The euro area at the start of Stage Three

The start of the single monetary policy of the Eurosystem for the euro area marked the beginning of a new era in the process of European economic integration. While important fields of economic policy, including fiscal policy, will remain primarily the responsibility of the 11 participating Member States, monetary policy is now determined at the euro area level. When deciding on monetary policy, the Governing Council of the European Central Bank (ECB) will focus on euro area-wide economic data within the framework of its monetary policy strategy adopted in late 1998 (see The stability-oriented monetary policy strategy of the Eurosystem in this Bulletin). Many of the key features of the euro area as a whole, such as the size and openness of the economy and the financial structure, are quite different from those of the individual Member States and should rather be compared with those of the United States and Japan. These characteristics should be borne in mind when undertaking economic analyses of the euro area. In order to familiarise the public at large with the euro area economy, this article highlights its key features. In addition, it describes the macroeconomic situation prevailing at the start of Stage Three, so as to provide a starting-point for the first, more detailed commentary on recent developments in the euro area (see Economic developments in the euro area in this Bulletin).

1 Key features of the euro area

The euro area: a large economy with a significant weight in the world economy

Putting the euro area into perspective (see Table 1), the most striking feature is that it comprises formerly small and medium-sized economies, which have joined together to form an economy with a large internal market. Indeed, with a share of world GDP of 15%, the euro area is one of the largest economies in the world, possessing a significant purchasing power which is matched only by that of the United States. In comparison, the largest Member State in the euro area accounts for only just over 4% of world GDP, while the individual shares of the smaller ones do not exceed 1%.

Being a large economy, the degree of openness of the euro area is much smaller than that of the individual Member States. With a ratio of exports of goods to euro area-wide GDP standing at around 14% (after adjusting for intra-euro area trade), the euro area s degree of openness is by and large comparable to that of the United States and Japan. This contrasts with the position of individual euro area countries, which were previously seen as small or medium-sized open economies , with, for example, export ratios (including intra-euro area trade) ranging from 19% to 62%, thus giving an average for the countries in the euro area as a whole of around 35%. The share of the euro area in total world exports (of goods) amounts to almost 16%, which substantially exceeds the shares of both the United States and Japan. Machinery and transport equipment, other manufactured articles and chemicals accounted for the bulk of trade effected with, in order of their share of trade, the United Kingdom, the United States, Switzerland and Japan, which together account for a large part of euro area external trade. For the euro area as a whole, trade in services is less significant and it is estimated not to have exceeded 4% of GDP in 1997.

Similarities to and differences from the United States and Japan

When considering other features of the euro area, it may be more appropriate to make comparisons with the United States and Japan rather than with the individual Member States, and to point to areas of similarity and differences. Patterns of production are broadly similar to those of the United States and Japan. Primary production, such as agriculture, fishing and forestry, accounts for around 2% of total output in all three economies. The services sector in the euro area accounts for about 67% of total production, which is a smaller share than in the United States (72%) but larger than in Japan (59%). The industrial sector (including construction) accounts for 31% of total production in the euro area, which in turn is more than in the United States but less than in Japan.

In terms of size and structure, the government sector in the euro area differs significantly from those of the United States and Japan. As represented by the share of government expenditure in GDP, the government sector is significantly larger in the euro area (49%) than in either Japan (39%) or the United States (35%). To a large extent, this can be explained by the

Table 1
Key characteristics of the euro area

	Reporting period	Unit	Euro area	United States	Japan
Population	1998	mn	292	270	127
GDP (share of world GDP) [1]	1997	%	15.0	20.2	7.7
Sectors of production					
Agriculture, fishing, forestry	1993	% of GDP	2.4	1.7	2.1
Industry (including construction)	1993	% of GDP	30.9	26.0	39.2
Services	1993	% of GDP	66.7	72.3	58.7
General government					
Receipts	1998	% of GDP	46.7	35.9	33.0
Social security contributions	1998	% of GDP	17.0	9.4	11.1
Expenditure	1998	% of GDP	49.1	34.5	38.6
Current transfers to households	1998	% of GDP	20.2	13.7	15.7
Exports of goods [2]	1997	% of GDP	13.6	8.5	10.0
Imports of goods [2]	1997	% of GDP	12.0	11.1	8.1
Exports (% of world exports) [2]	1997	%	15.7	12.6	7.7
Bank deposits [3] [4]	End-1997	ECU bn	4,657.9	3,953.4	3,663.4
	End-1997	% of GDP	83.9	55.3	98.8
Domestic credit [4] [5]	End-1997	ECU bn	7,128.5	5,881.5	4,710.8
	End-1997	% of GDP	128.5	82.2	127.1
Claims on the private sector	End-1997	ECU bn	5,125.9	4,931.1	4,033.6
Claims on the general government	End-1997	ECU bn	2,002.6	950.4	677.1
Domestic debt securities	End-1997	ECU bn	5,002.4	11,364.0	4,015.2
	End-1997	% of GDP	90.2	164.7	108.5
Issued by the private sector	End-1997	ECU bn	1,897.9	4,729.3	1,192.4
Issued by the public sector	End-1997	ECU bn	3,104.4	6,634.7	2,822.9
Stock market capitalisation [6]	Oct. 1998	ECU bn	3,190.9	9,679.7	3,300.9
Real GDP growth	1998	%	3.0	3.3	-2.5
CPI inflation [7]	Nov. 1998	%	0.9	1.5	0.8
Unemployment rate (% of labour force)	Nov. 1998	%	10.8	4.4	4.4
Broad money growth [8]	Q3 1998	%	4.4	7.4	3.3
Three-month interest rate	End-1998	%	3.25	5.00	0.18
10-year government bond yield	End-1998	%	3.94	4.70	2.02
General government					
Surplus (+) or deficit (-)	1998	% of GDP	-2.3	1.4	-5.5
Gross debt	1998	% of GDP	73.8	59.3	115.6
Current account balance [9]	1997	% of GDP	1.1	-1.7	2.3

Sources: Eurostat (population, stock market capitalisation, real GDP, euro area data for exports, imports, inflation (HICP), unemployment and current account balance), European Commission - autumn 1998 forecasts (shares of world GDP, general government data (calendar year basis)), OECD (sectors of production), IMF (exports, imports, bank deposits, domestic credit, gross debt for the United States and Japan), BIS (domestic debt securities), national data (for the United States and Japan: CPI inflation, unemployment, broad money growth, three-month interest rate, 10-year government bond yield, current account balance) and ECB (for the euro area: broad money growth, three-month interest rate, 10-year government bond yield).

1) *At constant prices and purchasing power standards in 1997; euro area: 1990 prices.*
2) *Excluding intra-euro area trade; exports: f.o.b.; imports: c.i.f.*
3) *Euro area: total deposits with MFIs; United States: demand, time and savings deposits in banking institutions; Japan: demand and time deposits in deposit money banks.*
4) *Euro area data for bank deposits and domestic credit are calculated on the basis of the irrevocable euro conversion rates announced on 31 December 1998.*
5) *Euro area: MFI loans to and holdings of securities of euro area residents; United States and Japan: domestic credit.*
6) *United States: the New York exchanges (NYSE and Nasdaq); Japan: Tokyo and Osaka exchanges.*
7) *HICP for the euro area; national data for the United States and Japan.*
8) *Euro area: M3 aggregate; United States: M2 aggregate; Japan: M2 and CDs.*
9) *Provisional data for the euro area.*

existence of different social security systems. Government current transfers to households in euro area countries, as a share of GDP, are relatively high compared with the United States and Japan. Another noticeable difference is that the proportion of GDP devoted to the provision of collective services by the government sector is also higher in the euro area than in either the United States or Japan. Also, with respect to the structure of government receipts, in the euro area and in Japan social security contributions represent about one-third of the government s current revenue, compared with only one-quarter in the United States. As regards tax income, the governments of both the United States and Japan rely more on direct taxation, whereas in the euro area indirect taxes represent a higher share of tax revenue.

Turning to a number of key monetary and financial indicators, several structural differences between the euro area s financial system and the financial systems of the United States and Japan may be noted. The key difference, in particular from the United States, lies in the relative roles played by banks and securities markets. Whereas the euro area s financial system is predominantly based on banking products and equity financing plays only a limited role, in the United States equity and debt securities markets provide the principal means of financing and saving.

This general picture of the financial structure of the euro area can be illustrated by reference to various indicators (see Table 1). Bank deposits, if measured relative to GDP, are more significant in the euro area (84%) than in the United States (55%), but less important than in Japan (99%). Similarly, the outstanding amount of domestic bank credit, both in absolute terms and relative to GDP, is far larger in the euro area than in the United States, although it is comparable, as a share of GDP, to that in Japan. In the euro area a relatively large amount of bank credit is extended to general government. By contrast, the amount of domestic debt securities relative to GDP in the United States far exceeds the amounts in either the euro area or Japan. In absolute terms, the outstanding amount of domestic debt securities in the United States, at ECU 11,364 billion, was more than twice that in the euro area at the end of 1997, and the difference is even more pronounced in terms of securities issued by the private sector. Finally, stock market capitalisation is also far higher in the United States than in the euro area and Japan.

Labour market characteristics also differ substantially between the euro area and the two other economies. The latest overall unemployment rate in the euro area (10.8%) is far higher than that in the United States (4.4%), and differences are accounted for by a host of factors, including structural features of the two labour markets, such as wage and non-wage labour costs, employment protection legislation and the scale and duration of unemployment benefits. From a medium-term perspective, experience also suggests that, for a comparable level of real GDP growth, the euro area has experienced much weaker employment growth than the United States. Also, by contrast with the United States, there has been a clear asymmetric response to fluctuations in economic activity, such that each downturn has brought about a higher level of unemployment in the euro area. However, labour markets are notoriously difficult to compare by referring to measured unemployment rates alone. This is particularly true in the case of Japan, where, despite persistent weakness of the economy, the official unemployment rate is also only 4.4%.

2 The economic situation in the euro area at the start of Stage Three

Monetary and financial developments reflect an environment of price stability

The broad monetary aggregate M3 has followed a rather smooth path, with growth rates of between 3.5% and 5% over the past two years. This monetary trend can be regarded as compatible with ongoing price stability and sustainable economic growth in the euro area. At the same time, interest rates declined all along the maturity spectrum, on account of the improvement in the price environment. The euro area average three-month interbank rate has shown a trend decline from a level of more than 7% in spring 1995 to 3.25% at the end of 1998. This decline reflects the achievement of price stability in the euro area and the increasing stability of intra-euro area exchange rates before the start of Stage Three. The euro area long-term interest rate (as measured by the average of 10-year government bond yields) has declined from more than 9‰% in early 1995 to just below 4% at the end of December 1998. In real terms, i.e. corrected for the decline in inflation, the long-term interest rate has fallen by around 3‰ percentage points since early 1995 to around 3% at end-1998. Within the euro area, the gradual disappearance of exchange rate risk premia, the reduction in inflation risk premia, the closing of short-term interest rate differentials and the progress towards fiscal consolidation which have taken place over the past few years have all played a positive role in this respect.

Increase in consumer prices at around 1%

Focusing on more recent trends, price increases as measured by the Harmonised Index of Consumer Prices (HICP) have declined from around 1.6% in mid-1997 to a level of 0.9% in November 1998. This was mainly due to a lower rate of increase in goods prices, of 0.3%, whereas the price increase for services remained broadly unchanged in 1998 at around 2%. An important factor underlying lower goods price increases in the recent past has been the considerable decline in oil and other commodity prices since their 1997 peak. Moreover, growth in compensation per employee slowed further in 1998 and unit labour costs declined slightly over the most recent quarters for which data are available.

Robust output growth in 1998, but slowdown in the course of the year

Following a recovery in 1997, real GDP growth in the euro area accelerated further in 1998 as a whole, being increasingly driven by domestic demand rather than by net exports. Private consumption has accounted for the largest single contribution to GDP growth in recent quarters, while fixed investment has expanded less strongly. However, against the background of a worsening of the external environment, the risk increased during the course of 1998 that the expansion in the euro area would not continue at its recent pace, and real GDP growth slowed after the summer months, falling from 3% in the first half of 1998 to 2.4% in the third quarter, compared with the corresponding period in the previous year. This coincided with a deterioration in industrial confidence, while consumer confidence remained at historically high levels.

Unemployment rate declines gradually as employment recovers

Notwithstanding the cyclical improvement in economic activity, unemployment in the euro area as a whole remains high. However, it declined slightly in 1998, following a pick-up in employment growth that started in early 1997. According to Eurostat, the standardised unemployment rate in the euro area declined to 10.8% in autumn 1998, i.e. to the lowest level in five years.

Improvements in fiscal positions have stalled

Compared with the progress in fiscal consolidation achieved in previous years, only a small further reduction in budgetary deficits across the euro area was achieved in 1998. The average deficit-to-GDP ratio in the euro area is estimated by the European Commission to have declined to 2.3% in 1998 from 2.5% in the previous year. This reduction, however, was the effect of favourable cyclical influences and lower interest payments. According to the European Commission, adjusting the deficit ratio for cyclical effects shows that the remaining structural deficit in the euro area in fact deteriorated slightly in 1998, rather than having improved. This would be the first deterioration in the cyclically adjusted deficit ratio since 1991, which contrasts with the commitment enshrined in the Stability and Growth Pact to respect the medium-term budgetary objective of achieving fiscal positions close to balance or in surplus . Moreover, the primary balance ratio is also estimated to have worsened in 1998 for the first time in several years. While the share of government expenditure in GDP appears to be on a declining trend after reaching a peak in 1993, the ratio of euro area government revenue to GDP declined in 1998 after increasing in the period 1995-97. In the euro area as a whole taxes increased slightly in 1998, whereas social security contributions were lower.

On average, the euro area general government debt is estimated by the European Commission to have been 73.8% of GDP in 1998, 1.2 percentage points less than in 1997. Government debt ratios in the euro area have been falling since 1996, not only because of the reduction in deficits, but also on account of the benefits accruing from a number of financial transactions, including, most notably, privatisation. However, debt ratios in the euro area as a whole are still far above the reference level of 60% of GDP laid down in Protocol No. 5 to the Treaty establishing the European Community, thus limiting substantially the budgetary room for manoeuvre in Member States. At the same time, deficit ratios are still too high to set debt ratios on a rapidly declining path.

Euro area currencies appreciated slightly

In 1998 euro area currencies appreciated by about 2.1% on average in nominal terms and by about 1.5% in real terms against their major trading partner currencies, compared with a year earlier. However, this appreciation - due mainly to a weakening of the US dollar and the pound sterling in the second and third quarters of 1998 - took place against the background of a marked depreciation in 1997, when, driven by the exceptional strengthening of the US dollar and the pound sterling, euro area currencies had fallen by about 9% vis- -vis their trading partner currencies. As a result, on the eve of Stage Three, euro area currencies stood, in effective terms, still somewhat below their average levels of the past few years.

On 31 December 1998, in accordance with Article 1091 (4) of the Treaty establishing the European Community, the irrevocable conversion rates for the euro were adopted by the EU Council (see Table 2), upon a proposal from the European Commission and after consultation of the ECB. In compliance with the legal framework for the use of the euro, the irrevocable conversion rate for the euro vis- -vis each participating currency is the only rate to be used for conversion either way between

Table 2

Irrevocable euro conversion rates

	EUR 1 =	
Belgium	BEF	40.3399
Germany	DEM	1.95583
Spain	ESP	166.386
France	FRF	6.55957
Ireland	IEP	.787564
Italy	ITL	1936.27
Luxembourg	LUF	40.3399
Netherlands	NLG	2.20371
Austria	ATS	13.7603
Portugal	PTE	200.482
Finland	FIM	5.94573

the euro and the national currency unit and also for conversions between national currency units. The last official ECU (and first euro) rate against the US dollar was set at USD 1.168 on 31 December 1998. The euro opened trading in Australia on 4 January 1999 at USD 1.175. In Europe the euro started trading at USD 1.1855.

External accounts recently affected by the deterioration in the global environment

Over recent years both the euro area trade and current account balances with the rest of the world have shown rising surpluses (on the basis of provisional data), from 1.2% and 0.5% of GDP respectively in 1995 to 1.6% and 1.1% of GDP in 1997. However, from mid-1998 onwards, the worsening in the global economy, whose origins lay in the Asian crisis, had a delayed impact on external accounts. Falling foreign demand caused a deceleration of export growth, which was also adversely affected by the currency appreciation. At the same time, while the growth of import volumes rose, as domestic demand remained strong, import prices declined, reflecting the fall in commodity prices.

3 Final considerations

Overall, the euro area, as one of the largest economies in the world, will play a significant role in shaping global macroeconomic conditions. Equally, it will be open vis- -vis its trading partners, although developments in the domestic economy will by far outweigh external factors. Residents of the euro area will undoubtedly benefit from the enhanced growth and employment opportunities which are afforded by a large internal market.

However, important challenges remain. These include, in particular, a high level of unemployment and fiscal imbalances, as reflected in both current deficit and debt levels in relation to GDP. In order to address these challenges, a large economy such as the euro area has to rely primarily on maintaining a sound and sustainable policy framework at home , thereby also contributing to a stable world economy. This framework is characterised by fiscal policies that are consistent with the Stability and Growth Pact, on the one hand, and ongoing structural reform in the labour and product markets accompanied by moderate wage developments, on the other. Maintaining this policy framework will help to foster competitiveness and profitability in the corporate sector, thereby promoting investment. Equally, it will help to sustain and foster the employment growth that has been seen recently, which will in turn support private consumption.

Monetary policy will play its part by pursuing its primary objective of price stability, thereby keeping inflationary expectations and risk premia in long-term interest rates low and hence contributing to an environment conducive to growth in economic activity and employment in the euro area.