

Economic and Monetary Union

EU Integration after Lisbon

Announcements

- ▶ Today: Staff seminar “Human Rights and Democratic Legitimacy”, 18:00, 05-432
- ▶ Today: Informal gathering “Mentoring”, 18:00, 05-132
- ▶ Thursday *next week*:
Georg-Forster-Lecture, “Minorities – a challenge for freedom and equality?” (N1)



G. Forster, 1754-1794

Last week's remaining question

- ▶ **Should** the Single European Market be completed?

Outline

Intro

EMU: history

1970s

Delors again

Creation of the EMU

Evaluations, problems, and recent
developments

Summary



Intro: What makes a state sovereign?

- ▶ Formally, recognition by other states
- ▶ “Three elements” (G. Jellinek)
 1. People
 2. Territory/borders
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 - ▶ Flag
 - ▶ Anthem
 - ▶ Stamps
 - ▶ Army

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 - ▶ **Money**



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 1. Fiscal policies (tax & spend, *borrowing money*)
 2. Setting of interest rates
 3. Setting of exchange rates

Two approaches to macroeconomic policy



John Maynard Keynes, 1883-1946



Milton Friedman, 1912-2006

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- ▶ Business cycles (“boom and bust”) inevitable, but harmful
- ▶ State should level out cycles
 - ▶ Spend during crises
 - ▶ Save during booms
 - ▶ Welfare state (automatism)

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- ▶ Neoclassical approach
- ▶ Free markets are best, government intervention and monopolies are harmful
- ▶ Inflation is harmful
- ▶ Focus on (low levels of) money supply

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 - ▶ But more stability for all?

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- ▶ Factors determining whether a CA is optimal
 - ▶ Inflation rates
 - ▶ Monetary policies
 - ▶ Exchange rates
 - ▶ Trade intensities
 - ▶ Labour market conditions
 - ▶ Institutional convergence

Monetary unions: no new idea

| w political union | w/o political union |
|--|--|
| England & Scotland from 1707 | Belgium-Luxembourg union 1923-2002 |
| US Federal Reserve system from 1913 | West/Central African CFA francs 1945- |
| Italian monetary union 1861-2002 | Latin MU (B, I, F, CH, Gr) 1865- WW1 |

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- ▶ Basic idea: encourage trade by reducing transaction costs
- ▶ Might also encourage foreign investments

Bretton Woods

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- ▶ Based on fixed exchange rates between major currencies (re-alignment possible but complicated)
- ▶ Dollar backed by gold standard (35 dollars per ounce) → US impact on world
- ▶ IMF could intervene to re-balance the system

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- ▶ IMF could intervene to re-balance the system
- ▶ US inflation following Vietnam, increased gold production, growth of international capital/currency markets
- ▶ Crisis of the system, which formally ended in 1973

EMU: early steps

- ▶ Rates within EC already fixed (CAP); dissent re full EMU
 - ▶ “Locomotive”: EMU leads to economic convergence
 - ▶ “Coronation”: EMU as final step of economic convergence (Germany)
- ▶ Werner Plan for EMU (1970) never fully implemented (US pressure)
- ▶ “Snake in the tunnel” (limited fluctuations) as first step → collapsed mid 1970s
- ▶ Late 1970s
 - ▶ France (Giscard) wants stable currency/exchange rates
 - ▶ Germany (Schmidt) concerned about too-strong Deutschmark
- ▶ “European Monetary System” (EMS) / “Exchange Rate Mechanism” (ERM) established in 1979

EMS

- ▶ “ECU” – (weighted) basket of currencies
- ▶ European Credit Facilities
- ▶ European Monetary Co-operation Fund
- ▶ Exchange Rate Mechanism (ERM)
 - ▶ Grid: bilateral parities +/- 2.5 per cent (6 for Italy)
 - ▶ Central Bank intervention & co-ordination
- ▶ Dominated by Germany/Deutsche Bundesbank; obsessed with inflation
- ▶ De-facto currency union on German terms
- ▶ Problems through 1980s, under massive pressure from currency speculation in early 1990s
- ▶ UK out, in (1990), out again (16.09.92, “Black Wednesday”)

Delor report (1989)

“Complete” EMU:

1. Stage I: Free movement of capital, macro-economic co-ordination from (90-94))
2. Stage II: Treaty revision, system of central banks, restrict fluctuations in ERM, convergence criteria, EMI (94-98)
3. Stage III: “Irrevocable” fixing of exchange rates, establishment of ECB, independent and responsible for price stability (99-)

EMU and Maastricht

- ▶ Maastricht: timetable for completion in 97/98
- ▶ UK negotiated opt-out
- ▶ Denmark given opt-out after failed referendum on Maastricht
- ▶ UK and Italy *forced* out of ERM, currency crisis in 1993
- ▶ “Widening” of bands to $\pm 15\%$



Franco-German conflict

- ▶ German government strongly in favour, but public sceptic (inflation)
- ▶ France in favour of looser rules for government deficits, more political control
- ▶ Conflict over president, site
- ▶ ECU renamed in 1995
- ▶ Amsterdam 1997
 - ▶ “Stability and Growth Pact” (Germany)
 - ▶ Agreement by QMV on fines (France)
- ▶ 1998: Duisenberg/Trichet; ECB at Frankfurt
- ▶ Little political influence, but Eurogroup



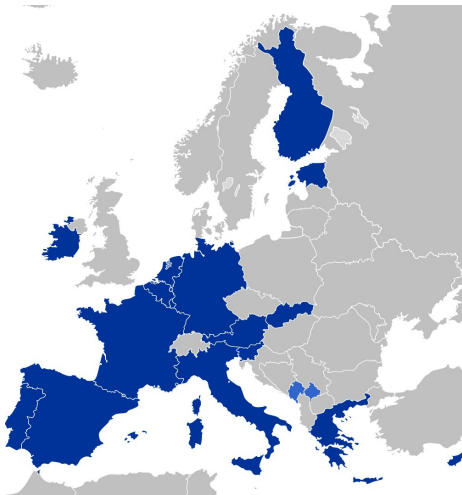
Convergence criteria/SGP

- ▶ Convergence (Maastricht) criteria
 1. Inflation: no more than 1.5 points above average of three best performing
 2. Government deficit:
 - ▶ Annual deficit ≤ 3 per cent of GDP
 - ▶ Government debt ≤ 60 per cent of GDP
 3. Exchange rates: must have been a member of ERM II for at least two years w/o devaluation
 4. Long-term interest rates not more than 2 points higher than average of three best performing countries
- ▶ Only 3 met all criteria (and Greece cheated) → political decision
- ▶ SGP: a series of Council resolutions to keep members in line once they have joined the Euro
- ▶ Much watered down since 1997 (by France and Germany)

Realisation of EMU

- ▶ ECB
 - ▶ National central banks become branches of ECB (European System of Central Banks, Eurosystem)
 - ▶ Independent
 - ▶ Price stability; means: interest rates and deposits
 - ▶ No credits for public sector; *buying government bonds*
- ▶ Executive Board + General Council (NCBs)
- ▶ Launch in January 1999 with 11 members (UK, Sweden, Denmark outside), Greece allowed in 2001
- ▶ Coins and notes from January 2002
- ▶ Slovenia (2007), Cyprus & Malta (2008)
- ▶ Slovakia (2009), Estonia (2011)

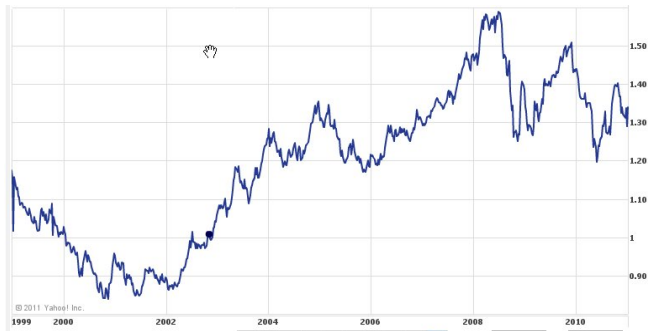
The Eurozone in 2011



EMU: economic implications

- ▶ Pressure to harmonise taxation (spill-over)
- ▶ Reduction of exchange costs → 0.5 points extra growth
- ▶ Increased competition and price transparency
- ▶ Even more trade within Eurozone
- ▶ Consumer prices stable/down
- ▶ Euro a second reserve currency – too strong/weak against Dollar?

Euro/Dollar exchange rates



EMU: political implications

- ▶ Different degrees of Europeanisation (inside/outside Eurozone)
- ▶ Two-tier EU?
- ▶ Spill-over: pressure towards true common economic policy
- ▶ Common social policies?
- ▶ Worries about “neo-liberalism”



EMU: problems

Eurozone is not an OCA (cf Mundell 1961)

1. Labour mobility = NOT
2. Flexible prices and wages = NOT
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4. Political will = YES

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- ▶ So interest/exchange rates might be too high/too low for some countries, optimal for others
 - ▶ “Core Eurozone” (Germany, France, BeNeLux, Austria, maybe Italy) might work quite well

EMU: the current crisis

- ▶ Problem began with lending crisis of the American banking sector
- ▶ Worldwide crisis in the financial and the real economy
- ▶ Initially un-coordinated European responses, banks “saved”
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- ▶ No Eurobonds, no European control of the financial sector, no tough sanctions against offending countries, no large transfers between countries . . .

Summary

- ▶ Best economic explanation: reduced transaction costs
- ▶ Alternative explanations
 - ▶ High degree of economic and political linkage between BeNeLux, France, Germany
 - ▶ Political will in France and Germany, and smaller countries
- ▶ Facilitated/encouraged by Commission, Central Bankers, (parts of the) industry
- ▶ Dominated by monetarist ideas → built-in conflict between ECB and government spending programs
- ▶ (Relatively) low levels of integration (EU *not*) a federal state → problems

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- ▶ Next week: financial transfers (cohesion)

Class questions

- ▶ What lessons can be drawn from the experiences of the single currency so far?
- ▶ Have there been significant changes in the EU since the introduction of the Euro?
- ▶ What can be said about the future prospect of joining the common currency by Denmark, Sweden, the UK, and the remaining new member states?