Political Economy of European Monetary Integration II

Europe in World Economy 2017

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Standard Economic Approach and Currency Unions

- Further analysis in this lecture employs the **neoclassical approach**
- Mainstream Economics
- **Definition of Economics** (Robbins 1935): “the science which studies human behavior as a relationship between ends and scarce means which have alternative uses”
- **Assumptions** – rational individual that attempts to maximize utility, self-interested individual, perfect knowledge (rational expectations)
- Focuses on markets as the prime means of coordination
- Main analytical tools: supply and demand curves

- **Monetary policy** – a process by which a monetary authority influences monetary variables (e.g. interest rate) in an attempt to control the supply of money (inflation)
- **Fiscal policy** – manipulation of the balance between government expenditures and revenues so as to influence the economy (aggregate demand)
- Most countries have their own currency and use both fiscal and monetary policies to their advantage
- **Monetary arrangements**
  - Floating
  - Managed floating
  - Fixed exchange rate
  - Currency board
  - Dollarization, euroizaition

- **Monetary sovereignty**
  - Macroeconomic management – influencing the development of an economy using monetary and fiscal policies
  - Seigniorage – is the difference between the value of money and the cost to produce and distribute it
  - Political symbolism – patriotism, national identity
  - Monetary insulation – insulation from economic but also political risk
- **Internationalization** (loss of sovereignty)
  - Efficiency – promotes competition
  - Network externalities – reduces transaction costs
  - Political advantages (reduces conflict probability?)
- **Impossible trilogy**
  - Stable exchange rate
  - Monetary policy independence
  - Unrestricted capital flows

- EMU stands for **Economic and Monetary Union**
- Economic and monetary unions usually have countrywide fiscal policy as well as a single monetary policy
- The EU budget amounts to only about 1 % of EU GDP
- EU used an alternative approach
  - Maastricht criteria
  - Stability and Growth Pact
  - Broad Economic Policy Guidelines
- Real coordination of economic policies has been rather limited

- Main components of monetary integration
  - Exchange rate union – permanently and irrevocably **fixed ER** among themselves
  - *Capital market integration – absence of all exchange controls for both current and capital transactions*
- Monetary integration should include:
  - A common monetary policy
  - A common exchange rate policy (+ pool of reserves)
  - A single monetary authority
- Policy consequences
  - *The rate of increase of the money supply must be decided jointly*
  - The **balance of payments** of the entire union with the outside world must be regulated at the union level

Gains from EMU

- A common pool of foreign exchange reserves economizes their use
- A single currency can play more important role internationally (seigniorage)
- Reduction of transaction costs
- Enhanced competition (price transparency)
- Possible lower interest rates for some countries
- Stability should lead to optimal allocation of resources (in the long run)
- Pooling of financial resources – easier financing from within the union
- Centralized budget – transfers to depressed regions
- A stronger voice at the union level for some countries

Optimum Currency Areas – cost-benefit analysis of single currency adoption

Possible costs

- Higher unemployment and some loss of output/wealth in the depressed country
- Higher inflation in the booming country

The costs should be only transitional if any because in the long run the market mechanism should restore equilibrium

Furthermore, the changing institutional structure should lead to a change in behavior so that the current problems are overcome more easily

How to reduce costs?

Price/wage flexibility

Labor/capital mobility

Financial market integration

Open an interdependent economies

Diversified economies

Similar production structures (similar shocks)

Similar inflation rates

Fiscal integration

Possible problems with neoclassical explanation:

- Variables behave smoothly because they were set in the model to do so (NAIRU)
- People are assumed to change their behavior to fit the expectations of the model
- Misunderstands the role of money in the society (monetary power, debtors × creditors)
- Assumes away important political considerations (distribution, patriotism etc.)

History

Gold standard

- Fixed exchange rate system
- Most important currencies pegged to gold
- Europe-led system, Bank of England as the most important element
- Governments sacrificed internal balance to maintain an external one

Interwar system

- Attempts to restore gold standard
- Problems with parities (undervalued×overvalued)
- Great depression – beggar thy neighbor policy (competitive devaluations)

Bretton Woods system

- Fixed but adjustable exchange rate system
- Currencies pegged to US dollar that was convertible to gold at $35 per ounce
- Provided stability for the post wwii world
- Mounting instability since the end of 1960s

First attempt at establishing EMU

- 1969 The Haague summit
- The Werner report
- Snake in the tunnel
- Nixon shock, first oil shock, enlargement

The European Monetary System

- Since 1979
- New accounting unit – European Currency Unit (ECU) – the basket of all EC currencies
- Exchange rate mechanism (ERM) – allowed exchange rate variation 2,25% from the ECU
- Qualified success
- 1992 crisis

EMU

- Delors report
- Three-stage timetable
  - First stage – intensify economic cooperation, all countries in ERM
  - Second stage – European Monetary institute (later European Central Bank), convergence tests, permanent peg
  - Third stage – the transition to full EMU, introduction of the euro
- Treaty on European Union
  - Opt out for the United Kingdom and Denmark
  - All other countries have to join when they are ready

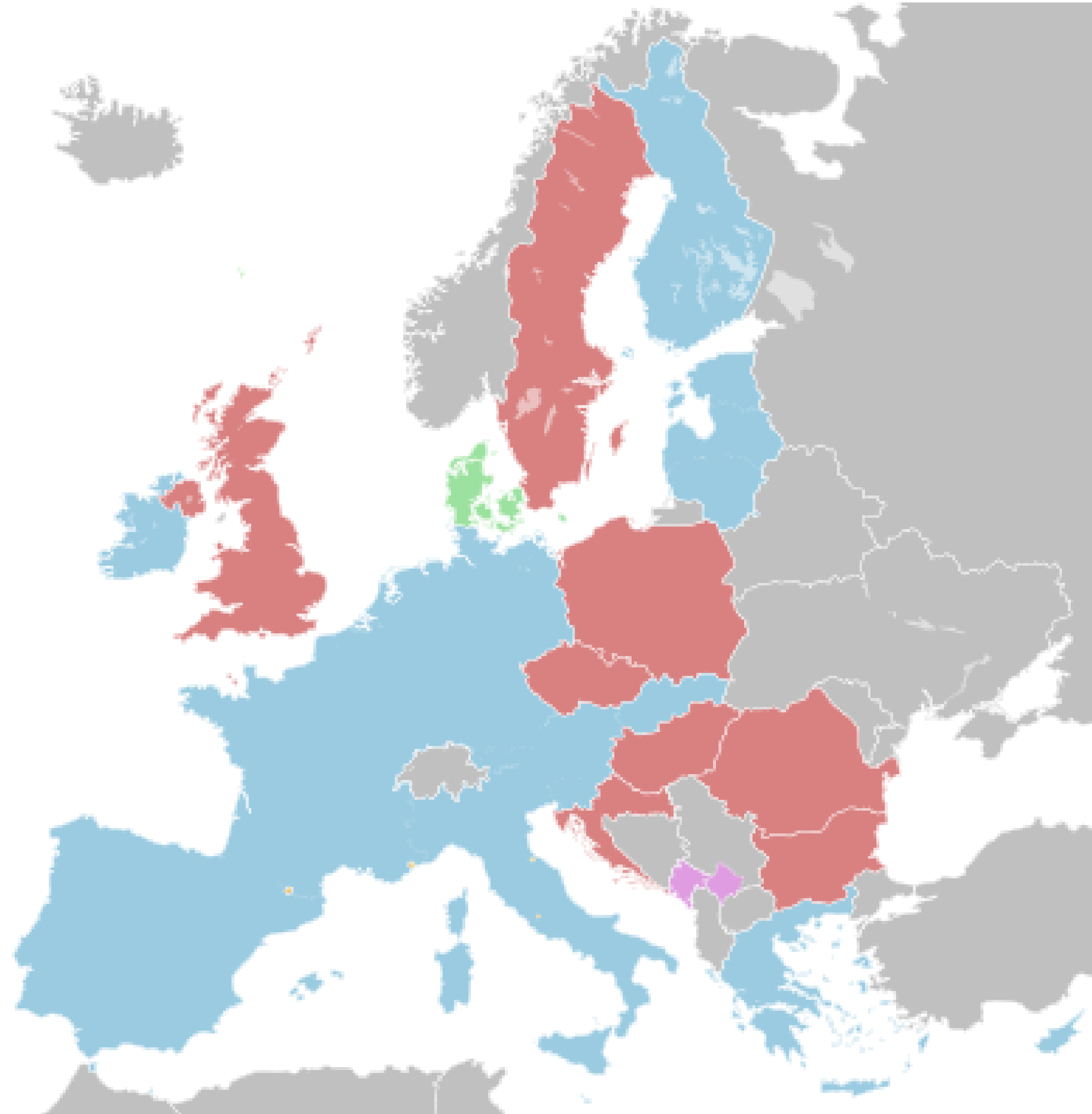
Maastricht criteria

- Government deficit: the ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding financial year
- Government debt: the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding financial year
- Exchange rates: participation in the exchange-rate mechanism of the European monetary system without any break during the two years preceding the examination of the situation and without severe tensions
- Price stability: the inflation rate of a given Member State must not exceed by more than 1½ percentage points that of the three best-performing Member States in terms of price stability
- Long-term interest rates: the nominal long-term interest rate must not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability

EU member states’ performance with regard to the convergence criteria

	deficit 95	deficit 96	deficit 97	debt 95	debt 97
Belgium	4,1	3,3	2,1	133,7	122,2
Denmark	1,6	1,4	+ 0,7	71,9	65,1
Finland	5,2	3,3	0,9	59,2	55,8
France	4,8	4,0	3,0	52,8	58,0
Ireland	2,0	1,6	+ 0,9	81,6	66,3
Italy	7,1	6,6	2,7	124,9	121,6
Luxembourg	+ 1,5	+0,9	+ 1,7	6,0	6,7
Germany	3,5	4,0	2,7	58,1	61,3
Netherlands	4,0	2,6	1,4	79,7	72,1
Portugal	5,1	4,0	2,5	71,7	62,0
Austria	5,9	4,3	2,5	69,0	66,1
Greece	9,1	7,9	4,0	111,8	108,7
Spain	6,6	4,4	2,6	65,7	68,8
Sweden	8,1	3,9	0,8	78,7	76,6
Great Britain	5,8	4,6	1,9	54,1	53,4

Eurozone member states



Monetary Policy

- European System of Central Banks
  - European Central Bank + national CB
  - **Governing Council**, Executive Board, General Council
  - Independence (term, secrecy, no monetization)
- Policy
  - Maintaining price stability, other goals subordinate
  - Inflation less but close to 2%

Economic Policy Coordination

- Eurogroup
  - Finance ministers of the eurozone
  - political control over the currency
- Real coordination is reactive and rather haphazard – open method of coordination
- Neoclassical approach
  - maintain price stability
  - provide credibility (CB independence + fiscal rules)
  - other monetary a fiscal policies are ineffective in the long run, lack of coordination should not matter much
  - structural policies are responsible for long term economic growth

Stability and Growth Pact

- The most important instrument of coordinated economic policy
- Adopted in Amsterdam, 1997; in force since 1999
- Reason: fiscal discipline in the EMU as the stability factor of single currency
- Criteria:
  - an annual budget deficit lower than 3 % of GDP
  - a public debt lower than 60 % of GDP or approaching that value
- Excessive budget procedure–proposal of Commission, decision by Council (including sanctions)
- Problems: Germany, France (no sanctions against them in the Council)→changes in the rules since 2005 (moderation of rules)