International Economics

XIII. European Economic and Monetary Integration

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1. The Early History of European Integration

Political Background

- Europe in ashes after WW2, beginning of the Cold War
- US hegemony: militarily, economically, monetarily → Bretton Woods

Intellectual Background in Europe

- Desire to avoid conflict, close Franco-German cooperation
- Close relationship between politicians and economists
- General trend toward liberalization of economies after wartime socialism

Postwar Liberalization

Return to Market Economy

- Most European countries returned to (semi-)free markets
- Most famously the German "Economic Miracle" from 1948
  - The end of price controls meant end of economic dysfunction and rapid economic growth
- Deregulation in other countries to greater or lesser extend
  - France, Italy, Belgium, etc.

Lingering Interventionism

- International trade and payments still heavily regulated
  - Bilateral, quasi-barter trade between countries
- The dollar shortage – European exchange rates were fixed too high against the dollar

The European Payments Union 1950-1958

Purpose

- Set up in 1950 to facilitate multilateral trade
- Trade was to be settled in terms of the European Unit of Account (EUA)
  - 1 EUA = 0.888671 grams of gold
  - The gold content of 1 US dollar
  - Accounts settled on a monthly basis

Success

- Trade doubled over the period
- In 1958 convertibility into dollars became possible
- A unit of account similar to the EUA continued in use

ECSC and the Treaty of Rome

European Community of Coal and Steel (ECSC)

- Established by Treatise of Paris 1951
- Signatories: BE, FR, DE, IT, LU, NL
- Integrated steel and coal industries into an interdependent structure
- Controlled by a High Authority

Treaty of Rome 1957

- Signatories: BE, FR, DE, IT, LU, NL
- Established the European Economic Community
- Reduction of trade barriers, customs union and a common market the goals
- EURATOM and the Common Agricultural Policy also established

EURATOM, EC, and EFTA

EURATOM (1958)

- Aimed to coordinate policy for peaceful use of atomic energy

EC (1967)

- Treaty of Brussels 1965
- Unified the communities (ECSC, EEC, EURATOM)
- Henceforth known as the European Communities
- EC was committed to a customs union, common market, coordinated economic policy and supra-national institutions
- UK forms the European Free Trade Association (EFTA) in 1960. Participants: UK, AT, CH, DK, NL, PT, ES.

2. From the Single Market to EU28

Origins

- Messina meeting 1955, Spaak Report of 1956 and intention of the Treaty of Rome 1957
- Difficulties due to variety of economic interests across Europe and ideological differences
- 1986 Single European Act (SEA) laid down detailed plans for a single market in Europe

The Single Market

- Removal of physical, technical, and fiscal barriers to trade
- Implementing the free movement of goods, services, labour and capital
- Common European regulations of products (Acquis communautaire)

Enlargement

Northern Enlargement 1973

- UK, DK, IE
- UK had tried to join earlier, membership blocked by France – saw UK as an American "Trojan horse" in the EC

Southern Enlargement 1981-1986

- Greece joined 1981, Spain and Portugal 1986. End of military dictatorships allowed accession
- All countries saw EC membership as means to guarantee stability, foster prosperity

Second Northern Enlargement 1995

- Austria, Sweden, Finland
- The end of the Cold War paves the way for accession of neutral countries

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Maastricht, Amsterdam, Nice

Maastricht Treaty 1993

- Treaty on the European Union
- Plan for EMU institutionalised

Treaty of Amsterdam 1999

- European Parliament strengthened
- Provisions for free movement of persons to EC part of the EU treaty

Treaty of Nice

- Mainly reform of European institutions prior to Eastern enlargement

Enlargement: EU28

- Formal requirements for accession (the Copenhagen criteria): political, economic, acquis

Three Waves of Enlargement

- 2004: Poland, Czechia, Slovakia, Hungary, Slovenia, Malta, Cyprus, Lithuania, Latvia, Estonia
- 2007: Romania and Bulgaria
- 2013: Croatia

Other Possible Candidates

- The remaining Balkan countries
- Caucasus countries
- Turkey

Brexit

- British referendum in June 2016 on continued membership led to majority against
- The UK left the EU end of January 2020 and continued to be a member of the customs union and the common market until end of year 2020

The EU-UK Trade and Cooperation Agreement

- There are no tariffs or quotas, but VAT and some other duties now apply
- No longer general access to each other's services market
- No longer free movement of persons
- UK leaves EU Common Fisheries Policy, fishing quotas in UK waters reduced, subject to annual renegotiation

3. The European Institutions

Pillar 2

Common Foreign and Security Policy (CFSP)

Pillar 1

The European Communities

EC

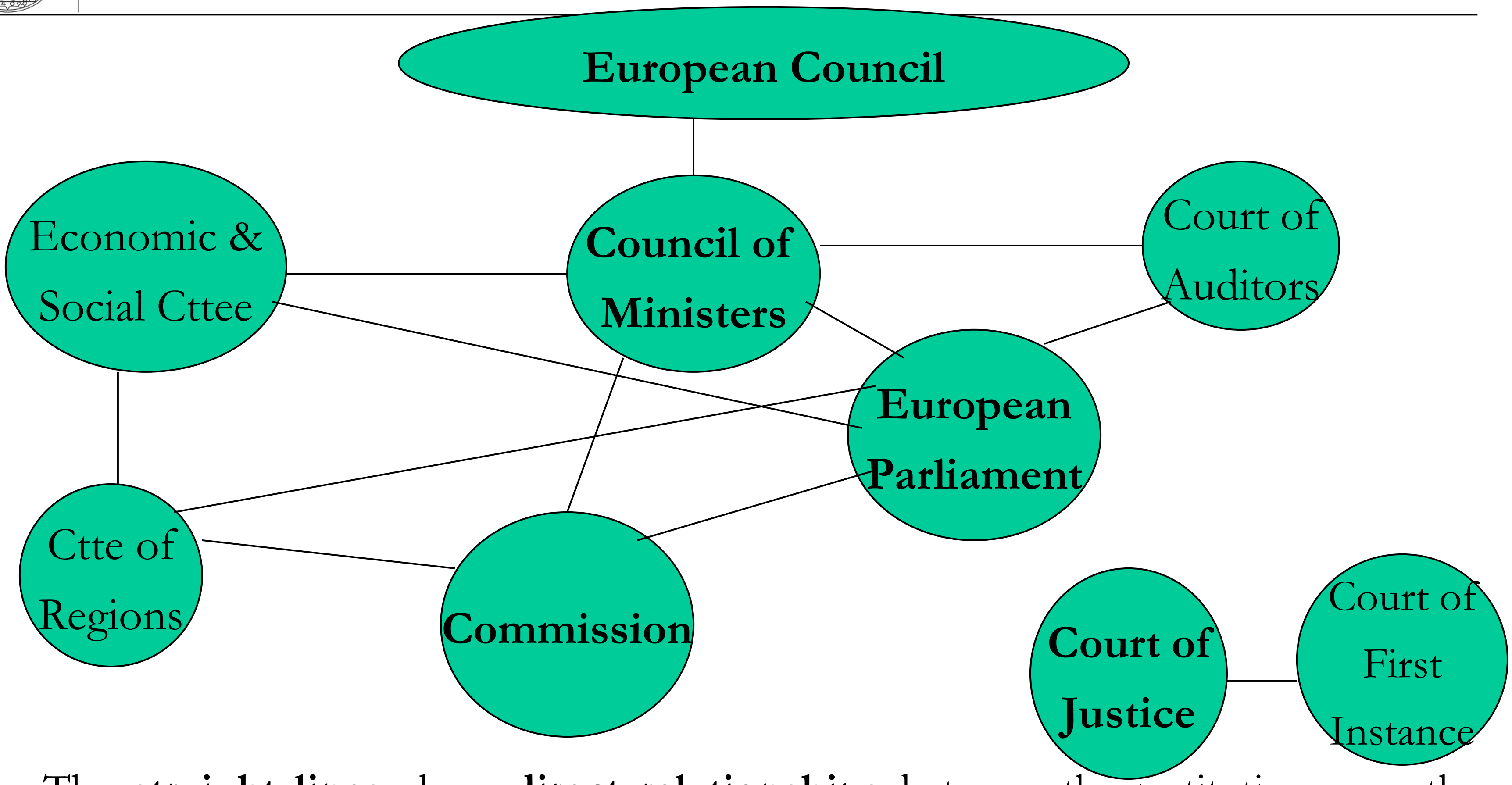
ECSC

EURATOM/ EAEC

Pillar 3

Police and judicial cooperation in criminal matters (PJCCM)

Community Institutions



- The **straight lines** show **direct relationships** between the institutions, e.g. the Court of Justice and Court of First Instance are entirely independent of the others

Council of the European Union

Formerly the Council of Ministers

- The heart of decision-making
- Composed of the relevant ministers from each country
- Designed to represent member states, defend national interests
- Presidency rotates every six months

Functions and decision-making rules

- The council has both legislative and executive functions (Single Market, EMU)
- Unanimity: industry, taxes, culture, R&D, regional and social funds
- Qualified majority: agriculture, internal market, environment

The European Commission

Structure

- A cross between civil service and an executive body
- The College of Commissioners comprises 27 members
- Commissioners appointed by national governments
- Reappointed every five years

Tasks

- The Commission is involved in almost all aspects of the European policy-making process
- Policy initiation, implementation, management, international representation
- Supervision of EU law

The European Parliament

- Originated as an un-elected, part-time institutions, today elected (705 MEPs)
- Independent from the national governments
- The Parliament shares power in legislation with the European Council
- Shares budgetary authority with the European Council
- Democratic supervision of the Commission
  - Approves appointment of commissioners and supervises all European institutions

The European Court of Justice

- The Community Courts comprise the Court of Justice and the Court of First Instance of the European Communities
- 15 judges appointed by the member states

Tasks

- The Community Courts are responsible for enforcing the rules laid down in the treaties
  - Together with national courts
- Ensures that Community law is interpreted consistently across member states
- Case law of the Courts has a major impact

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4. European Monetary Integration

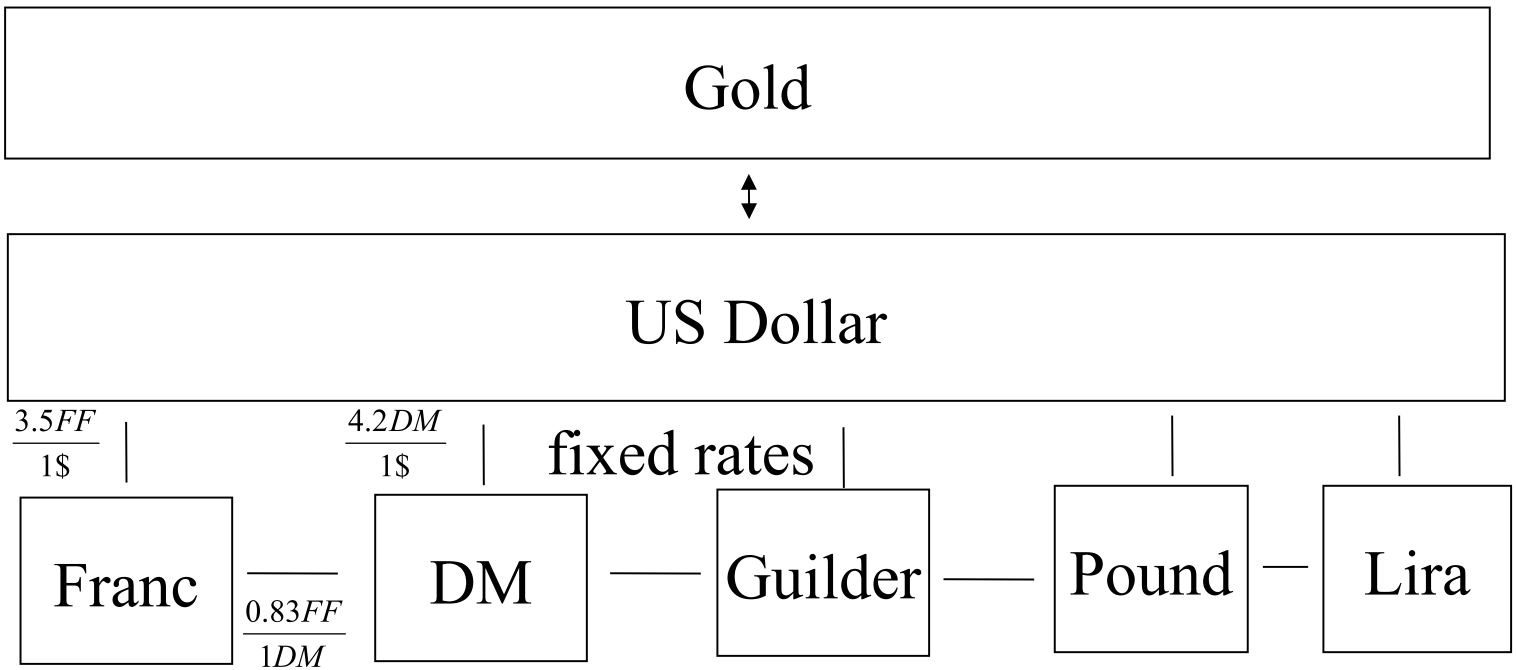
Early Plans

- Plans for a complete monetary union go back to the 1960s
- The Barre report (by Vice-President of the Commission Raymond Barre) of 1969 called for a move toward economic and monetary union

The Werner Plan 1970

- Aimed for full monetary union by 1980
- Free movement of capital and limits to fluctuation of exchange rates
- Monetary union achieved when exchange rates irrevocably frozen and a new single currency introduced
- The Werner Plan also called for the creation of a Community System for the Central Banks

The Bretton Woods System 1944-1973



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The Werner Plan

Aims

- Total convertibility of currencies
- Elimination of exchange rate fluctuations, permanently fixed parities
- Liberalisation of capital flows
- Community system of central banks (a la US Fed)

Monetarist vs. Economist view

- Monetarist: monetary integration will lead to macroeconomic convergence
- Economist: Fixing of exchange rates has to come at end of a long period of convergence
- Compromise: first stages relied on voluntary coordination of economic policies, had to take account of EC guidelines
  - Transfer of authority postponed until final stage and never achieved

The Snake in the Tunnel

End of Bretton Woods

- 15 August 1971 dollar convertibility suspended
- December 1971 the Smithsonian Agreement was concluded
  - Currencies pegged to the dollar within bands of +/- 2.25 percent
  - The dollar was devalued to 38 $/ounce of gold

The Snake in the Tunnel

- An attempt by European governments to prevent excessive fluctuations
- The bands between any two currencies were limited to +/- 2.25 percent
- Already in February 1973 the Americans devalued again
- The snake system ended soon thereafter
- Effectively, it became a Deutsche Mark zone, with currencies linked to or tracking the D-Mark

The European Monetary System (EMS)

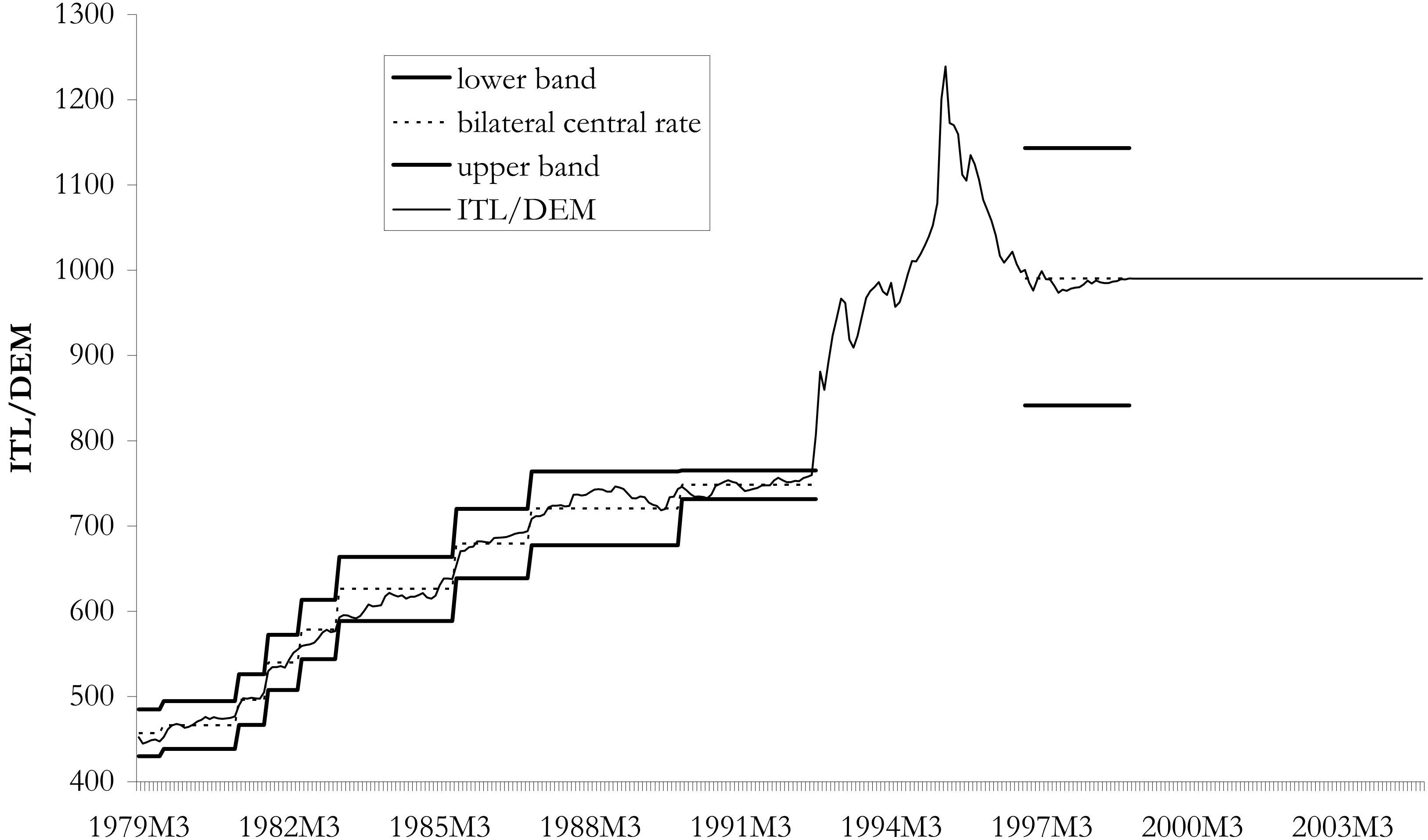
A New Attempt at Monetary Integration

- The EMS introduced 1979
- The Exchange Rate Mechanism (ERM) was set up to keep exchange rate fluctuations within narrow bounds

Crisis in 1990-1992

- Divergence in monetary policy led to breakdown of the system
- Speculative attacks against the French franc triggered the crisis
- Bands were broadened from +/- 2.25 percent to +/- 15 percent
- Both UK and Italy left the ERM after the crisis

Italy's Drop Out



European Units of Account

The European Unit of Account (EUA)

- The official unit of account in the EC 1975-1979
- However, no longer defined as a weight of gold
- Defined as a basket of European currencies, the weight of each currency determined by the economic importance of the country

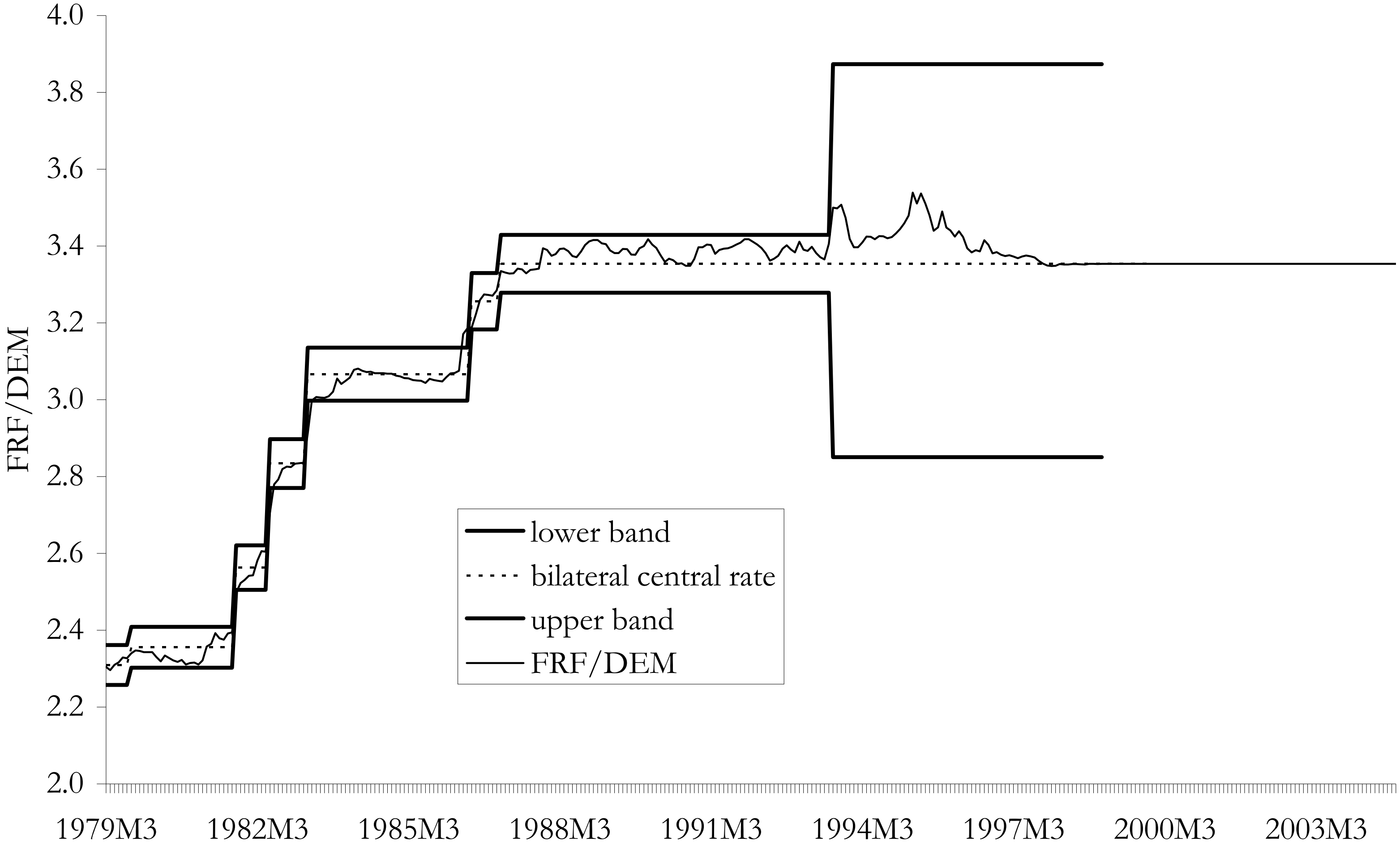
The ECU

- The EUA was replaced, at parity, by the European Currency Unit (ECU) in 1979
- The ECU was also only a unit of account

The Euro

- In 1999 the ECU was replaced by the euro, at the value 1 euro = 1 ECU
- The euro is both a unit of account and a real currency in its own right
- These artificial units of account was part of the management of exchange rates, an attempt to ape the gold standard without gold

Realignments in France



Economic and Monetary Union (EMU)

EMU was agreed as part of the Maastricht Treaty

- Monetary Union was to be achieved as exchange rates converged
- The euro, replacing the ECU, was to be introduced in 1999

Preconditions for Joining

- Low inflation: price inflation must not exceed by more than 1.5 percent that of the best performing countries during one year prior to joining
- Exchange rate fluctuations: A country has to be within the normal margins of the ERM for two years before joining
- Fiscal criteria: Government deficit no more than 3 percent of GDP and government debt no more than 60 percent of GDP

5. The European Central Bank (ECB)

The Central Bank for the Euro Area

- The main task: to maintain the euro's purchasing power and price stability in the euro area
- The euro area (or eurozone) is constituted by the 19 countries that have introduced the euro as their primary currency

The European System of Central Banks (ESCB)

- Comprises the ECB and all the national central banks of EU member states, whether they have adopted the euro or not
- The national central banks transmit payments between the countries

The Design of the ECB

The Anglo-French Model

- Several objectives: price stability, stabilization of the business cycle, high employment, financial stability
- No privileged role for price stability
- Central bank not independent, monetary policy subject to government approval

The German Model

- Price stability is the primary objective, other objectives may not endanger price stability
- Central bank is independent
- The government cannot influence monetary policy decisions

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ECB Monetary Policy

The German Model Prevailed

- ECB objective is price stability, target rate of inflation below 2 percent

First pillar of Strategy

- Inflation projections, range of indicators of future price developments
- Includes: wages, exchange rate, bond prices, yield curve, price indices, business and consumer surveys...

Second Pillar of Strategy

- Inflation is a monetary phenomenon, therefore growth of money stock central to ECB inflation targeting
- GDP expected to grow 2 percent and velocity to decline 0.5 percent
  - Therefore money stock (M3) can grow 4.5 percent per year

The ECB Two Pillar Strategy

Primary Objective of Price Stability

Governing Council takes monetary policy decisions based on a unified overall assessment of the risks to price stability

Economic Analysis

Analysis of economic dynamics and shocks

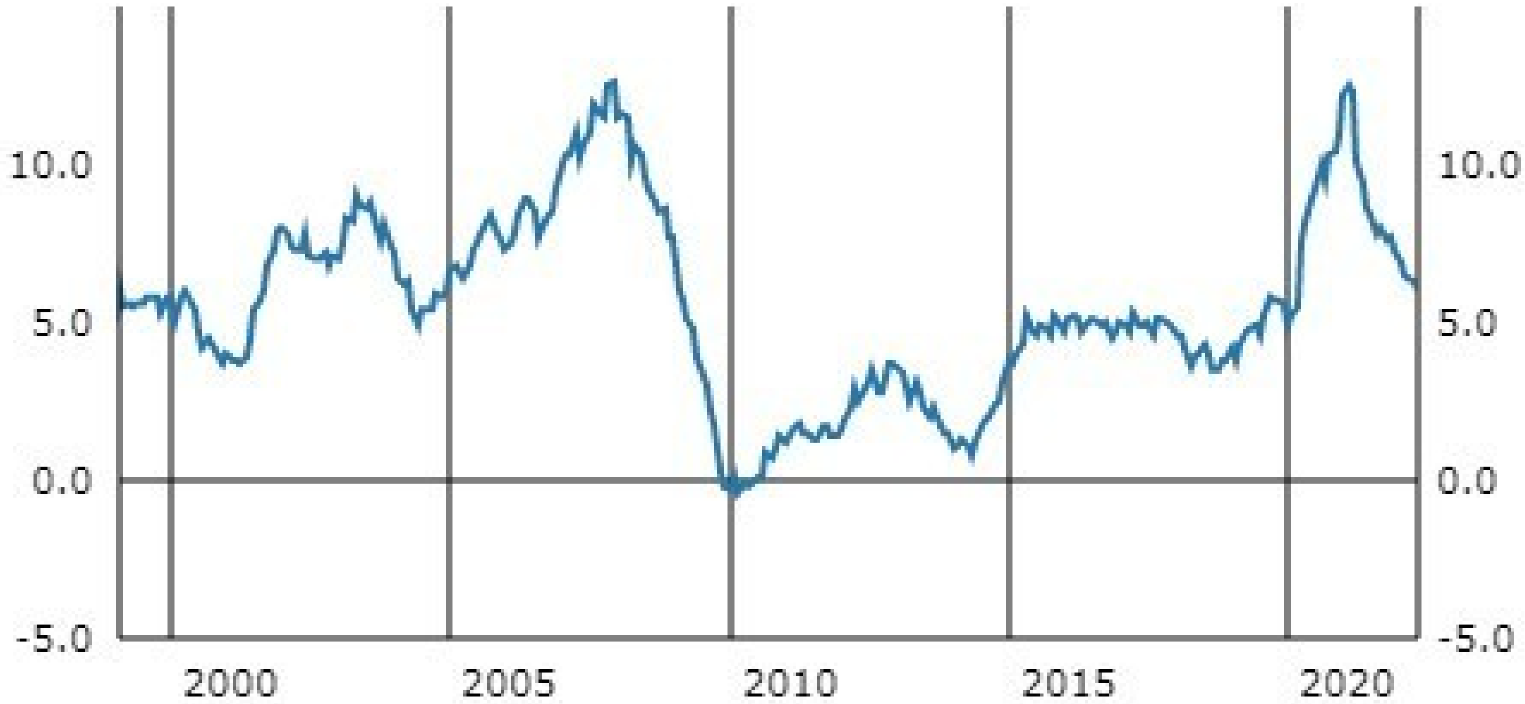
cross checking

Monetary Analysis

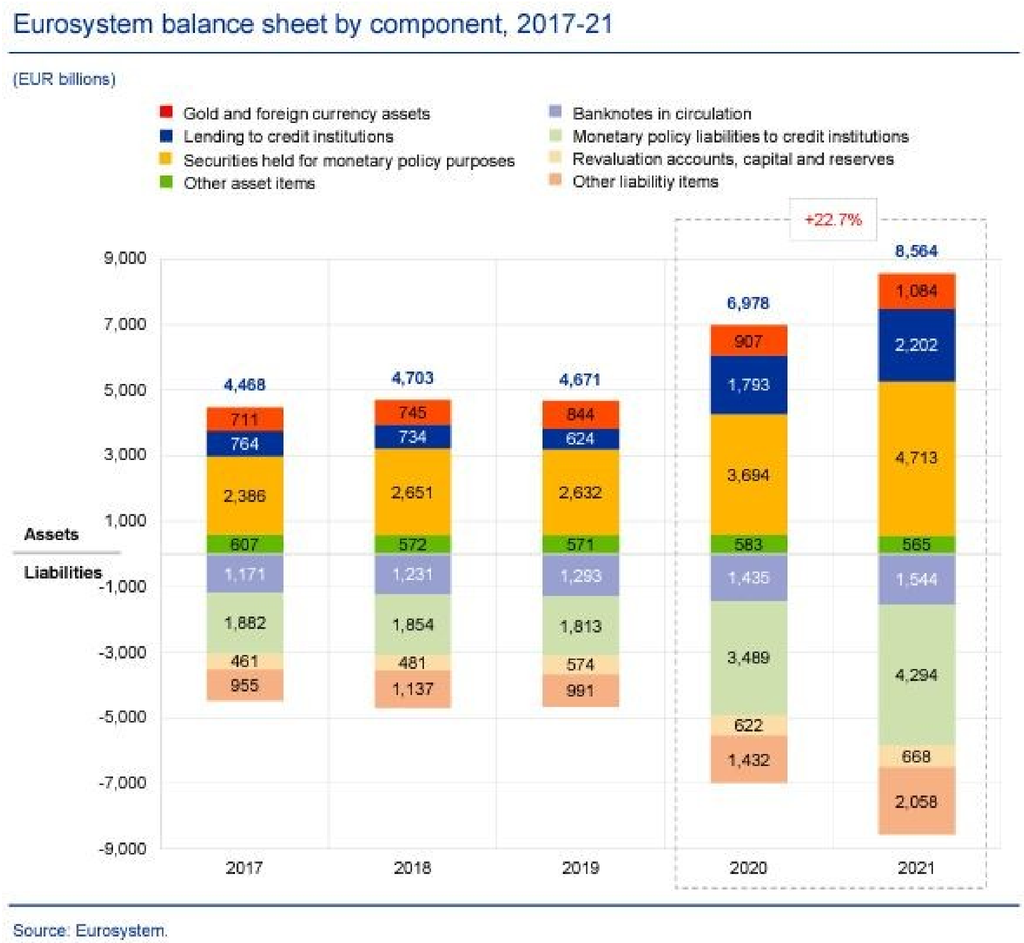
Analysis of monetary trends

Economic Information

Euro M3 growth rate 1999-2022



Eurosystem Balance Sheet 2017-2021



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6. TARGET2

- TARGET2 (Trans-European Automated Real-time Gross Settlement Express Transfer System 2) is the European real-time gross settlement system for the eurozone introduced in 2007

Purpose

- Transmitting payments across Europe
- National banks settle their claims through central banks
- Central banks settle their claims through TARGET2

Example

- A German car manufacturer sells cars to a Spanish customer
- The German company acquires a credit (asset) against its bank
- The Spanish customer acquires a debit (liability) against its bank
- This is completely analogous to current account surpluses and deficits
  - Germany here has a surplus, Spain a deficit
- The German bank gets a credit against the Bundesbank, and the Spanish bank a debit against the Bank of Spain
- On the individual level, this is business as usual – the Spanish company pays its debts etc.
- On the European level, the system works differently

Example

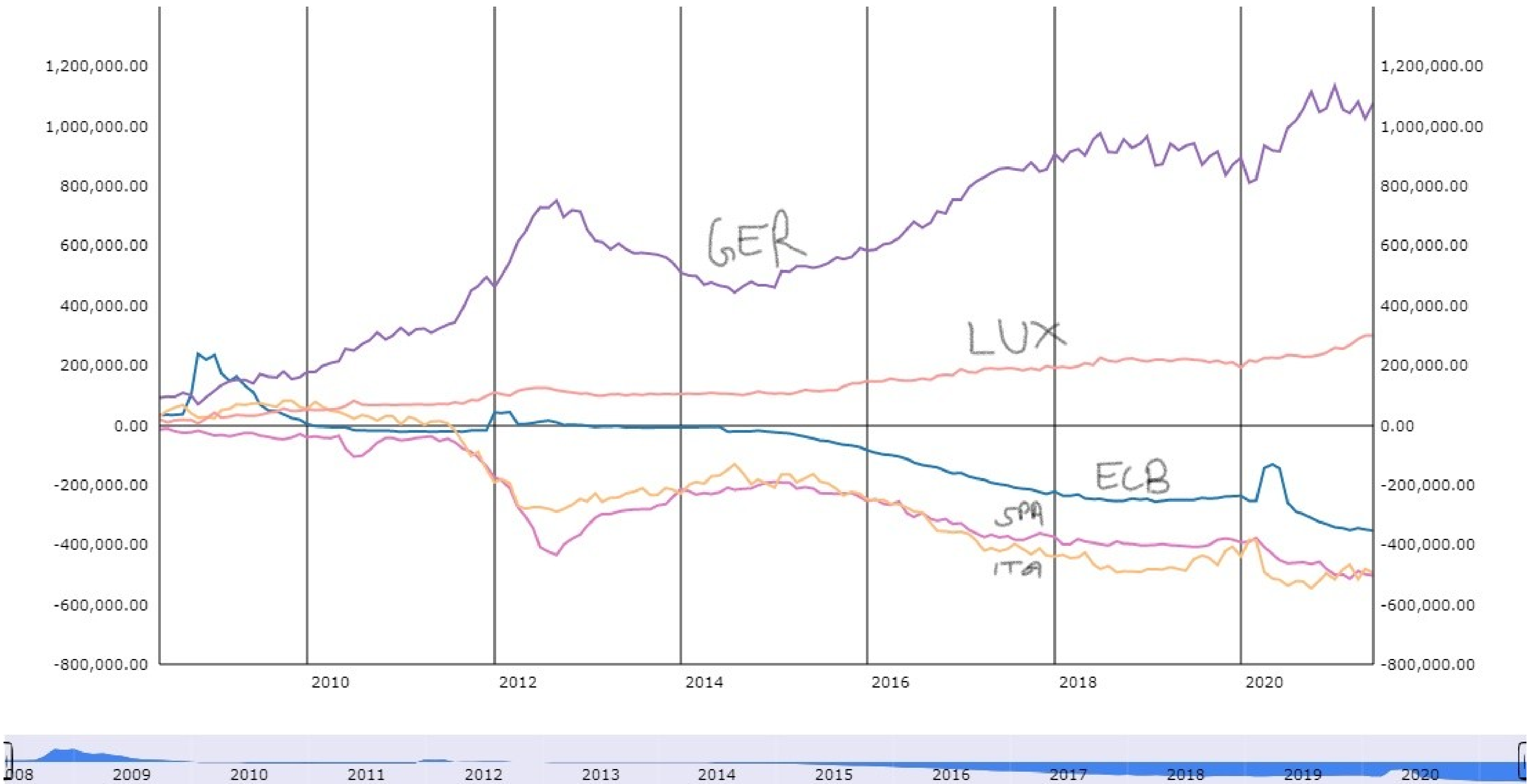
On the European Level

- The Bundesbank acquires a credit against the ECB
- The Bank of Spain accumulates a debit against the ECB
- A transaction in reverse would then settle the account
  - If a Spanish exporter earns a claim against a French importer
  - and a German importer accumulates a debit against an Italian exporter

Permanent Imbalances Possible

- It is possible for a country to accumulate debits (or credits)
- If Spanish imports are financed through bank credit expansion, for instance
  - The Spanish money supply expands, leading to a CA deficit
  - The CA deficit is reflected in accumulating TARGET2 debits
  - This is mirrored by accumulating credits by exporters to Spain

TARGET2 Imbalances



TARGET2 Imbalances

- Credits in the system ultimately represent the claims of savers, while debits represents the debts of companies, governments, and individuals

The first period of imbalance (2008-2013)

- Represented a hidden bailout of uncompetitive economies
- Spanish banks could create money and buy Spanish government debt
- The resulting trade deficit was financed by accumulation of balances by Germany and other countries (Netherlands, Luxembourg…)
- The second period since 2015
- The ECB launched its own direct interventions in the market, buying up assets etc
- A lot of these assets were bought from investors in Germany and Luxembourg, whose central banks accumulated credits from the ECB

Can the Balances Be Paid?

Unlikely

- The ECB would have to accumulate hard assets to pay
  - These can only be transferred from member states
- For Italy and Spain to pay off their debits would constitute a massive wealth transfer to their creditors
  - (Just like the accumulation of debits constituted a massive wealth transfer from their creditors)

Realistically, some kind of default or haircut will be necessary

- Inflation, simply creating the necessary money is also a possibility
  - Ruled out by rules governing the ECB
- Alternatively, massive centralization of the system in the ECB will eliminate the imbalances and prevent the accumulation of new ones
  - Such a scenario will probably also constitute a partly repudiation of the debts

7. Conclusion

1. Economic and monetary integration has continued apace in Europe after WW2
2. After the end of Bretton Woods, European monetary cooperation aimed at fixed exchange rates and eventually a common currency
3. The EMS gave way to the EMU and the introduction of the euro in 1999
4. While the ECB is tasked with monetary policy, national central banks have been able to expand domestic money supplies, leading to imbalances