24</sup>

#### **4.5 Venture capital**

Venture capital is typically a small share of overall business financing. Nevertheless, its importance goes far beyond its share because venture capital occupies a key place in the initial stages of the life-cycle of a firm.

In the euro area, partly due to initiatives at EU level such as the Risk Capital Action Plan (RCAP) of April 1998, the venture capital industry grew rapidly in the 1990s. In more recent years, the industry has suffered a set-back linked to the economic slowdown and the large price fall correction in stock markets for high-growth companies in the course of 2000. However, the correction in the venture capital market can be seen as a necessary consolidation and the industry remains structurally sound. A notable development has been the growing involvement of institutional investors, in particular pension funds, in this market.

Despite this growth, the Commission in its October 2001 mid-term review of the RCAP observed that European risk capital markets remain fragmented – with the largest part of private equity investment undertaken domestically - and that the gap with the US had widened between 1998 and 2000. In 2001, venture capital investment in the euro area totalled €8.8 billion (0.13% of GDP), down from €12.5 billion in 2000. Because the stock market bubble for technological companies burst, the fall was even more dramatic in the US: venture capital investment in 2001 was €39.9 billion (0.35% of GDP), compared to €95.1 billion one year earlier.

The fact that venture capital investment in the euro area takes place primarily at domestic level partly reflects the importance for the capital providers to be close to their portfolio companies for the purpose of monitoring their investments. It is equally plausible, however, that the pattern of internationalisation of private equity management and investment is in part driven by differences in the regulatory, tax and legal infrastructure of the EU countries. For instance, national regulations on whether pension funds and insurance companies are allowed to invest in private equity still differ and national tax system impact differently on venture capital investments.

#### **4.6 Financial intermediaries**

The impact of financial integration has not been confined to the different financial market sections; it has also extended to the activities of financial intermediaries. European banks are increasingly involved in offering financial services to foreign businesses and individuals. The market for corporate finance services in Europe is increasingly open to global competition. In some activities, such as bond and equity issuance, as well as syndicated lending, domestic intermediaries have been losing ground with respect to US competitors. The introduction of the euro has further intensified competition among

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<sup>24</sup> For instance, the clearing functions of three of the Euronext exchanges (Amsterdam, Brussels and Paris) have legally merged since the beginning of 2001 into Clearnet SBF as the central counterparty for all the transactions carried out on Euronext. To facilitate cross-border transfer of securities, links between security settlement systems have been established. However, the use of these links has been more modest than expected. (ECB (2001) Payment and securities settlement systems in the European Union (Blue Book)).

financial intermediaries by facilitating price transparency, by reducing foreign exchange revenues, by eliminating the competitive advantage for domestic players associated with the existence of national currencies and by promoting the development of much broader and more liquid securities markets which foster securitisation and disintermediation.

The most visible response of financial intermediaries to these pressures has been consolidation, either through mergers and acquisitions or through cross-shareholdings. Consolidation has been accompanied by a restructuring process and a reorientation of activities from “traditional” bank lending towards “investment banking” style activities. This reorientation in banks’ activities has enhanced financial market intermediation by creating and selling new capital market products or advising clients on the pricing and structuring of a merger or acquisition. As a result, there has been a shift in bank revenue flows from interest income to non-interest income (fees and commission), and reduced reliance on deposits in favour of securities issuance. Yet, the decline in investment banking activities in 2001 has underlined the need for the EU banking sector to enhance efficiency and profitability in traditional banking activities.

Consolidation among financial intermediaries has so far taken place mainly within national boundaries, implying a significant increase in industry concentration at the national level particularly in the smaller Member States. The trend towards domestic conglomeration (i.e. consolidation across financial sectors) is also increasing in many parts of the EU. However, cross-border mergers and acquisitions have not been insignificant and have shown an increasing trend. Because the significant differences in national legal and regulatory environments (e.g. consumer and competition laws) make a pan-European product range impractical at present, the scale and scope of economies from cross-border mergers would seem to be less than those from domestic mergers. Cultural factors and differences in the framework for corporate governance also tend to discourage cross-border consolidation. In these circumstances, financial intermediaries may prefer to engage in defensive mergers at the domestic level in preparation for pan-European competition when integration of the EU financial system is more advanced.

#### **4.7 Challenges for policy-makers**

The introduction of the euro, by largely reducing exchange rate risk within the EU and by acting as a catalyst for reform, has been a main factor in speeding up integration. Even with the euro in place, the objective of a single financial market – an objective that dates back to the early 1970s – still remains to be achieved. While financial market integration is to a large extent market-driven, as the financial institutions themselves take advantage of the opportunities offered by financial market integration, there is a need for public policy action in a range of areas.

The political support for policy has been growing over time as policy-makers increasingly recognise the economic benefits of financial integration. In an integrated market, savers and investors benefit from broader choices at lower transaction costs. At the macroeconomic level, this translates into higher saving, investment, productivity, and eventually economic growth. These effects were discussed recently in an EFC Report on Financial Integration to the Oviedo informal Ecofin Council (13-14 April 2002). Successive European Councils (most recently the Barcelona European Council in March 2002) have established the integration of EU financial markets as a priority of economic reform in the EU.

This priority is reflected in a coherent policy strategy at EU level and in the urgency which has been attributed to its implementation. First, and most importantly, the EU is committed to implementing the Financial Services Action Plan (FSAP) – a package of 42 policy initiatives aimed at improving the functioning of the EU financial system – by 2005. An even tighter deadline, 2003, has been set for actions relating to securities markets and for the Risk Capital Action Plan (RCAP). The latter is the blueprint for developing an integrated and efficient market for equity financing of young and innovative businesses. Second, the implementation of the FSAP is to be consistent across all of the Member States so that there is effective – rather than just nominal - integration of national financial markets. The new decision-making framework for securities legislation, adopted on the basis of the proposals by the Lamfalussy Committee<sup>25</sup> should contribute to this objective and ensure that legislation is more swiftly adapted to the evolving financial markets. Third, competition policy is to be pro-active as financial integration proceeds, so as to ensure that economic benefits are fully exploited. Fourth, consumers and investors are to be adequately protected so that they have the confidence to operate in, and enjoy the full benefits of a single market extending across the Union.

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<sup>25</sup> Committee of Wise Men on the Regulation of European Securities Markets. The Committee issued its Report in February 2001. To speed up and facilitate the creation of an EU regulatory framework for securities markets, the Committee proposes a new four-level approach to legislation:

- Level 1 - the adoption of framework principles, as proposed by the Commission to the Council and European Parliament for co-decision;
- Level 2 - the adoption of implementing legislation, as prepared by the Commission with the assistance of a new EU Securities Committee and a Committee of EU Regulators; the European Securities Committee would be created to resolve technical regulatory issues on a fast track basis to ensure their speedy adoption;
- Level 3 - the consistent transposition of Level I and Level 2 legislation into national law on the basis of enhanced co-operation among national securities regulators ;
- Level 4 - stricter enforcement of legislation by the Commission with Member State governments, national regulators and the private sector.

The European Parliament gave its agreement to this approach on 5 February 2002.

## 5. THE EURO AS AN INTERNATIONAL CURRENCY

### 5.1 Introduction

An international currency performs the traditional functions of money at an international level. It must serve as a *unit of account*, a *means of exchange* and a *store of value*. As can be seen from the table below, the way in which a currency performs these functions differs for the private and the official sector, but the private sector dominates the internationalisation of a currency due to its much bigger size.

#### Principal uses of an international currency by the private and official sectors

	Private sector	official sector
<b>unit of account</b>	Invoicing currency Quotation currency	anchor or reference currency for exchange rate regimes
<b>means of exchange</b>	Payment currency Vehicle currency	intervention currency
<b>store of value</b>	Financing currency Investment currency	reserve currency

The US dollar is still the leading international currency, but the euro became the world's second leading currency after its launch. There are a number of factors that support the use of the euro as an international currency. The first is the size of the euro-area economy. The euro area accounts for approximately 16 % of world GDP, making it somewhat smaller than the US (21 %), but much larger than Japan (8 %). Figures for the share of the three areas in total world trade in goods and services are similar. The second factor which makes the euro attractive as an international currency is its stability, which reflects the sound economic fundamentals in the euro area, underpinned by the stability-oriented economic-policy framework under EMU. The third factor is the ongoing integration of national financial markets in Europe into broad, deep and liquid pan-European financial markets, which will enhance the role of the euro in international borrowing and lending activity.

The history of the international monetary system includes periods when two currencies have competed with each other as international currencies (sterling and the US dollar in the inter-war period). Because network and scale effects drive the internationalisation of a currency, the US dollar is likely to remain the dominant currency. In any event, the process of internationalisation of the euro is driven by the private-sector.

### 5.2 International use of the euro by the private sector

The private use of a currency internationally as a unit of account can be seen in the *invoicing* of trade and financial transactions and in *quotations* of commodity prices. Although there is little evidence on

invoicing, there is no doubt that the dollar remains the dominant currency for this purpose. In 2000, prior to the introduction of euro notes and coins, the share of the euro in the invoicing of international transactions was estimated to be between 15 % and 17 % of the total. Now that euro notes and coins have been introduced, however, the euro is likely to progressively expand its role as an invoicing currency, especially at regional level. The increased use of the euro for invoicing purposes will be reinforced by the historical tendency for international transactions to be invoiced in the exporter's currency and by the large share of the euro-area in world trade. The dollar also remains the dominant quotation currency for commodities. Although there are some commodity futures listed in Europe which are priced in euro, their number remains limited for the time being.

The private use of a currency internationally as a means of payment is reflected in its usage as a *payment currency* and as a *vehicle currency* in foreign exchange markets. As far as the euro's role as a payment currency is concerned, the Commission's quarterly survey of banks in the euro area indicates that the euro's share of international payments by euro-area residents increased very rapidly prior to its launch, from 24 % in volume terms (36 % in value terms) in the third quarter of 2000 to nearly 40 % (48 % in value terms) in the third quarter of 2001. With the launch of euro notes and coins and the conversion of all remaining euro-area accounts into euros, the share of the euro in international payments will no doubt increase still further.

A currency's use as a vehicle currency (i.e. as a means of exchanging two other currencies) in the foreign exchange markets is a key attribute that greatly influences its attractiveness as a means of performing the other functions of an international currency (e.g. a reserve currency). However, this is also an area where inertia is very strong, as there are scale economies to be had from using just one vehicle currency. At a global level, the US dollar remains the dominant vehicle currency as it benefits from direct inter-bank markets with all other currencies. On the basis of available information, the euro does not play a significant role as a global vehicle currency, although it has inherited a vehicle currency role from the German mark at a regional level. However, the introduction of the euro has had an impact on the currency composition of foreign exchange market activity by eliminating intra-euro-area trading (see box below). Figures from the BIS triennial survey of foreign exchange market activity published in October 2001 reveal that in April of that year the euro featured in 38 % of all foreign exchange transactions – higher than the mark's share in 1998 (30 %), but well below the combined share of all euro legacy currencies (53 %) in that year.

When the private sector uses a currency as a *financing currency* or an *investment currency*, this reflects its function as an international store of value. A review of the international use of the euro by the ECB published in September 2001 indicates that it is now the second most important financing currency used at international level, with shares of between 22 % and 34 % depending on the financial instrument and how it is measured. On the basis of the so-called narrow measure that includes only issuance by non-residents, the average share of the euro legacy currencies in bond and note issuance was 19 % in the period 1994-1998. In 1999, the euro's share rose to 34 % on average, perhaps reflecting eagerness on the part of major issuers to establish themselves in the new currency. But historically low euro interest rates, should also have increased the attractiveness of borrowing in euro for foreign companies. Whilst there has been continued strong activity in euro-denominated securities issuance by non-residents, the euro's share has been somewhat volatile since its 1999 peak but remained at a high level. The broad measure includes issuance by euro-area residents aimed at the international financial market. The euro has a higher share of the international issuance of bonds and notes (38 % on average in 2000) if one uses the broad measure, because of the much lower share of yen-denominated debt security issuance with international characteristics. There has also been a strong

increase in euro issuance in the international money market, which can be explained by an expected and actual increase in liquidity resulting from the creation of an integrated euro money market.

The euro is also the second most important investment currency used at international level, although information on the assets side is less readily available than on the liabilities side. The ECB review reveals that the euro's share of international investments ranges from 22 % to 32 % depending on the assets under consideration. It is highest for bond investments and lowest for international bank assets.

***Box : The impact of the euro on foreign exchange markets***

According to figures from the BIS, average daily turnover in traditional foreign exchange markets (i.e. the markets for spot transactions, forward transactions and foreign-exchange swaps) declined by 19 % between 1998 and 2001. One of the main contributors to this fall in turnover was the introduction of the euro because it eliminated trading between the legacy currencies (the other factors are consolidation in both the banking and corporate sectors and the growing share of electronic brokering). Trading among the legacy currencies had already started to decline well ahead of the start of Stage Three of EMU. Between 1995 and 1998, trading between the EMS currencies fell by some 5 % of global turnover. With the introduction of the euro on 1 January 1999 a further 6 % or so of total turnover was eliminated.

The decline in turnover was not reversed by any increase in trading in the euro compared to the legacy currencies (see main text). Nevertheless, the BIS reports that the dollar/euro pair was by far the most traded currency pair in 2001, accounting for some 30 % of global turnover. The introduction of the euro initially led to a substantial drop in market volumes in both spot and forward markets. In the forward market euro volumes fell by an initial 40 % compared to previous volumes in trades involving the legacy currencies. Since then, however, volumes have recovered somewhat. Consequently, the overall decline in volumes compared to the period before the launch of the euro is now around 25 %.

### **5.3 The international use of the euro by the official sector**

Perhaps the most visible international usage of a currency by the official sector is in its function as a unit of account. The euro is widely used as an *anchor or reference currency* in the exchange rate regimes of third countries. Over fifty countries have managed exchange rate arrangements that include a reference to the euro, either in isolation or in conjunction with other currencies. The type of arrangements adopted by third countries range from currency boards to managed floating policies. Geographically, these countries are located mainly in Europe and Africa. The main motivating factors behind the choice of the euro as an anchor or reference currency by third parties are the extensive trade, aid and financial linkages that these countries have with the economy of the euro area and, for some countries, the EU accession process (see below).

An international currency can perform the function of a means of payment for the official sector. This can be seen in the use of the currency for *official intervention* in foreign exchange markets. The dollar enjoys dominant- but not exclusive - use as an intervention currency at global level. The suitability of the dollar as an intervention currency reflects its liquidity on foreign exchange markets. Nevertheless, the euro has been used as an intervention currency by several third countries at regional level. This usage of the euro is closely related to its role as an anchor currency. Euro-denominated intervention most obviously occurs in the new exchange rate mechanism (ERM II), where EU Member States with a derogation – currently only Denmark, but previously also Greece until the end of 2000 – link their currencies to the euro.

Finally, the official sector's use of an international currency as a store of value can be seen in its holdings of *foreign reserves*. Figures from the latest IMF Annual Report show that the US dollar remains the dominant reserve currency. At the end of 2000, the dollar accounted for 68 % of foreign reserves. The euro is the second most important reserve currency after the dollar, accounting for 13 % of foreign exchange reserves. The share of the euro remained virtually unchanged from 1999. Adjusting the data to take into account only holdings of legacy currencies held outside the euro area, the IMF Annual Report indicates that the combined share of these currencies in of total international reserves in 1998 was virtually identical to the share of the euro in 1999 and 2000.

#### **5.4 The candidate countries and adoption of the euro**

The EC Treaty provides for a clear and unique institutional path for the adoption of the single currency by the candidate countries. Upon accession, the new Member States will participate in EMU with the status of Member States with a derogation from adopting the euro. This status will be granted in the accession Treaties. New Member States will have to treat their exchange rate policies as a matter of common concern and are expected to join ERM II at some point after accession. Then, for the adoption of the euro, the Treaty requires that new Member States reach a high degree of sustainable convergence. The equal treatment principle will be applied in full to the candidate countries. This path excludes both adoption of the euro immediately upon accession, and adoption of the euro before accession, sometimes referred to as “*euroization*”.

What are the implications for economic policy in the candidate countries? The key message is that, even in the countries where transition is most advanced, the reform agenda for accession must take priority over policy moves inspired by the prospect of EMU participation. Compliance with the Copenhagen criteria takes precedence over compliance with the nominal convergence criteria, and therefore EMU participation, for at least two reasons. Firstly, greater progress towards real and structural convergence should take place before nominal convergence, although the two can be mutually supportive. Secondly, only countries that are functioning market economies capable of coping with competitive pressures can be assessed for nominal convergence. In other words, the convergence criteria must be applied to “comparable economies”.

After accession, ERM II is flexible enough to accommodate different regimes, provided that the countries' commitments and objectives are credible and in line with those of the mechanism. The only clear incompatibilities vis-à-vis ERM II that can already be identified at this stage are fully floating exchange rates, crawling pegs and pegs against anchors other than the euro. In principle, the option of maintaining a euro-based currency board until the adoption of the euro is available on a case-by-case basis, as an additional unilateral commitment to a greater degree of fixity against the euro, within ERM II. However, when a country with a currency board wants to join ERM II, the request will still have to be examined in the context of the common procedure set out in ERM II Resolution, and the central parity/conversion rate will have to be agreed multilaterally. This implies that some of the countries that might be able to successfully operate a currency board with the euro would not necessarily have to go through a “double regime change” (moving away to some flexibility before going back again to a harder peg and, subsequently, the irrevocable fixing of the exchange rate).

Generally speaking, the candidate countries will have to reconcile their ambitions for exchange rate stability and inflation reduction in the run-up to accession and participation in the ERM II.

## **5.5 The euro area's contribution to global policy coordination**

The single monetary and exchange rate policies, accompanied by increased coordination of policies on the fiscal and structural fronts, have significant implications for the economic relationship between the euro area and the rest of the world. Monetary and exchange rate policies have become exclusive Community competence; financial markets in Europe are being progressively integrated; and the overall policy stance of the euro area is what matters for the rest of the world when international - economic and fiscal issues are discussed.

International institutions in charge of multilateral surveillance, such as the IMF and the OECD, have started to acknowledge the implications of these changes by assessing on a regular basis the overall macro-economic stance of the euro area. The change is also reflected in G7 Finance Ministers' and Central Bank Governors' statements which no longer refer to the macro-economic developments and prospects of specific euro area Member States but to the overall euro area outlook.

### *Internal coordination on external positions*

The EC Treaty sets out procedures, albeit in very condensed form, for the Community to deal with the international (institutional) aspects of EMU. Most of them are found in Article 111 (formerly Article 109). Although Article 111 is a procedural article and is clearly a compromise between different viewpoints, it clearly shows that exchange rate policy (i.e. formal agreements on an exchange rate system and general orientations for exchange rate policy) are a matter for the Council (with only the "ins" to vote). The article also sets out the procedure to be used by the Community to decide its position to be used in international discussions on "issues of particular relevance to economic and monetary union". The same article prescribes that representation of the Community at international level is to be decided unanimously by the Council on the basis of a Commission proposal in compliance with the allocation of powers laid down in Articles 99 and 105. It was thus expected that, with Stage Three of EMU, Europe would assume a role in the international financial and monetary system commensurate with its economic weight.

Since 1999, practical arrangements have been devised for the internal coordination of external positions. In particular, the Eurogroup/Ecofin have devoted much work establishing common positions and understandings. These positions have covered a wide range of issues, including international financial architecture, financing for development and the economic situation in the world or in various key countries. They provide an input for action by the European Executive Directors on the IMF Board and guide the Presidency, and other European representatives, during international meetings, such as the International Monetary and Financial Committee (IMFC), G7 meetings and OECD/EDRC consultations with the euro area..

While substantial progress has been made, various challenges still need to be addressed, such as how to ensure that the agreement among Europeans on principles is implemented in practice. This would mean, for example, ensuring that the European common views on the need for private sector involvement are applied to specific crisis resolution cases. Also, common positions have to evolve and be adapted by drawing on the lessons of new experiences and/or on dialogue with our international partners. By the same token, there is scope for increasing the number of issues on which a common position could be taken in order for Europe to develop a more pro-active and consistent role in the international monetary and financial system. Finally, agreed European common positions have to be communicated effectively to the relevant interlocutors.

### *External representation of the euro area*

These challenges are closely connected to the external representation issue. Different European Councils have dealt with the issue of international economic co-operation and external representation (notably Luxembourg and Vienna), but no Council decision has yet been taken to legally underpin the resulting framework. The European Council conclusions, moreover, only address the Community representation in certain international gatherings. For the IMF, the Vienna conclusions stated that *"The ECB, as the Community body competent for monetary policy, should be granted an observer status at the IMF board. The views of the European Community/EMU on other issues of particular relevance to the EMU would be presented at the IMF board by the relevant member of the Executive Director's office of the Member State holding the euro Presidency, assisted by a representative of the Commission."*

For the G7, the Vienna Presidency conclusion stated that *"The European Council endorses the report of the Council on the external representation of the Community, which foresees that the President of the ECOFIN Council, or if the President is from a non-euro area Member State, the President of the Euro 11, assisted by the Commission, shall participate in meetings of the G7 (Finance)"* In Annex II of the Conclusions, it was noted that *"the President of the ECB attends meetings of the [G7] for the discussion which relate to EMU, e.g. multilateral surveillance, exchange-rate issues, and for agreement of the relevant sections of the published Statement"*.

In actual fact, the European Council conclusions have only partially been implemented. So far, the Eurogroup Chairman and the ECB President attend only the session of the G7 Finance Ministers and Central Bank Governors meetings relating to multilateral surveillance and exchange rate issues. Nor is the participation of the Commission fully in line with these agreements.

Institutional changes within the IMF have also been limited. The ECB has obtained observer status on the IMF Board and is allowed to attend Board meetings on issues of particular relevance for the euro area.

Progress towards adequate European representation and a single European voice is hindered by several factors. Amongst them the grouping of European countries in IMF constituencies with non-EU countries and even the inclusion of some EU countries in a constituencies led by a non-EU countries. Also, membership of the IMF is based upon the concept of "country".

In conclusion, the EMU project is still in the making as regards the external side. But, on important international issues, EMU has fostered a common European position-taking process. This allows the Community to start playing an international role commensurate with its financial and economic weight. This needs to be complemented by further progress on representation. The ad-hoc arrangements that were made at the start of Stage III of EMU have proven to be useful, but only partially meet the expectations for a unified and strong European presence in international matters. Because of the informal nature of the arrangements, their lack of formalisation, the lack of continuity associated with them and the constraints inherent in informal coordination, they do not allow the Community's position to have its full impact on the discussions at international level.

Proper representation of the euro area in international organisations could significantly improve multilateral co-operation against the background of a financial world that seems to be moving towards a tri-polar currency system. The challenge of achieving appropriate representation and participation

for the euro area in international decision making procedures is thus a significant issue for non-Europeans as well. This is apparent in the pressure from other industrial and emerging market economies to streamline EU representation. Addressing this issue is a crucial challenge for EU policy-makers, who have to ensure that the EU becomes an effective player in the pursuit of its own interests on the international stage.