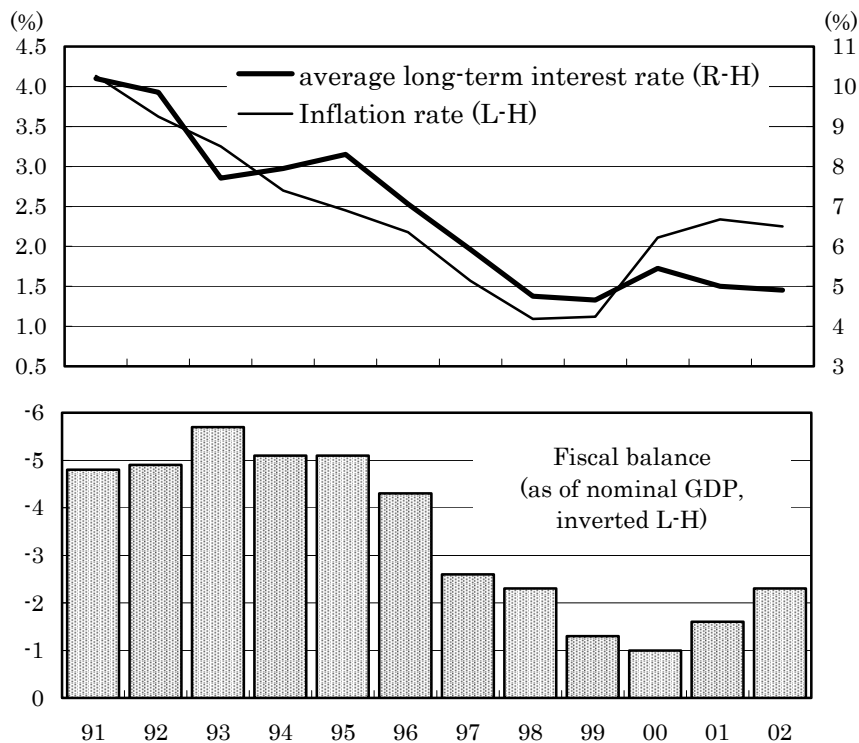


Europe Needs Growth To Assure Stability¹

In order to assure the strength and stability of the euro, Europe's new single currency, the EU countries decided to impose strict fiscal discipline on countries joining the Economic and Monetary Union (EMU). The Stability and Growth Pact was agreed in December 1996. Since Germany suffered from hyperinflation in the past, it has made every effort to keep its currency, the Deutsche mark, strong and stable thereafter; it was the leading advocate for the Pact.

Owing to the Stability and Growth Pact, fiscal conditions in general have improved in the Euro area, and as a result, both long-term interest rates and inflation rates have fallen, making it possible for economies that used to suffer from high inflation to grow vigorously.

With an improvement in its fiscal balance, both interest rates and inflation rates are declining.

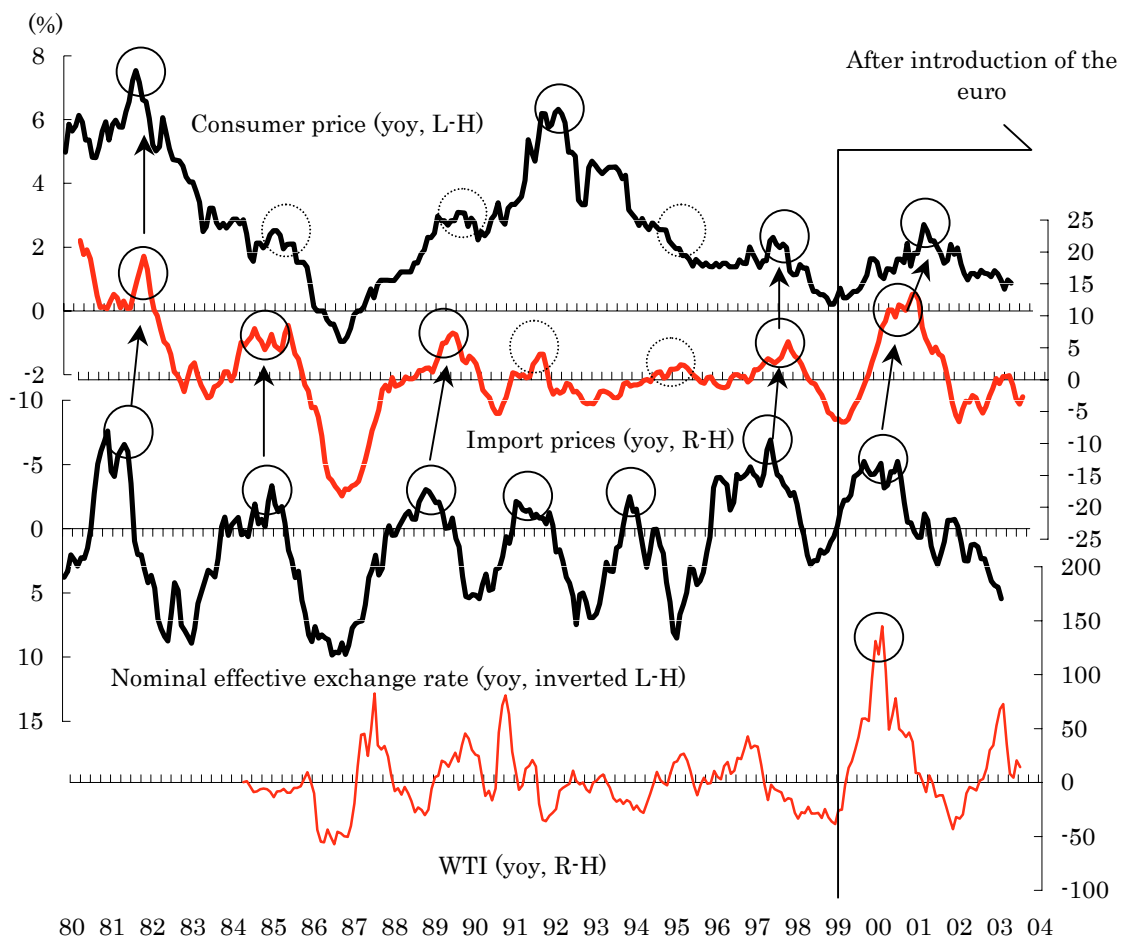


Source: Datastream, EU

¹ This is an English summary of a report originally published on August 12, 2003. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

Meanwhile, despite the Stability and Growth Pact and a general improvement in fiscal balances, the euro weakened continuously from its inception in 1999 to mid-2002. While the weak euro helped to raise price competitiveness and supported growth of the German economy through expansion of exports, domestic demand remained sluggish, partly because structural problems were not addressed. In addition, despite the weak euro, inflation has remained mostly muted, partly because of global disinflationary pressures.

Due to global disinflation, the weak euro has not rekindled inflation.



Source: Datastream

Ironically, the strengthening of the euro since mid-2002 hurt the German economy, as exports slowed and its fiscal balance worsened. German budget deficits surpassed 3% of nominal GDP, and Germany will be subject to a fine under the Stability and Growth Pact that it supported, unless it tightens fiscal policy, even at risk of falling into a recession.

Since Germany accounts for approximately one third of the Euro economy, a possible prolonged slowdown of the German economy may hinder the Euro economy as a whole. In fact, the elasticity of the real GDP growth rate in the Euro area vis-à-vis that of the German economy is estimated 1.18, indicating that a 1% increase of German real GDP will raise the real GDP of the Euro area by 1.18%. Other major countries do not have such influence. Given these findings, it is not likely that the Euro economy will recover at full scale without the recovery of the German economy.

Germany is the engine of the Euro area economy.

	Share of each economy in real GDP of the Euro area (%)	Estimated elasticity of real GDP growth rate of the Euro area	Adjusted R-square	D.W.
Germany	32.4	1.18	0.999	0.811
France	22.2	0.95	1.000	1.036
Italy	16.7	0.93	0.999	0.522
Spain	8.7	0.82	0.997	0.214

Note: Estimated equation is as follows

$\ln(\text{real GDP of the Euro area}) =$

Constant + a * $\ln(\text{real GDP of each country})$ + German unification dummy

Source: EU Commission

As the macro economic performance has converged within the Euro area, Germany's role as a model of strong and stable economy may be ending. But that does not mean that a slowdown in the German economy will not affect the Euro economy. If the German economy is destabilized, the stability of the Euro area will be damaged. What is important today is not that Germany pursues a tight fiscal policy, but that it stimulates the economy to assure room for pursuing needed structural reforms. Five years after its inception, it may be time for the Pact to place more weight on "Growth" than "Stability."

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*The information and the views contained herein are subject to change without notice.

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