Jörg Hinze*

Does a Weak Euro Signify Poor Competitiveness of the Euro Zone?

The pronounced decline in the euro's exchange rate since the currency's launch at the start of 1999, especially against the US dollar, has rekindled the discussion surrounding the competitiveness of the euro zone. This marks quite a shift of focus within just a short period. When the new monetary union came into being, the emphasis was on the increased significance of the corresponding economic zone, given its economic muscle and its prominent position on world markets. This was taken to indicate that the EMU economies were highly competitive. On the other hand, the drop in the euro's value since its launch is said by many to reflect a poor competitive position. This article will examine some possible explanations for the depreciation of the euro against the dollar, focussing on the competitiveness of the euro zone, particularly relative to the USA, by applying selected indicators.

The euro's performance is normally judged against its exchange rate at the time European Monetary Union (EMU) entered its final stage at the start of 1999. And there is no denying that the euro's external value has dropped substantially on that basis. By the middle of this year, the currency had fallen against the US dollar by some 20% (from just under $1.20 to about 95 cents), against the Japanese yen by 25% and even against the British pound by 10%; measured against a weighted average of the euro's 13 most important counterparts,[1] the effective devaluation was 15%. At the time of its launch, the general view was that the euro was not overvalued, as it was trading below the ECU's average exchange rate during the 1990s of $1.21 to the ECU. But of course, a number of fundamental factors have worked in favour of a weaker euro relative to the dollar in the interim period. Economic growth in the USA has been substantially stronger, yet with inflationary pressure hardly any more in evidence than in the euro zone, while at the same time American interest rates have been noticeably higher at this more advanced stage in the growth cycle.

To properly judge the euro's exchange-rate performance, we need to ask two main questions. The first is whether the currency's exchange rate at the time of its introduction was a close approximation to its equilibrium level or whether it may have been overvalued. The second is to what extent the euro's decline has been determined by fundamental factors – i.e. by price, growth and interest-rate differentials – and to what extent by other causes.

Even if for no other reason than the euro's short history, these questions cannot be answered simply. Naturally, the ECU's exchange rate against the dollar and other currencies in the past offers a means of comparison, yet the ECU and euro are not truly comparable in all respects. The ECU was an artificial currency whose exchange rate was computed as a weighted average of the rates for the currencies participating in the European Monetary System (EMS), but was not determined directly in the marketplace. Under the EMS there were substantial shifts at times in the exchange rates among the ECU participating currencies themselves and hence between the individual currencies and the ECU, both of which are an impossibility with the euro.

Econometric Estimate of ECU/Euro Exchange Rate Movement

In seeking an econometric estimate of the ECU's dollar exchange rate as determined by major

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[1] These 13 industrial and newly industrialized trading partners, known as the narrow group, account for two thirds of the euro zone's foreign trade relations. Cf. European Central Bank (ECB): The nominal and real effective exchange rates of the euro, ECB Monthly Bulletin, April 2000, pp. 39 f.

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fundamental factors before the euro was introduced, the following equation gives a very good fit:

$$\text{ECU/EURO} = \underset{(111.7)}{1.11} + \underset{(12.8)}{0.12}\text{*PRICEDIFF(1)} + \underset{(1.8)}{0.01}\text{*GRWTHDIFF(–1)} + \underset{(21.8)}{0.08}\text{*BONDDIFF} - \underset{(-4.9)}{0.07}\text{*DUMMY93}$$

R^2(adj.) = 0.96 DW = 2.21

Where:

ECU/EURO = Exchange rate of the ECU or EURO to the US dollar (dollar/ECU or euro)

PRICEDIFF = The differential in price inflation

GRWTHDIFF = The differential in economic growth

BONDDIFF = The yield differential on 10-year government bonds

DUMMY93 = A dummy variable for the 4th quarter of 1992 and 1st of 1993

The figures in parentheses behind the regression variables signify leads (+) and lags (–)

The figures in parentheses below the regression coefficients are their t-values

R^2(adj.) = Adjusted coefficient of determination

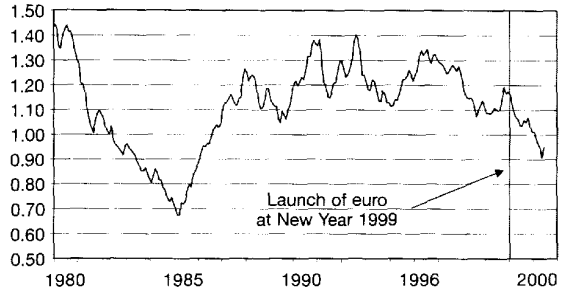
DW = Durbin-Watson statistic

Based on quarterly values for the period 1992–1998. (Before that time, data are not always compatible, particularly with regard to the growth differential between the euro zone and the USA).

All regression coefficients in the estimated equation are statistically significant except for the coefficient for the growth differential, which in any case is very small. The dummy variable was devised to model the turbulences occurring in the European Monetary System in autumn 1992 and spring 1993, calling for three realignments of the exchange rates within the EMS in close succession. The equation only provides a good estimate of the ECU's dollar exchange rate, up to the introduction of the euro. Thereafter, the euro's exchange rate performed considerably less well than a projection of this estimate (see Figure 3).

If the base period for the estimate is prolonged up to the year 2000, the structure of the equation barely changes, so evidently the fundamental links between the euro and the dollar remain in effect. However, the estimate loses precision substantially from 1999 onwards. A computation of the deviation between the actual and the projected euro/dollar exchange rate by devising dummy variables for the period after the euro's introduction showed the euro at an exchange rate 10 cents below what would be expected on the basis of the fundamentals from the start of 1999, and a further 8 cents below it from the start of 2000.

Figure 1
Movement of the ECU (up to 1998) and the Euro (from 1999) against the US Dollar



Source: Deutsche Bundesbank.

Explanations for the Euro's Weakness

How ought these discrepancies to be explained in economic terms?

☐ Firstly, some evidence suggests that the depreciation of the euro has at least partly been due to its being overvalued at the time of its introduction. But of course, there is no exact means of calculating equilibrium exchange rates, and the range of estimates that have been made for the euro's value in dollar terms is very wide, from $1.26[2] to $0.87, though it should be said that the latter is based only on tradable goods and services.[3,4] However, taking purchasing-power parity based on GDP as a best estimate, the OECD calculated this to suggest an exchange rate of €1 = $1.06 in 1999.[5]

☐ Secondly, it was only to be expected that, in its early stages, the euro would not immediately attain the same acceptance as the deutschmark had had when it was the dominant currency in the calculation base for the ECU. The fact that there is no national sovereign body to back up the European Central Bank (ECB) and that the bank first needed to build up its own policy-making credibility is likely to have in-

[2] Cf. Enrique Alberola, Susana G. Cervere, Humberto Lopez, Angel Ubide: Global Equilibrium Exchange Rates, Dollar "Ins", "Outs", and Other Major Currencies in a Panel Cointegration Framework, IMF Working Paper, presented at the Deutsche Bank conference on Equilibrium Rates of the Euro, March 2000, pp. 23 ff.

[3] Cf. Stephan Schulmeister: Die Kaufkraft des Euro innerhalb und außerhalb der Währungsunion, study by Österreichisches Institut für Wirtschaftsforschung for the Austrian Federal Chamber of Labour, February 2000, pp. 30 f.

[4] Prices of internationally traded goods are often used as a means of measuring the level of integration in product markets (cf. Bernhard Fischer: Globalization and the Competitiveness of Regional Blocs in Comparative Perspective, HWWA Discussion Paper No. 50, 1998, p. 9).

[5] Cf. OECD, Main Economic Indicators, current year.

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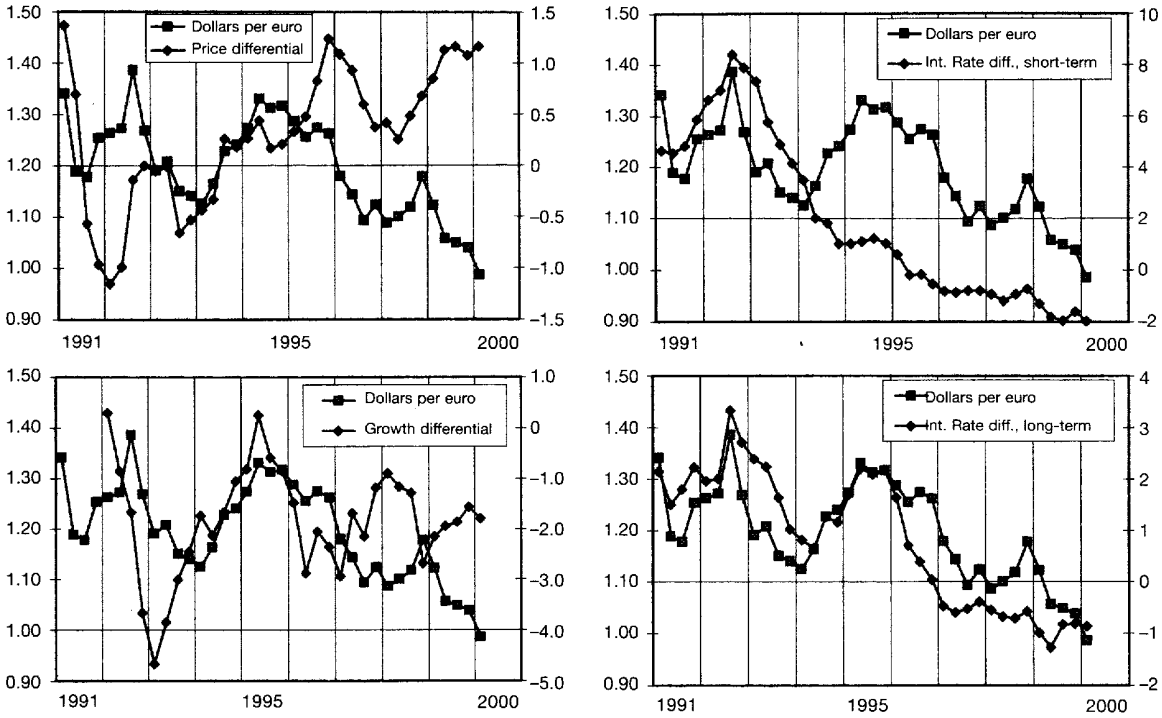
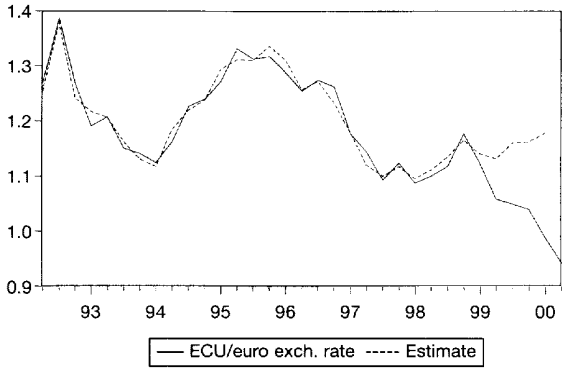
Figure 2
Movements of the ECU or Euro Exchange Rate to the US Dollar plotted against Major Fundamental Factors



Source: Deutsche Bundesbank.

fluenced some market participants to exercise restraint with regard to investment in the euro zone. The lack of transparency in the ECB's decision-making since it took office has not exactly helped to enhance this reputation.[6]

Figure 3
Movements of the ECU/Dollar or Euro/Dollar Exchange Rate – actual and estimated –
(US dollars per ECU/euro)



☐ Thirdly, there may have been other economic reasons for the declining exchange rate which the estimating equation does not adequately take into consideration, such as the pronounced increase in the price of oil in the early part of this year. In the first half of 2000, it reached the $30-per-barrel mark for the first time since the Gulf crisis in the early 1990s, and because petroleum bills are mainly settled in dollars, this has increased demand for the currency around the world. Exchange-rate models taking explicit account of the oil price as an explanatory variable do indeed show oil price increases exerting downward pressure on the euro's exchange rate.[7]

☐ Even when the above factors are taken into account, the extent of the euro's depreciation against the US dollar and other major currencies is still surprising. Increasingly, the discussion is turning to

[6] The weakness of the euro is occasionally attributed to the fact that the ECB does not expressly declare that it has any responsibility for the currency's external value. Cf. CEPS: Quo Vadis Euro?, pp. 60 f.

[7] Cf. Jörg Clostermann, Bernd Schnatz: The determinants of the Euro-dollar exchange rate, Deutsche Bundesbank, Discussion Paper 2/00, May 2000, p.13 f.

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the issue of whether this represents a reassessment of the euro's underlying value as investors take a less favourable view of the euro zone's economic prospects, particularly in comparison with the United States. In the last two years, the US economy has confounded the forecasts of most experts, who had expected the boom to run out of steam, and if anything it has even grown with added momentum, whereas the cyclical upturn in Euroland has been slow in getting started; so the growth differential, far from narrowing as had been expected, has widened still further since monetary union came into force. Although, in the estimated equation presented here, the growth differential between the United States and the euro zone does not play a major part in determining the exchange rate, it does currently appear to be accorded greater significance – witness the economic-policy discussions on the "new economy". The differences between the USA and Europe in their economic dynamism are often interpreted to imply that the American economic system is superior to that of the euro zone, whether due to lower levels of regulation or due to the US lead in what are considered the technologies of the future.

In the following we shall therefore pursue the question of the euro zone's competitive position in the international economy, particularly relative to the USA. However, competitiveness can be taken to mean very different things: a universally valid theoretical concept of international competitiveness does not exist, nor does any precise definition of the term or unambiguous methods of measuring it. Instead, we have to make do with numerous individual indicators that serve as measures of competitiveness but address only specific aspects of it.

Favourable World Market Position for Euro Zone Suppliers

One of the most closely watched indicators of competitiveness is a country's or region's share of world trade. In these terms, there can be no doubting the EMU countries' ability to assert their position on world markets: even during the year preceding the euro's introduction this position was extraordinarily strong, and indeed it has strengthened further as the common currency has depreciated over the last year and a half. Taking only their external trade as a measure (i.e. excluding trade among EMU member states), these countries accounted for almost 20% of the world's exports in 1999, or almost one third more than the United States;[8] if the internal trade among Euroland countries is also counted in, their share of world trade of just under one third is more than twice that of the USA.

Although world market shares do serve as an important indicator of competitiveness, taken on its own its usefulness is limited. For one thing, it is an indicator geared to past results rather than future potential and, for another, it is ultimately microeconomic in nature, being closely linked to the performance of businesses. Although such world market shares are always calculated for countries or regions, it is the individual suppliers that are actually competing with one another. As will be seen later, the EMU countries

[8] This is undoubtedly partly due to the larger proportion of total value added in the economy contributed by the industrial sector in the EU than in the USA; the EU figure was 20.6% in 1997 and the US figure just 18%. Cf. Eurostat: Panorama of European Business 1999. EU businesses and the challenges of the years' 2000 [*sic*], press release dated 30th May 2000.

Gerd Winter (ed.)

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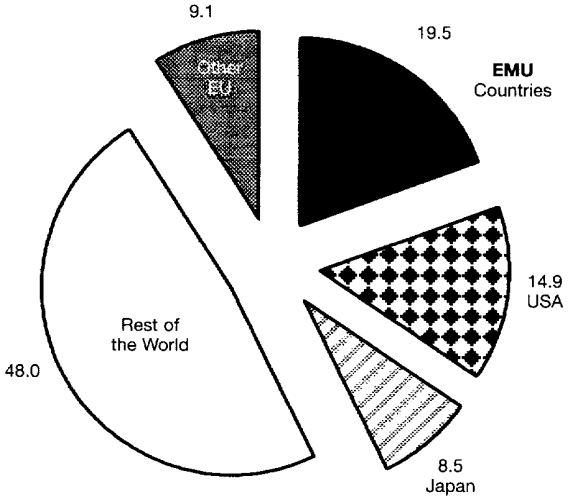
Figure 4
Share of World Market held by Exports, 1998
(excluding trade among EMU countries)



Sources: Eurostat; own calculations.

fare better with such business-related indicators than they do with macroeconomic factors. In this age of globalisation, firms have become more flexible and more mobile: this may not mean relocating a whole company, just certain of its production facilities. This has made the factors that influence the attractiveness of different locations much more important when assessing a country's or region's overall competitive position.

Relatively Greater Competitiveness of Companies

The relatively greater competitiveness of companies from the EMU countries rather than of the countries themselves as business locations is particularly clearly brought out by the competition studies published each year by the World Economic Forum (WEF) and the Institute for Management Development (IMD). They analyse the competitiveness of 59 and 47 countries, applying 200 and just under 300 criteria, respectively. Without wishing to address in detail the problems raised by studies of this kind, the criteria applied and how rankings are drawn up,[9] certain common findings of the two studies are still striking in fundamental terms (see Table 1):

☐ The United States tops the rankings both in terms of overall competitiveness and the factors particularly applying to businesses (microeconomic competitiveness/domestic economy).[10] Under the criteria assessing government influence, i.e. key determinants of a country's competitive position as a business location, the USA does substantially better than the countries participating in EMU.

Table 1
Competitive Rankings for Major Industrial Countries, 1999

	World Economic Forum (WEF) (Ranking among a total of 58 countries)			Institut for Management Development (MD) (Ranking among a total of 47 countries)		
	Overall competitiveness	Microenonomic competitiveness	Government	Overall competitiveness	Domestic economy	Government
EU						
of which: EMU						
Germany	25	6	45	9	11	31
France	23	9	56	21	13	40
Italy	35	25	57	30	23	45
Spain	26	23	39	23	24	13
Netherlands	8	3	32	5	7	18
Austria	20	11	43	19	14	24
Belgium	24	15	51	22	15	43
Luxembourg	7	–	20	4	3	7
Ireland	10	17	7	11	2	5
Finland	11	2	25	3	4	10
Portugal	27	29	40	28	21	25
of which: non-EMU						
United Kingdom	8	10	16	15	26	19
Denmark	17	7	41	8	10	22
Sweden	19	4	49	14	27	39
Greece	41	36	44	31	25	36
USA	**2**	**1**	**15**	**1**	**1**	**15**
Japan	**14**	**14**	**23**	**16**	**29**	**23**

Sources: WEF – World Economic Forum: The Global Competitiveness Report, 1999. IMD – Institute for Management Development: The World Competitiveness Yearbook 1999.

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☐ The EMU countries do relatively well when the competitive criteria relate to the efficiency of domestic business. By way of contrast these countries – particularly the larger ones such as Germany, France and Italy – occupy the lower rankings when the criteria are associated with government influence. In other words, such influence tends to be regarded as a brake on, rather than a boost to, economic development in these countries.

Deficiencies in Macroeconomic Competitive Conditions

The framework for economic activity laid down by the state naturally also dictates some of the major competitive conditions on a macro level. Concrete examples include the extent of government bureaucracy, regulation of the factor and goods markets, the overall tax burden, etc. In a globalised world in which capital may move freely, these factors have an ever more important part to play in the competition among locations. Yet most of the EMU countries exhibit a very poor showing in this respect.

A classic example is the field of taxation. Taxes and other levies are now a significant locational factor as the international dimension in economic activity grows. It is extremely difficult to compare the effective tax burden in different countries, particularly for corporate taxes and charges, because of the widely differing and complex legislation involved.[11] When top taxation rates (the only quantity that can be compared with any degree of objectivity internationally) for both companies and their workforces, and also the actual tax load in the economy, are compared the EMU countries, especially the large ones, again perform unfavourably (see Table 2). Then the burden of statutory social insurance contributions must also be taken into account, and this too is rather high in many parts of Euroland. It is true that many European governments are now keen to bring down corporate taxation in particular; however, the scope available to them is constrained not only by the EMU convergence rules calling for a sustained improvement in public sector budgets, but often also by the substantial resistance to cuts in government spending.

Table 2
International Comparison of the Tax Burden

	Total tax receipts[1] in % of GDP (1997)	Highest rates of Personal income tax[2] (1998)	Highest rates of Corporate income tax (1998)
EU			
of which: EMU			
Germany	37.7	55.9	47.5[a]
France	46.1	61.6	41.7
Italy	44.9	46.0	37.0
Spain	35.2	56.0	35.0
Netherlands	43.2	60.0	35.0
Austria	44.7	50.0	34.0
Belgium	46.5	60.8	40.2
Luxembourg	41.0	47.2	31.2
Ireland	37.3	46.0	32.0
Finland	46.9	55.5	28.0
Portugal	34.2	40.0	34.0
of which: non-EMU			
United Kingdom	34.6	40.0	31.0
Denmark	49.7	58.0	34.0
Sweden	53.3	56.0	28.0
Greece	32.2	45.0	35.0
USA	**27.9**	**45.8**	**39.5**
Japan	**28.4**	**65.0**	**50.0**

[1] Taxes and social insurance contributions.
[2] Top rate of central government tax + regional or local government + other supplementary charges.
[a] Corporation tax on retained profit + solidarity surcharge, but excluding trade tax; inclusion of trade tax brings the figure to some 64%.

Sources: OECD; IMD; Federal Ministry of Finance.

Large Direct Investment Deficit

Another quantity frequently used as an indicator of the attractiveness of particular economies is the level of direct investment. This is based on the assumption that, in the course of globalisation, mobile investment capital will increasingly flow to whichever locations offer the most favourable conditions. Changes in the levels and flows of direct investment are interpreted as changes in the relative attractiveness of locations, so a net outward flow, possibly a growing one, in direct investment is taken as an indicator of poor locational quality and a net inward flow as one of a good location (see Table 3).

Flows of direct investment out of the euro zone to the rest of the world far outweigh the investment coming in. The deficit in this category again grew strongly in 1999, to reach a new all-time high of almost €150 billion. This was due not only to a continuing increase in the amount invested abroad by euro-area companies but also by a marked simultaneous decline in inward direct investment, which

[9] The different evaluations of particular countries, Germany being one of them, made by the IMD and WEF are due partly to differences in the set of criteria used, and partly to different relative weightings of the criteria. On the methodology of these comparisons, see Nancy Lane: Methodology and Principles of Analysis, in: IMD: The World Competitiveness Yearbook 1999, pp. 48-58.

[10] In the WEF's ranking, the United States is beaten only by Singapore for overall competitiveness.

[11] For an international comparison at the employee level, cf. Jörg Hinze: Relation zwischen Bruttoarbeitskosten und Nettolöhnen, HWWA Report No. 202, Hamburg 2000, pp. 62-71.

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was down by almost a quarter compared with 1998. While the increased outward direct investment could be seen as part of the process of developing new markets and a sign of increased exporting operations by companies in the EMU area, it is certainly a matter for concern that the interest of third-country investors should have fallen away so substantially in the very year of the euro's introduction.

Nevertheless, it is still too soon to reach a final judgement on this issue. The movement in the euro/dollar exchange rate that occurred in 1999 and the early part of this year may now have shifted the relative attractiveness of investment in these two currency areas. Of course, the overall economic and policy-making environments play at least as great a part as the exchange rate does, but direct investment outside the euro zone has now become substantially more expensive (and hence less attractive) while inward investment has grown cheaper. So it remains to be seen how direct investment patterns will continue during the current year. If, however, the net flow of direct investment were to deteriorate even further, this would undoubtedly fuel the doubts as to the euro zone's competitiveness, especially vis-à-vis the United States.[12]

EMU Area Lags on the Innovation Front

The most important determinant of a country's future competitiveness is its innovative capacity. This has a vital influence on productivity growth and hence on future prosperity.[13] Investment in research and development has a predominantly long-term impact. Although there are a number of quantitative indicators available to evaluate it, a more important aspect is the quality of such investment, especially when it comes to the new technologies. Here too, the EMU countries appear to have fallen behind the United States, part of the reason being a lack of skilled staff, as in the field of communications and information technology, or more restrictive laws in the EU relative to the USA, as in the case of biotechnology or genetic engineering.

If, once again, we apply the criteria for technological innovative capacity used by the World Economic Forum and the Institute for Management Development, covering scientific education and training, the quality of research institutions, public and private-sector expenditure on research and development, the implementation by businesses of new technologies and research findings, the number of international patents obtained, the use of computer-based technologies, and so on, the USA again comes out on top, with Japan in second place. The EMU countries are some way down the list, with Germany ranked highest among them (see Table 4).

Weaknesses in EMU Economic Policy

Economic policy, or rather the market participants' judgement of it, plays no small part in influencing not only the exchange rate but also competitiveness vis-

Table 3
Direct Investment Into and Out Of the Euro Area
(in billion euro or ECU)

	Out of euro zone	Into euro zone	Net Invest-ment flow	For comparison: EU to US	US to EU	Net flow between EU and US
1997	–93.4	45.3	–48.1			
1998	–183.0	80.4	–102.6	–112.3	61.7	–50.6
1999	–212.5	65.2	–147.3			

Sources: Eurostat, ECB.

Table 4
Ranking of Innovative Capacity in Technology

	WEF Technical sophistication	IMD Science & technology
EU		
of which: EMU		
Germany	3	4
France	11	7
Italy	28	29
Spain	25	26
Netherlands	13	8
Austria	22	21
Belgium	21	18
Luxembourg	19	20
Ireland	18	11
Finland	5	6
Portugal	38	38
of which: non-EMU		
United Kingdom	19	14
Denmark	12	9
Sweden	6	5
Greece	48	31
USA	**1**	**1**
Japan	**2**	**2**

Sources: WEF – World Economic Forum: The Global Competitiveness Report, 1999. IMD – Institute for Management Development: The World Competitiveness Yearbook 1999.

[12] It is true that American direct investment in the EU (data only available by region) has grown substantially in recent years, by almost five times in the 1992–1998 period. However, direct investment by EU-based organizations in the USA grew by a factor of sixteen in the same period. The net flow of direct investment, from the EU's viewpoint, was still slightly in surplus in 1992 (+ECU 5.4 billion) but was vastly in deficit by 1998 (–ECU 50.6 billion).

[13] Cf. Michael E. Porter, Gregory C. Bond: Innovative capacity and prosperity: the next competitiveness challenge, in: WEF: The Global Competitiveness report 1999, pp. 54 f.

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à-vis other locations. However, this can hardly be measured objectively, let alone quantitatively, so it counts as a "climatic factor". When perceptions of this kind turn negative, the effect is usually very detrimental because it takes a good run of favourable news to correct them. Economic policy in the euro zone has mainly been criticised because it is poorly coordinated, because there are signs of slacking in some countries in their efforts to consolidate public-sector budgets, and because progress is so slow in implementing reforms to resolve structural problems.

Most "EMU watchers" see labour market and social policies as especially problematic, especially in the "large" countries in the group,[14] due to a combination of limited incentives to work and the high "costs" of labour, which in turn impose constraints in other fields such as taxation policy. The institutional structures in the labour market are frequently held to be no longer competitive.[15] Most European countries also spend considerably more on social policy than the United States, both per capita and as a proportion of their gross domestic product. The general direction of this policy is one of securing a certain standard of living rather than reintegrating unemployed people into the labour market. Especially unskilled or low-skilled workers with proportionately low earning power have little incentive to get into work in some countries. At the same time, the demographic trend involving a steadily ageing population calls for incisive reforms to the social welfare systems in most of the EMU countries. Were current social policies to be retained unchanged, not only would there be no sure way of financing them in the future, but the burden of contributions would rise too. In spite of the evident need for reform, there are few signs yet that the problems are being effectively tackled. Under these circumstances, social insurance costs are increasingly turning into negative factors in the competition among locations.

Conclusion

Until the euro was introduced in 1999, the exchange rate of the ECU to the US dollar was readily explicable in terms of major fundamental factors such as price and interest-rate differentials. However, the subsequent movement of the euro/dollar exchange rate has been much less favourable than would have been expected on the basis of those fundamental factors, so other factors have evidently come into play. A body of evidence suggests that, as European Monetary Union was put into practice and the integration project moved a step further, a new, qualitative aspect has emerged in the assessment of the common currency zone's performance and potential, and equally of the new currency itself, the euro.

Many see the euro's weakness against the US dollar as a manifestation of the EMU participants' poor competitiveness, particularly relative to the United States. In many fields, the USA is the world's leading business nation. Its economy has been growing with considerable momentum while price inflation has remained relatively low, unemployment is down to a very low level and the government sector is generating a growing surplus. The main reasons cited are very flexible markets, not least the labour market, and business's ability to innovate, a situation summed up as the "new economy".

In many respects, the countries integrated within EMU lag substantially behind the USA. Even now that economic activity around Euroland is picking up noticeably, the growth path is still a weaker one than in the United States. Certainly, companies from the euro zone hold a good competitive position on the world's markets, but nowadays a country or region needs locational competitiveness to hold its own, i.e. it needs to be attractive to the mobile factors of production, to mobile human and real capital. And on this macroeconomic level, the euro zone does have some quite substantial weaknesses, with many structural problems still unresolved.

On top of that, we have further uncertainty in the economic policy arena. Political decision-making processes in the EU and hence in the euro zone are often rather inflexible, restraining the capacity to implement reforms and to restructure as needed. The enlargement of both the EU and the euro zone now in prospect – both of which are undoubtedly politically desirable and also offer economic opportunities in the longer term – are also something of a burden in the short term: the entry candidates have less developed and less powerful economies than the current EU member states, and past experience has shown that the new members' accession is likely to generate substantial costs. An exchange rate is a price that is primarily determined by macroeconomic factors; in this respect, the euro's exchange rate is at least partly a reflection of the deficiencies still existing among the EMU countries in certain important determinants of competitiveness.

[14] IMF: World Economic Outlook, May 2000, pp. 18 f.

[15] Horst Siebert: How competitive is Europe's labor?, in: WEF: The Global Competitiveness report 1999, pp. 86-93.

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