



TOPIC 6

THE PROCESS OF MONETARY UNION

Economics and politics of monetary integration; Delors Report and Maastricht; SG Pact

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1. ECONOMICS AND POLITICS OF MONETARY INTEGRATION



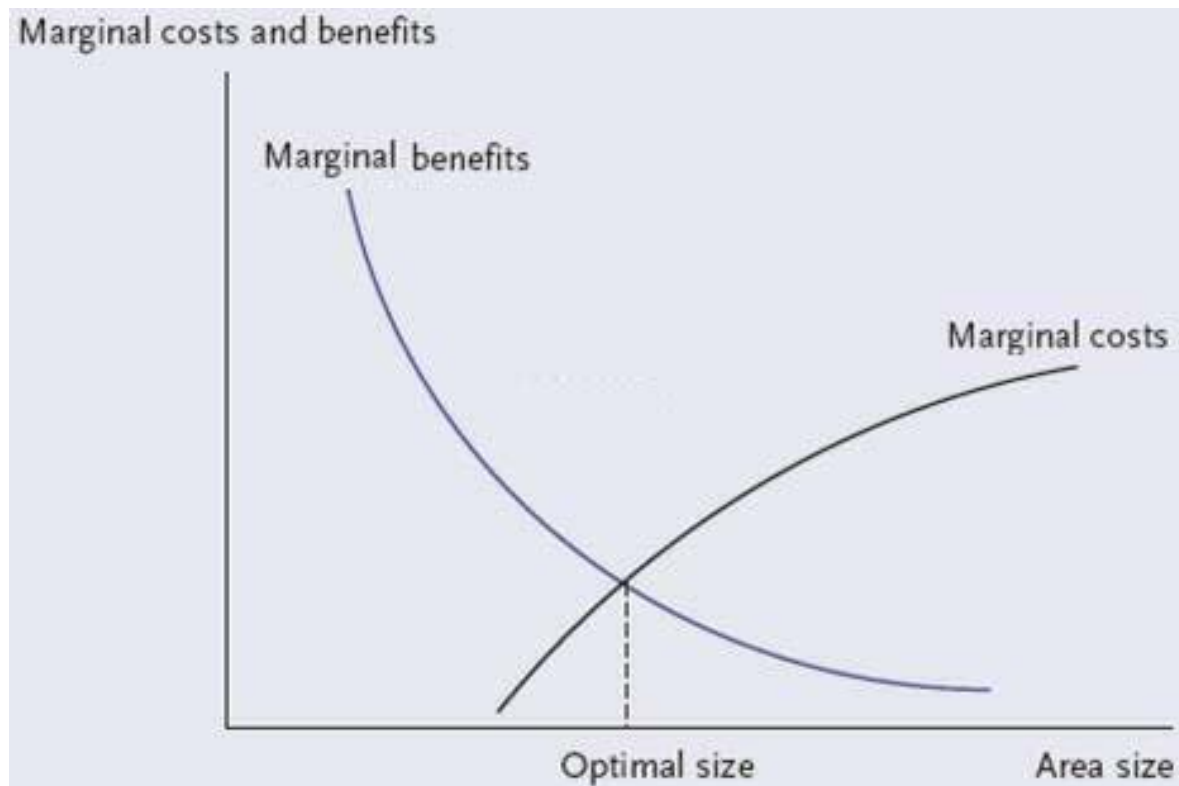
A Good Question, No Simple Answer

- Should currency area borders coincide with national borders?
- If not, how best to delineate currency areas?
- What economic criteria should be used?



The Economic Toolkit

- There must be benefits and costs involved in adopting a common currency.
- The solution has to involve trading off these benefits.



In a Nutshell



- The benefits:
 - money exhibits increasing returns to scale (network externalities)
 - the world is the way to maximize these benefits.
- The costs:
 - loss of monetary and exchange rate instruments
 - matters in presence of:
 - price and wage stickiness
 - asymmetric shocks.



Six OCA criteria

- Three classic (economic) criteria
 - Mundell
 - Kenen
 - McKinnon
- Three political criteria



The three economic criteria



Criterion 1 (Mundell): Labour Mobility

- In an OCA labour moves easily across national borders.
- Caveats:
 - labour mobility is easy within national borders (culture, language, legislation, welfare, etc.)
 - capital mobility: difference between financial and physical capital
 - in presence of country specialization, skills also matter.



Criterion 2 (Kenen): Production Diversification

- Countries whose production and exports are widely diversified and of similar structure form an OCA.
- Indeed, in that case, there are few asymmetric shocks and each of them is likely to be of small concern.

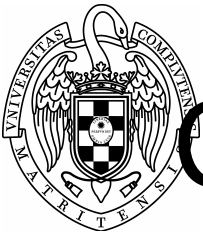


Criterion 3 (McKinnon): Openness

- Countries which are very open to trade and trade heavily with each other form an OCA.
- Distinguish between traded and nontraded goods:
 - traded good prices are set worldwide
 - a small economy is price-taker, so the exchange rate does not affect competitiveness.
- In the limit, if all goods are traded, domestic good prices must be flexible and the exchange rate does not matter for competitiveness.



The three political criteria



Criterion 4: Fiscal Transfers

- Countries that agree to compensate each other for adverse shock form an OCA.
- Transfers can act as an insurance that mitigates the costs of an asymmetric shock.
- Transfers exist within national borders:
 - implicitly through the welfare system
 - explicitly in federal states.



Criterion 5: Homogeneous Preferences

- Countries that share a wide consensus on the way to deal with shocks form an OCA.
- Matters primarily for symmetric shocks:
 - prevalent when the Kenen criterion is satisfied.
- May also help for asymmetric shocks:
 - better understanding of partners' actions
 - encourages transfers.



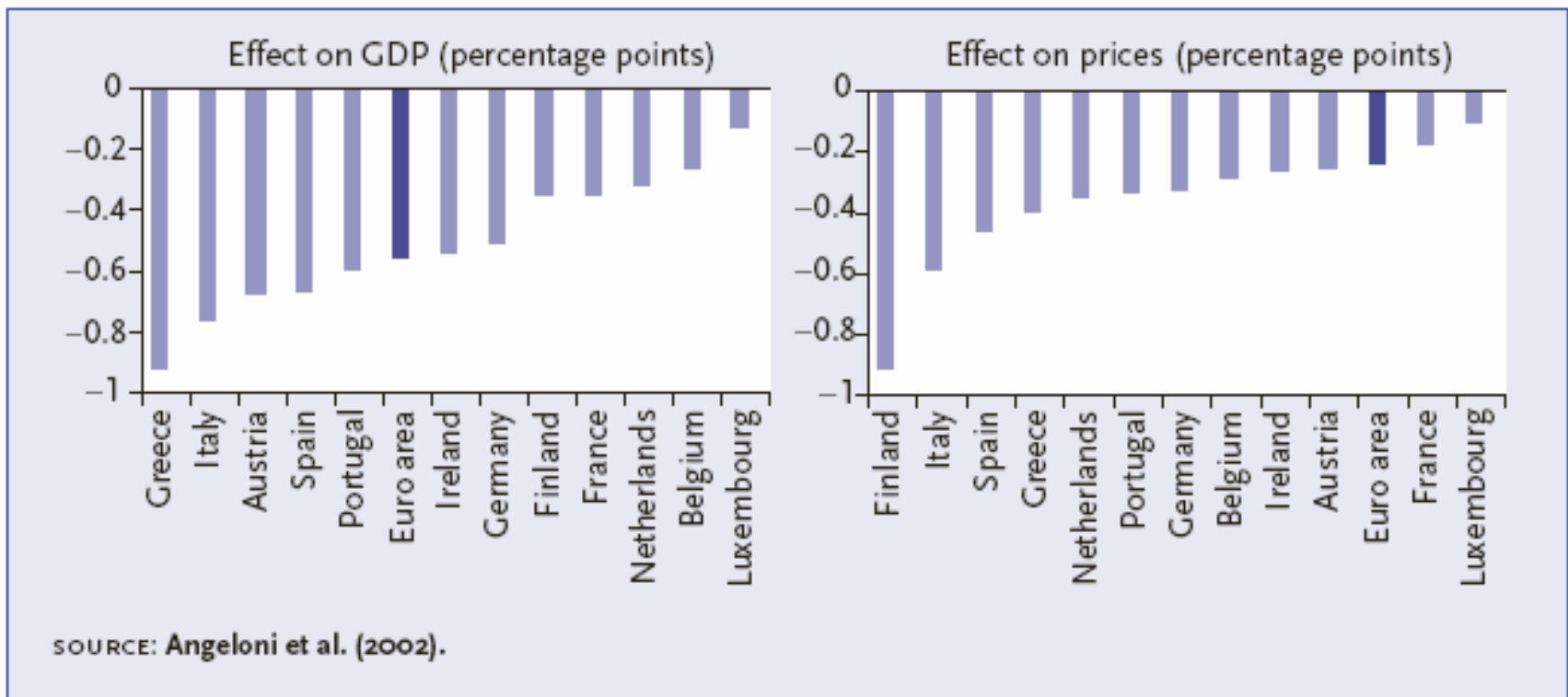
Criterion 6: Commonality of Destiny

- Countries that view themselves as sharing a common destiny better accept the costs of operating an OCA.
- A common currency will always face occasional asymmetric shocks that result in temporary conflicts of interests:
 - this calls for accepting such economic costs in the name of a higher purpose.



Is Europe An OCA?

- Asymmetric effects of symmetric shocks: effects on GDP and prices of a change of the common interest rate.





Inside the OCA Index: Openness

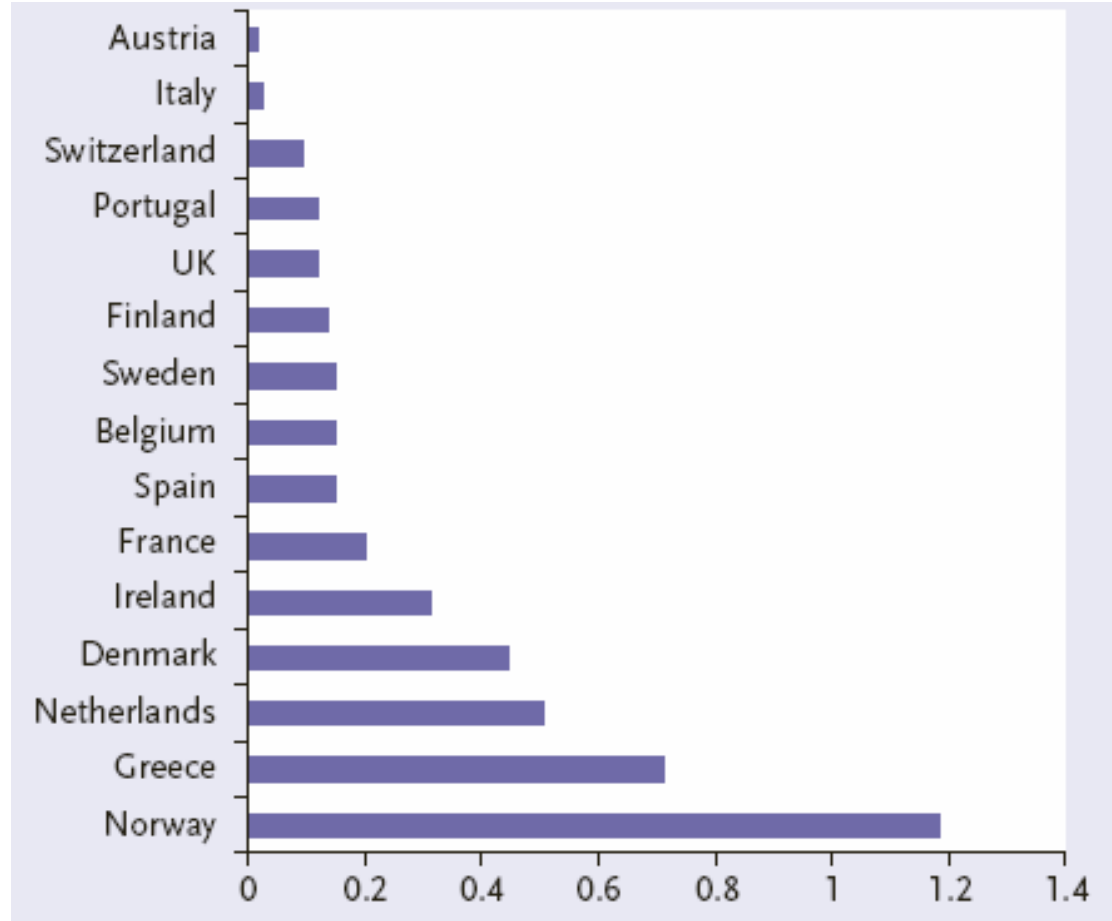
- Most EU countries are very open.
- The McKinnon criterion is broadly satisfied.

Austria	52.3	Cyprus	48.3	Denmark	42.8
Belgium	87.2	Czech Republic	76.0	Sweden	43.9
Finland	35.4	Estonia	92.0	UK	27.9
France	27.2	Hungary	70.1		
Germany	39.9	Latvia	55.0	Bulgaria	65.9
Greece	25.5	Lithuania	56.9	Croatia	54.4
Ireland	72.6	Malta	81.8	Romania	39.3
Italy	27.9	Poland	40.9	Turkey	36.5
Luxembourg	133.3	Slovak Republic	83.6		
Netherlands	66.4	Slovenia	63.1		
Portugal	36.2			US	13.8
Spain	29.5	EU-25	10.7	Japan	13.5



Inside the OCA Index: Diversification

- Most EU countries have a diversified production structure (intra-industry trade dominates).
- The Kenen criterion is broadly satisfied and well explains which countries joined the euro area.





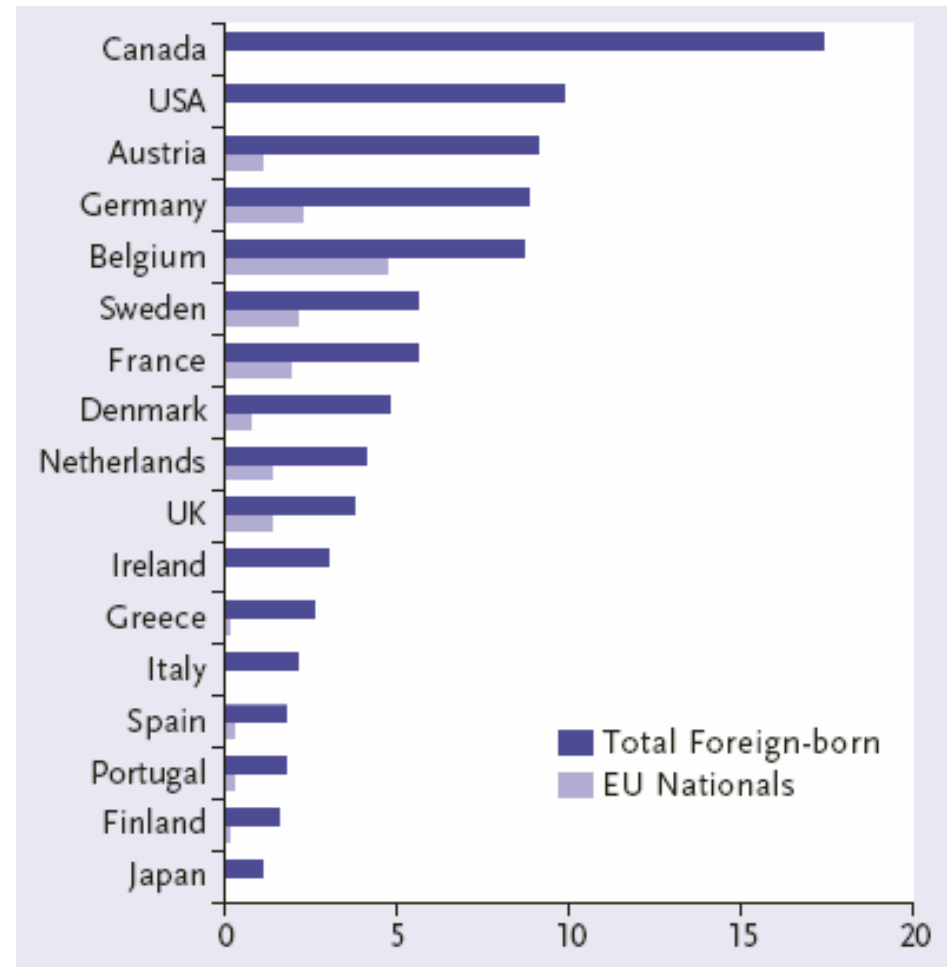
Inside the OCA Index: Labour Mobility (1)

- The labour mobility criterion cannot be black-and-white.
- The migration response to economic incentives must factor in many costs:
 - moving costs
 - risk of becoming unemployed
 - longer run career opportunities
 - family prospects
 - eligibility to welfare
 - taxation
 - cultural/linguistic differences
 - national attachment.



Inside the OCA Index: Labour Mobility (2)

- An international comparison suggests that labour mobility is low in Europe:
 - across countries.





Inside the OCA Index: Labour Mobility (2)

- An international comparison suggests that labour mobility is low in Europe:
 - across countries
 - even within countries.



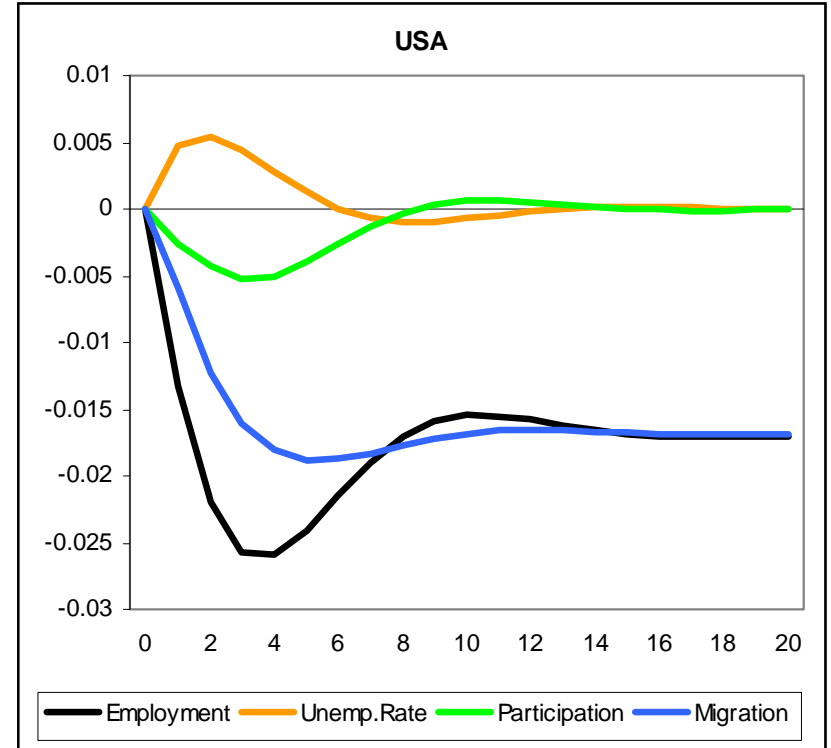
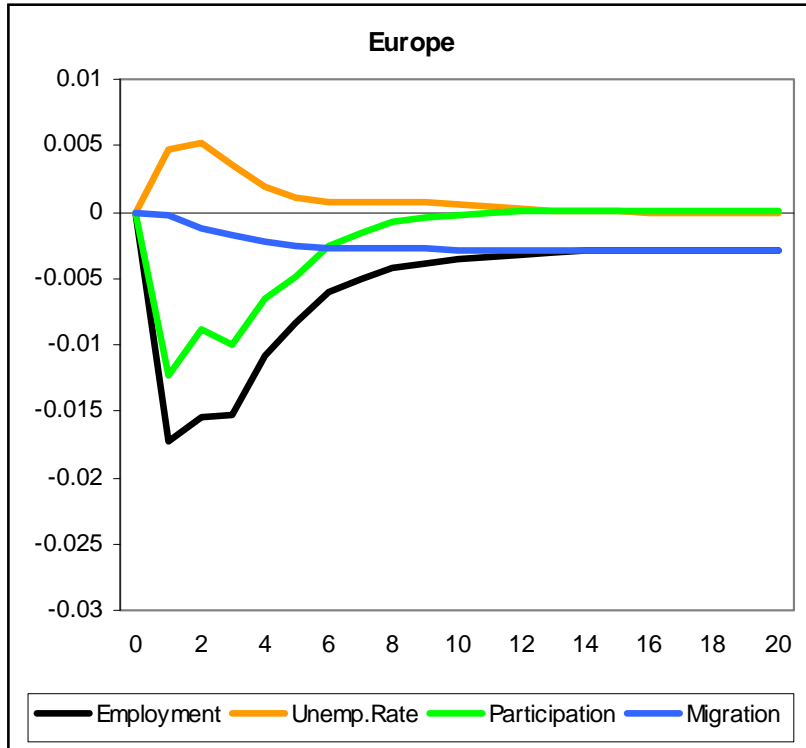


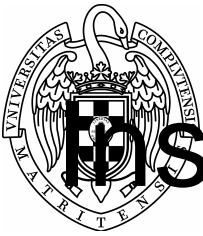
Inside the OCA Index: Labour Mobility (3)

- Low labour mobility implies that unemployment bears much of the burden of adjustment to shocks.
- A US-EU comparison.



Inside the OCA Index: Labour Mobility (3)





Inside the OCA Index: Transfers

- The EU does not satisfy the transfer criterion.
- The overall EU budget:
 - is low, capped at 1.27% of EU GDP
 - entirely used for administration, CAP, regional and structural funds.



Inside the OCA Index: Homogeneity of Preferences

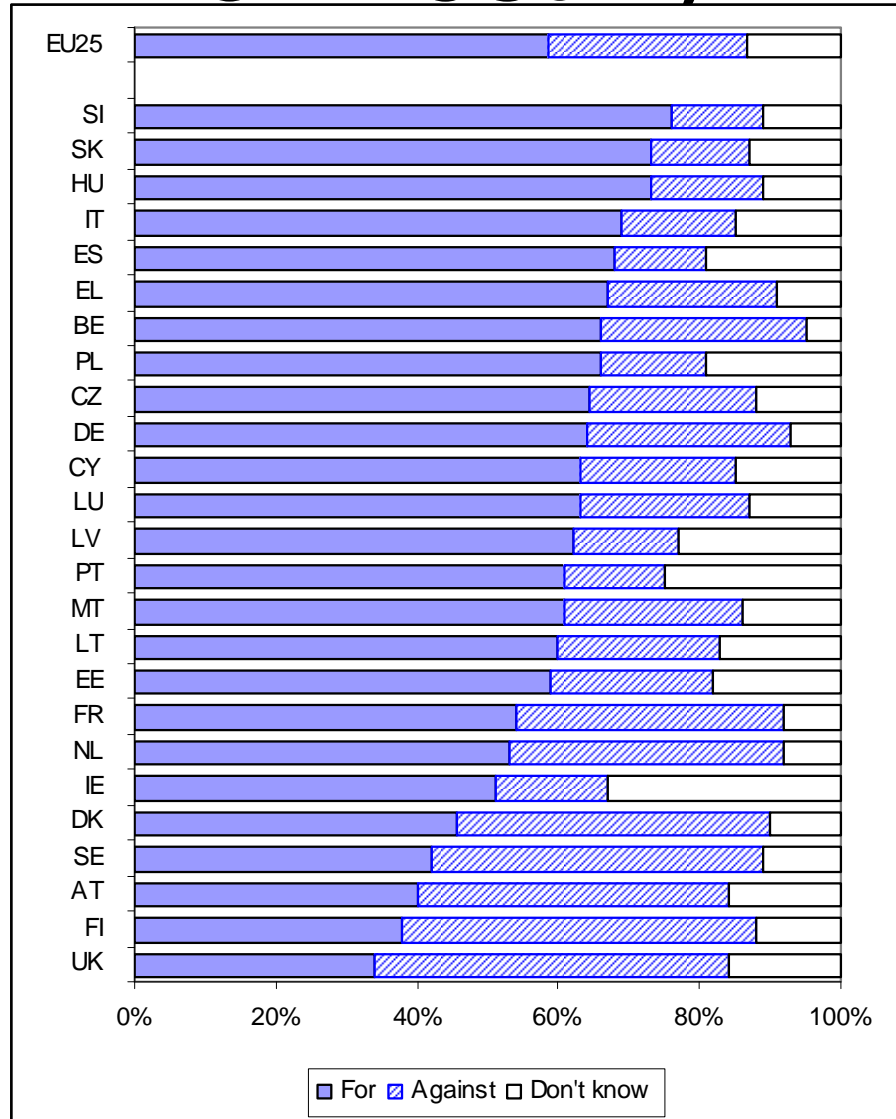
- Little is known about this criterion.



Inside the OCA Index: Commonality of Destiny

- Little is known about this criterion.
- Public opinion polls do not detect deep opposition to EU institutions.

Inside the OCA Index: Commonality of Destiny





Overall

- The OCA glass is half full, or half empty.

Criterion	Satisfied?
Labour mobility	No
Trade openness	Yes
Production diversification	Yes
Fiscal transfers	No
Homogeneity of preferences	Probably
Commonality of destiny	?



History Never Ends: The Endogeneity of OCA Criteria

- Living in a monetary union may help fulfill the OCA criteria over time.
- Would the US be an OCA without a single common currency?
- Will the existence of the euro area change matters too?



Will Trade Deepen?

- Little evidence that reducing exchange rate volatility increases trade.
- Mounting evidence that eliminating exchange rate volatility by adopting a common currency raises trade a lot:
 - estimates range from 50 per cent to 100 per cent
 - the ‘border effect’ provides similar estimates.



Will Diversification Grow or Decline?

- Argument 1: intra-industry trade will grow.
- Argument 2: specialisation will increase.
- No firm conclusion so far.



EMU and Labour Markets

- Mobility may not change much, but wages could become less sticky.
- Two views:
 - the virtuous circle: labour markets respond to enhanced competition by becoming more flexible
 - the hardening view: labour markets respond to enhanced competition by increasing protective measures that raise stickiness.
- The jury is still out.



Are the Other Criteria Endogenous?

- Transfers:
 - currently no support for more taxes of finance transfers.
- Homogeneity of preferences:
 - no presumption that it will change soon.
- Commonality of destiny:
 - no presumption that it will change soon.



In the End

- Monetary union is not only about economics.
- The OCA criteria do not send a clear signal:
 - the EU is not a perfect OCA
 - a monetary union may function, at cost.
- The OCA criteria tell us where the costs will arise:
 - labour markets and unemployment
 - political tensions in presence of deep asymmetric shocks.



2. THE DELORS REPORT AND THE MAASTRICHT TREATY



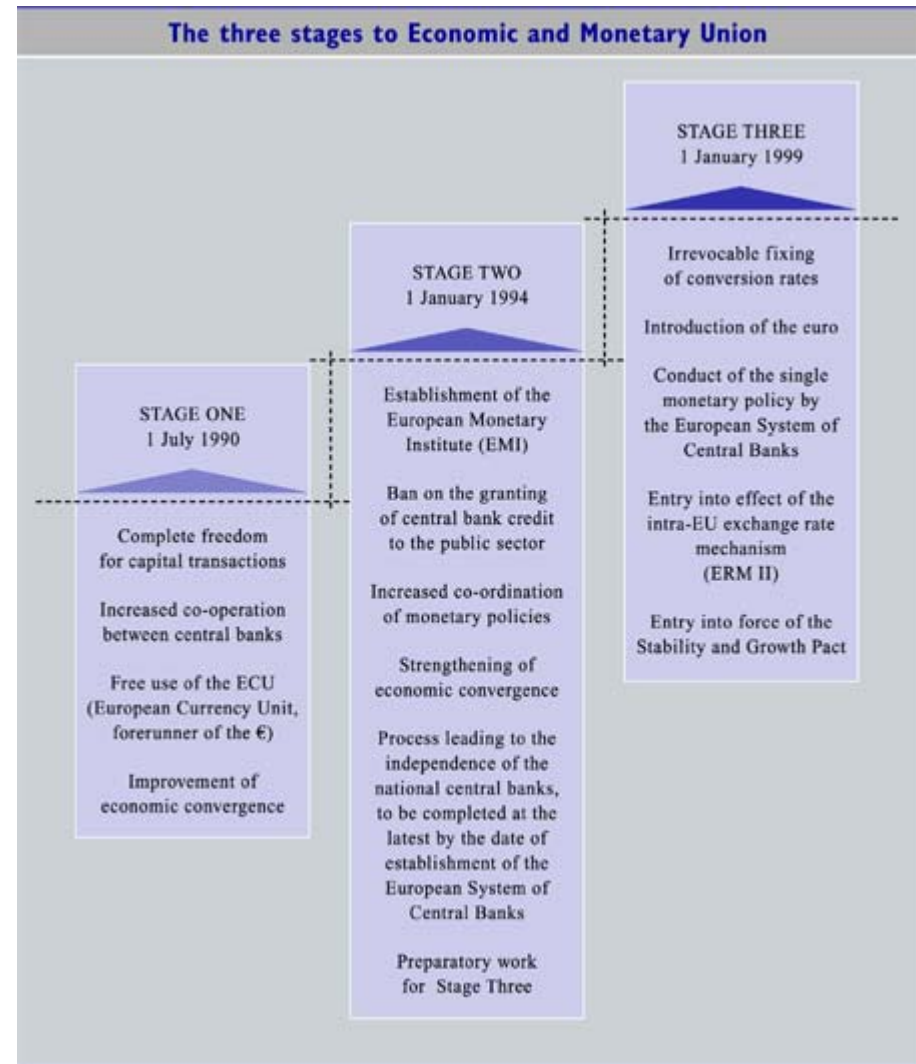
The Long Road to Maastricht and to the Euro

Towards Maastricht		Between Maastricht and the single currency		The single currency	
1970	Werner Plan	1994	European Monetary Institute (precursor of ECB)	1999	Monetary union starts
1979	EMS starts	1997	Stability and Growth Pact	2001	Greece joins
1989	Delors Committee	1998	Decision on membership	2002	Euro coins and notes introduced
1991	Maastricht Treaty signed	1998	Conversion rates set		
1993	Maastricht Treaty ratified	1998	Creation of ECB		



The Maastricht Treaty

- A firm commitment to launch the single currency by January 1999 at the latest.





The Maastricht Treaty

- A firm commitment to launch the single currency by January 1999 at the latest.
- A list of five criteria for admission to the monetary union.
- A precise specification of central banking institutions.
- Additional conditions mentioned (e.g. the excessive deficit procedure).



The Maastricht Convergence Criteria

- Inflation:
 - not to exceed by more than 1.5 per cent the average of the three lowest rates among EU countries.
- Long-term interest rate:
 - not to exceed by more than 2 per cent the average interest rate in the three lowest inflation countries.
- ERM membership:
 - at least two years in ERM without being forced to devalue.

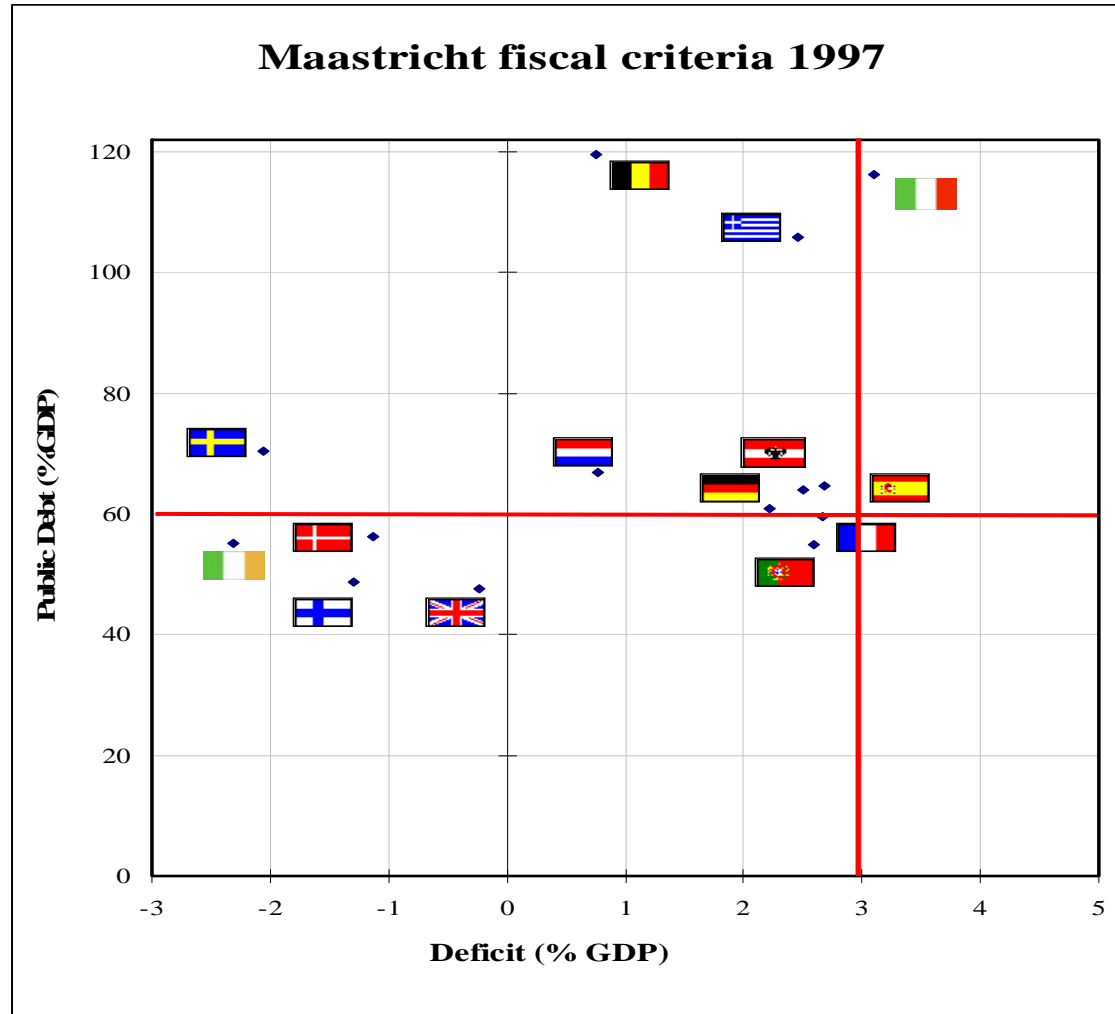


The Maastricht Convergence Criteria

- Budget deficit:
 - deficit less than 3 per cent of GDP.
- Public debt:
 - debt less than 60 per cent of GDP:
 - *Note:* Observed on 1997 performance for decision in 1998.



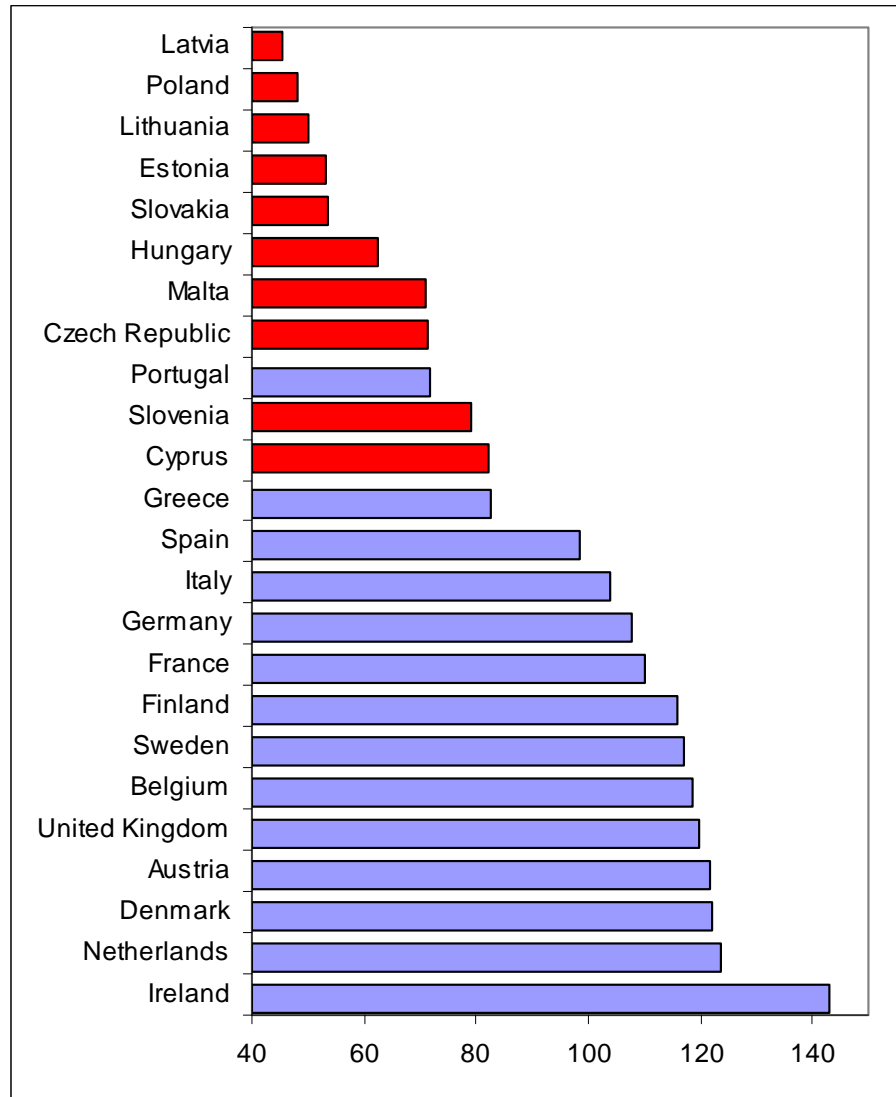
The Debt and Deficit Criteria in 1997





The next wave of candidates

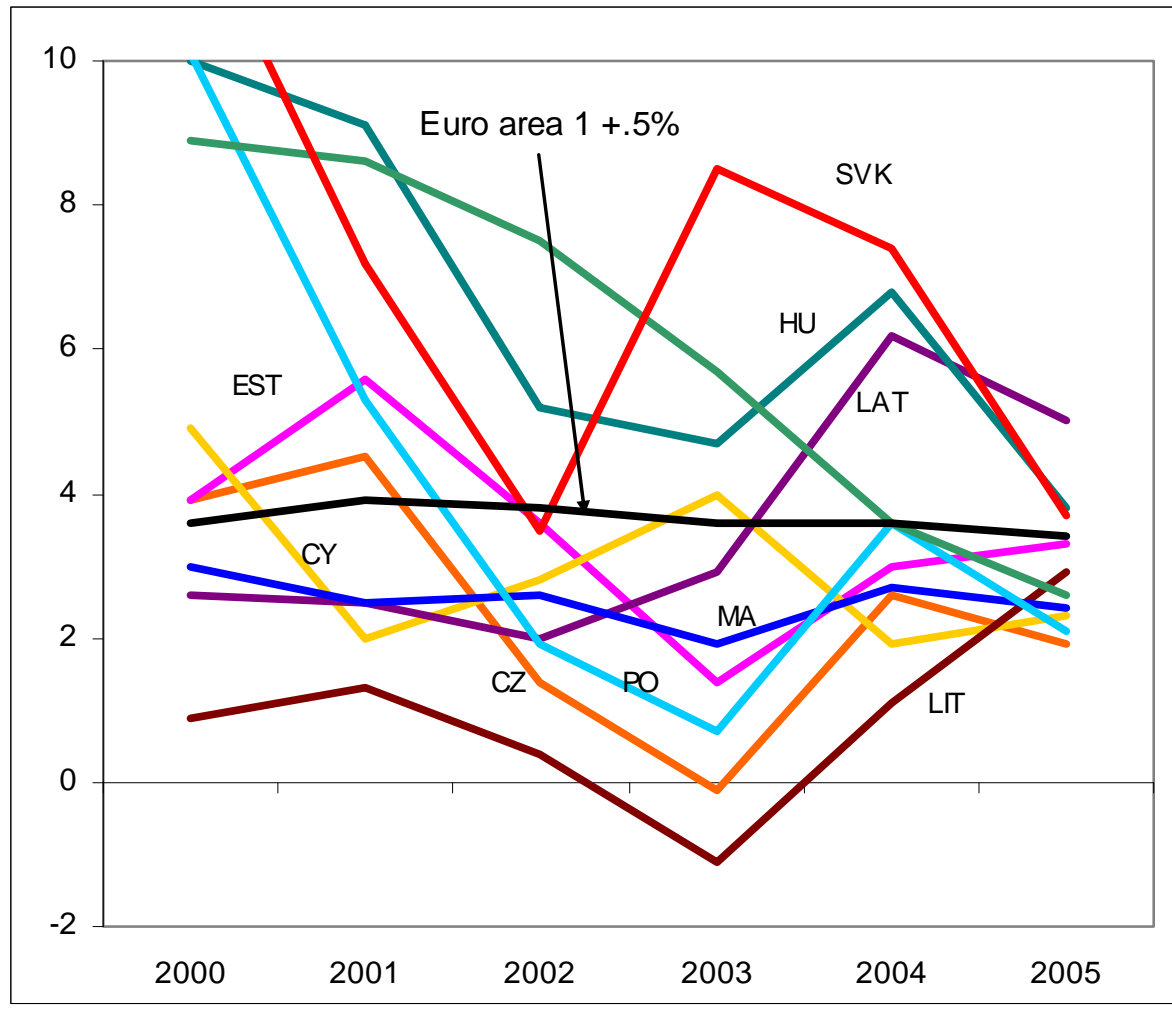
Quite different development levels (GDP per capita as % of EU)





The next wave of candidates

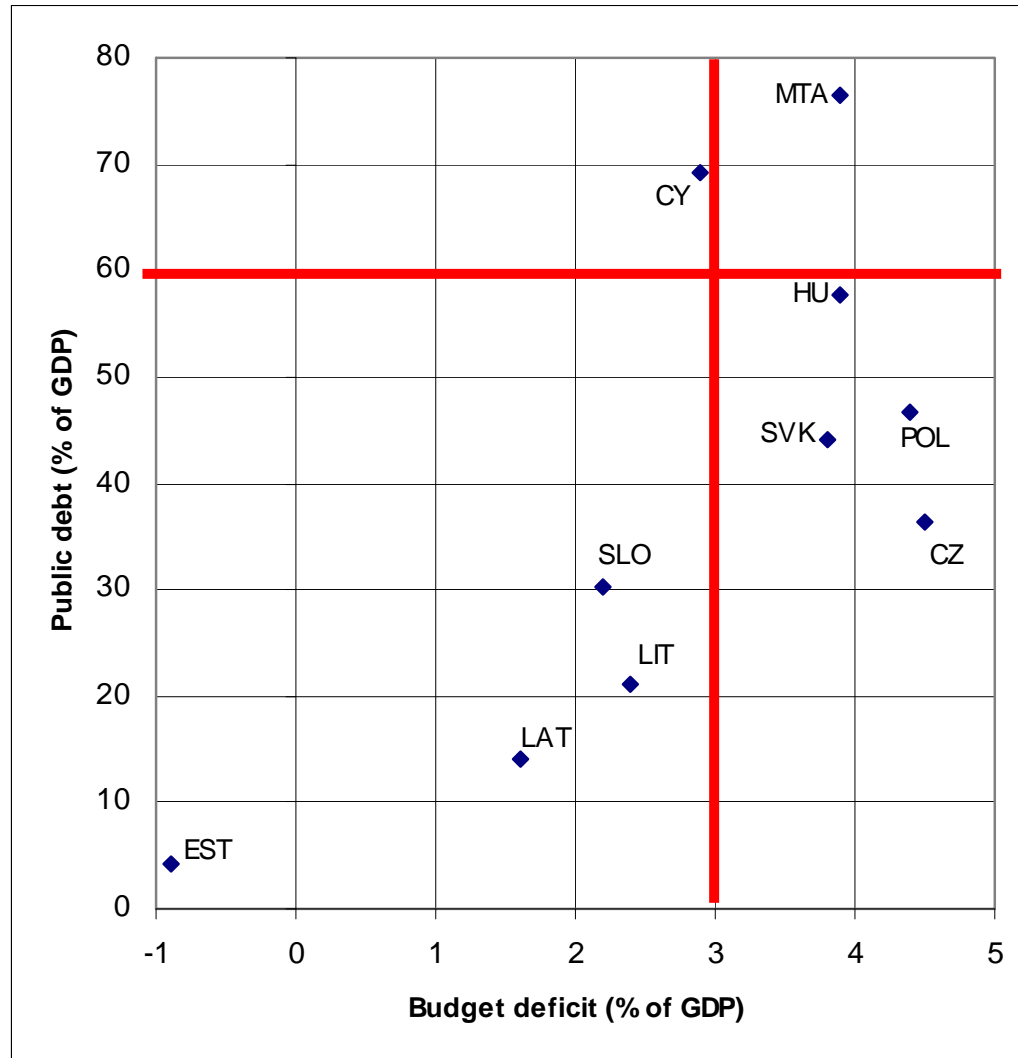
The inflation criterion





The next wave of candidates

The budget and debt criteria





Architecture of EMU: monetary rules and institutions



A Tour of the Acronyms

- N countries with N National Central Banks (NCBs) that continue operating but with no monetary policy function.
- A new central bank at the centre: the European Central Bank (ECB).
- The European System of Central Banks (ESCB): the ECB and all EU NCBs (N=15).
- The Eurosystem: the ECB and the NCBs of euro area member countries (N=12).



The System





How Does the Eurosystem Operate?

- Objectives:
 - what is it trying to achieve?
- Instruments:
 - what are the means available?
- Strategy:
 - how is the system formulating its actions?



Objectives (1)

- The Maastricht Treaty's Art. 105.1:
'The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2.'
- Article 2. The objectives of European Union are a high level of employment and sustainable and non-inflationary growth.
- In clear:
 - fighting inflation is the absolute priority
 - supporting growth and employment comes next.



Objectives (2)

- Making the inflation objective operational: does the Eurosystem have a target?
- It has a definition of price stability:
“The ECB has defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%.”
- And it has an aim:
“In the pursuit of price stability, the ECB aims at maintaining inflation rates below, but close to, 2% over the medium term.”



Objectives (2)

- Leaves room for interpretation:
 - where below 2 per cent?
 - what is the medium term?

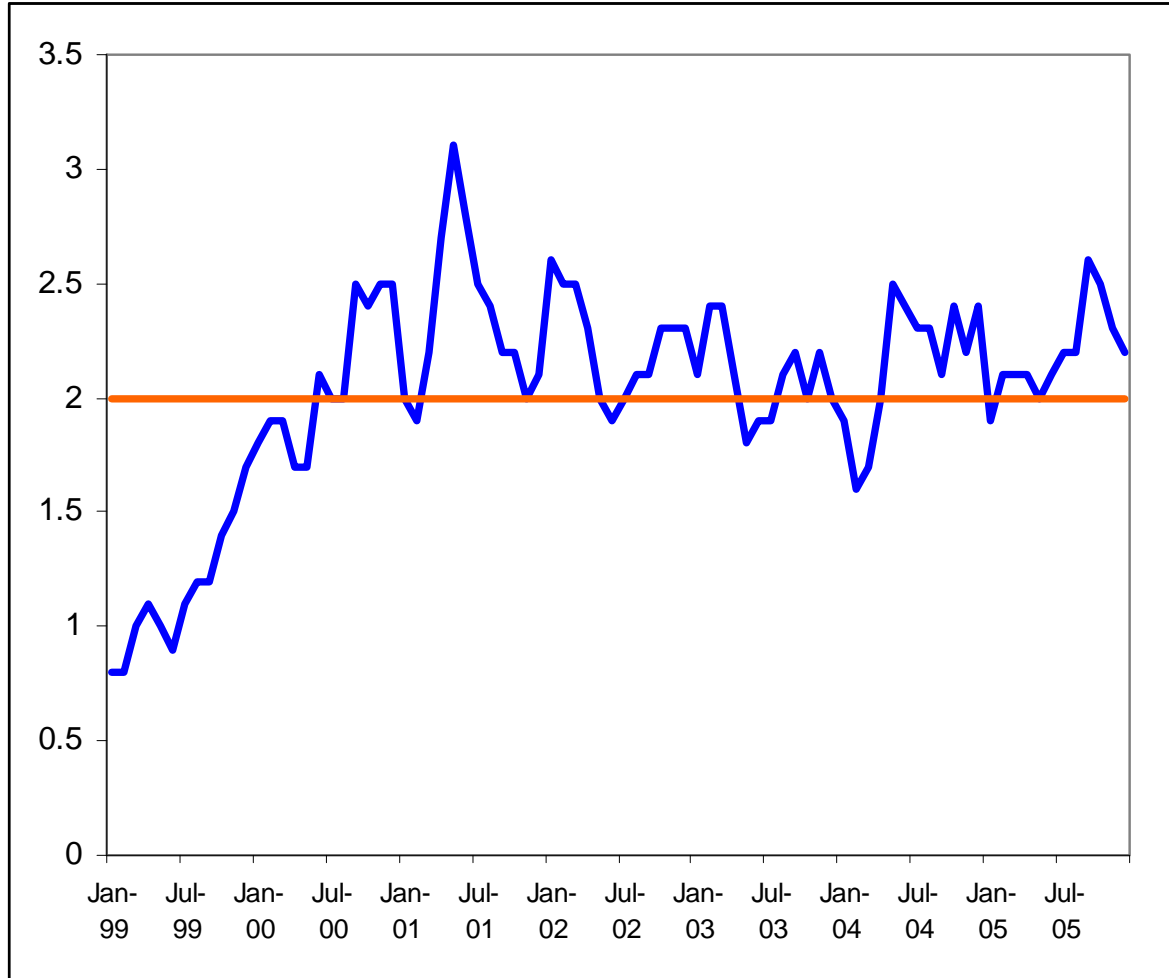


The Record So Far

- A difficult period:
 - an oil shock in 2000
 - a worldwide slowdown
 - September 11
 - the stock market crash in 2002
 - Afghanistan, Iraq
 - The weak dollar

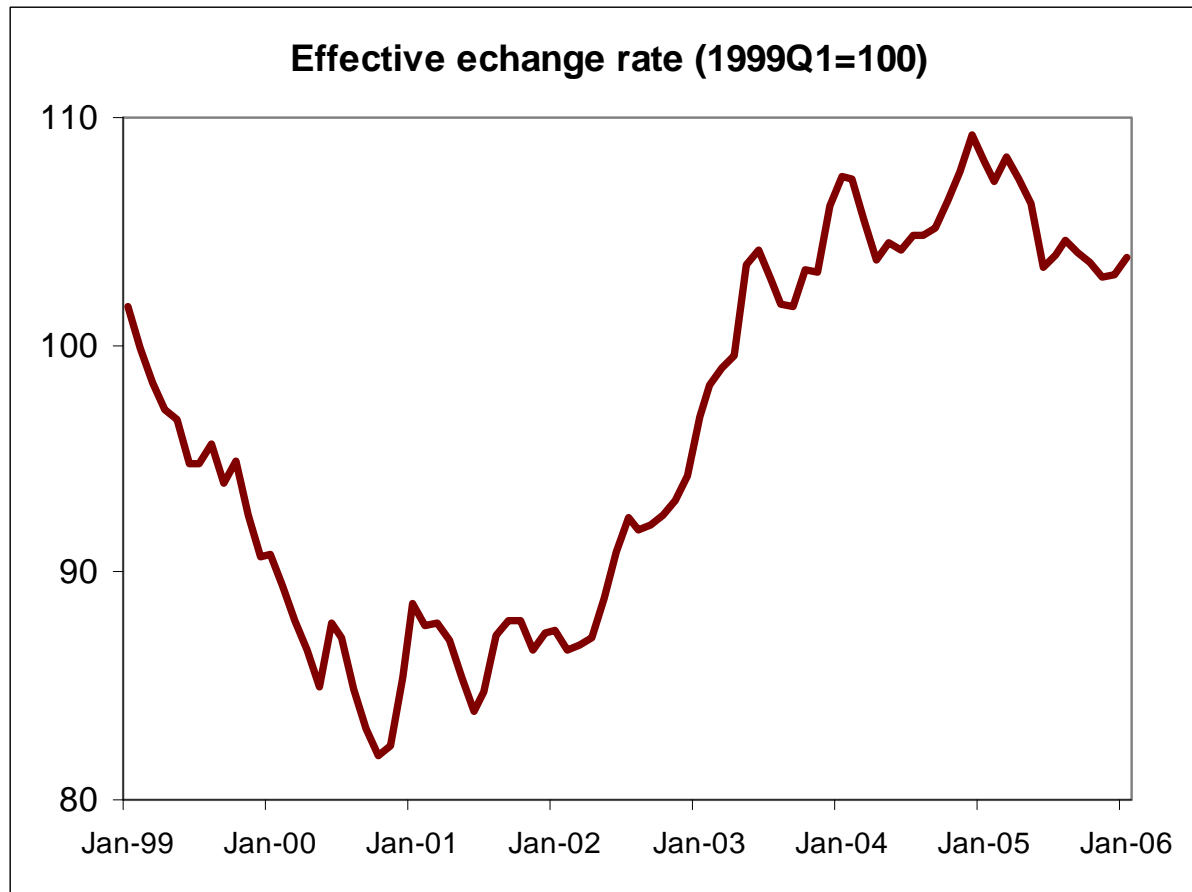


Inflation: Missing the Objective, a Little



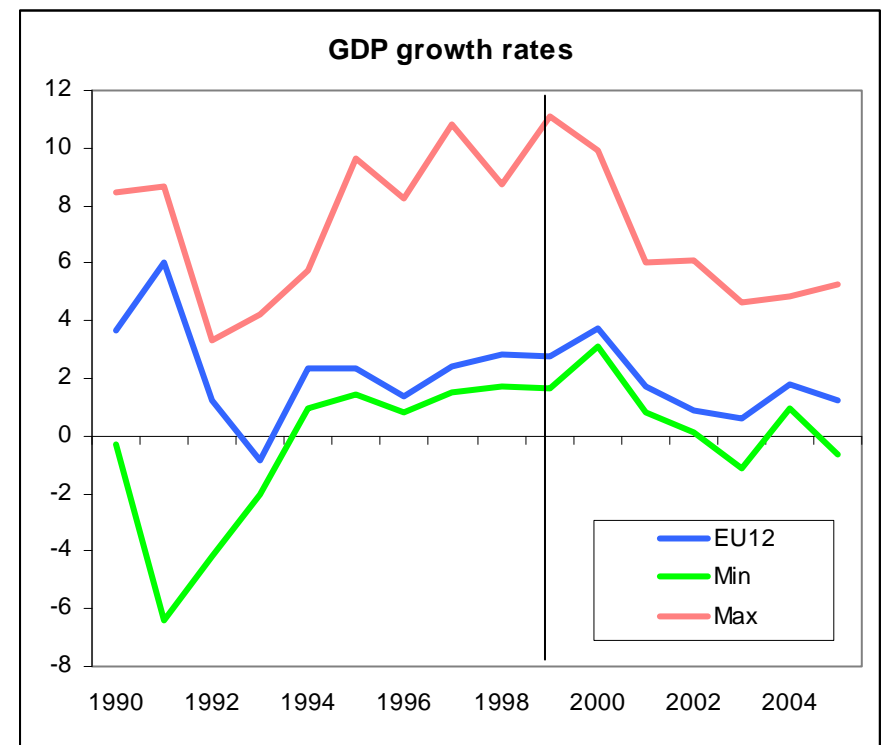
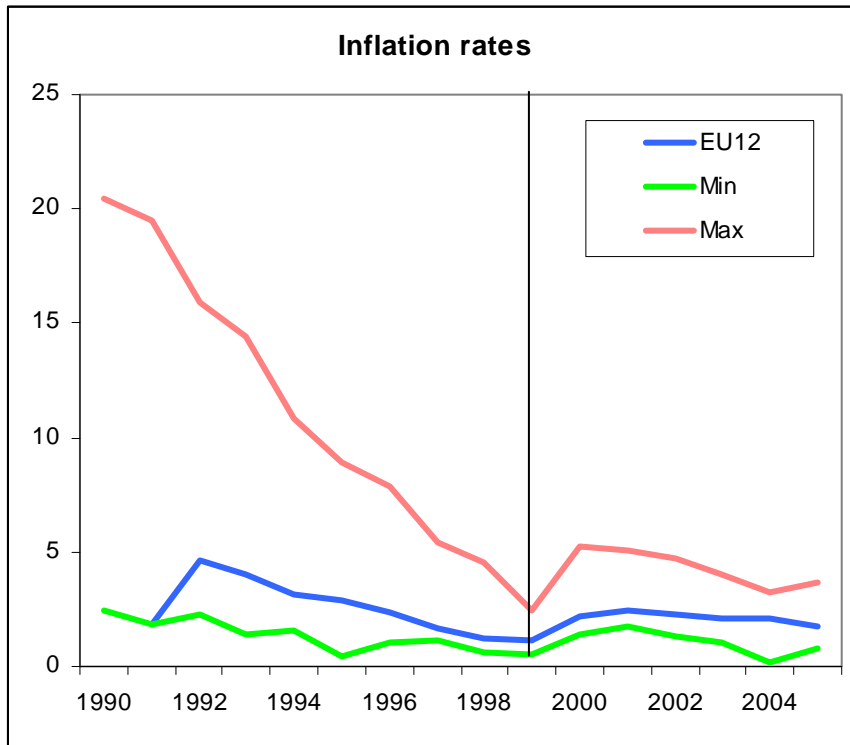


The Euro: Too Weak First, Then Too Strong?



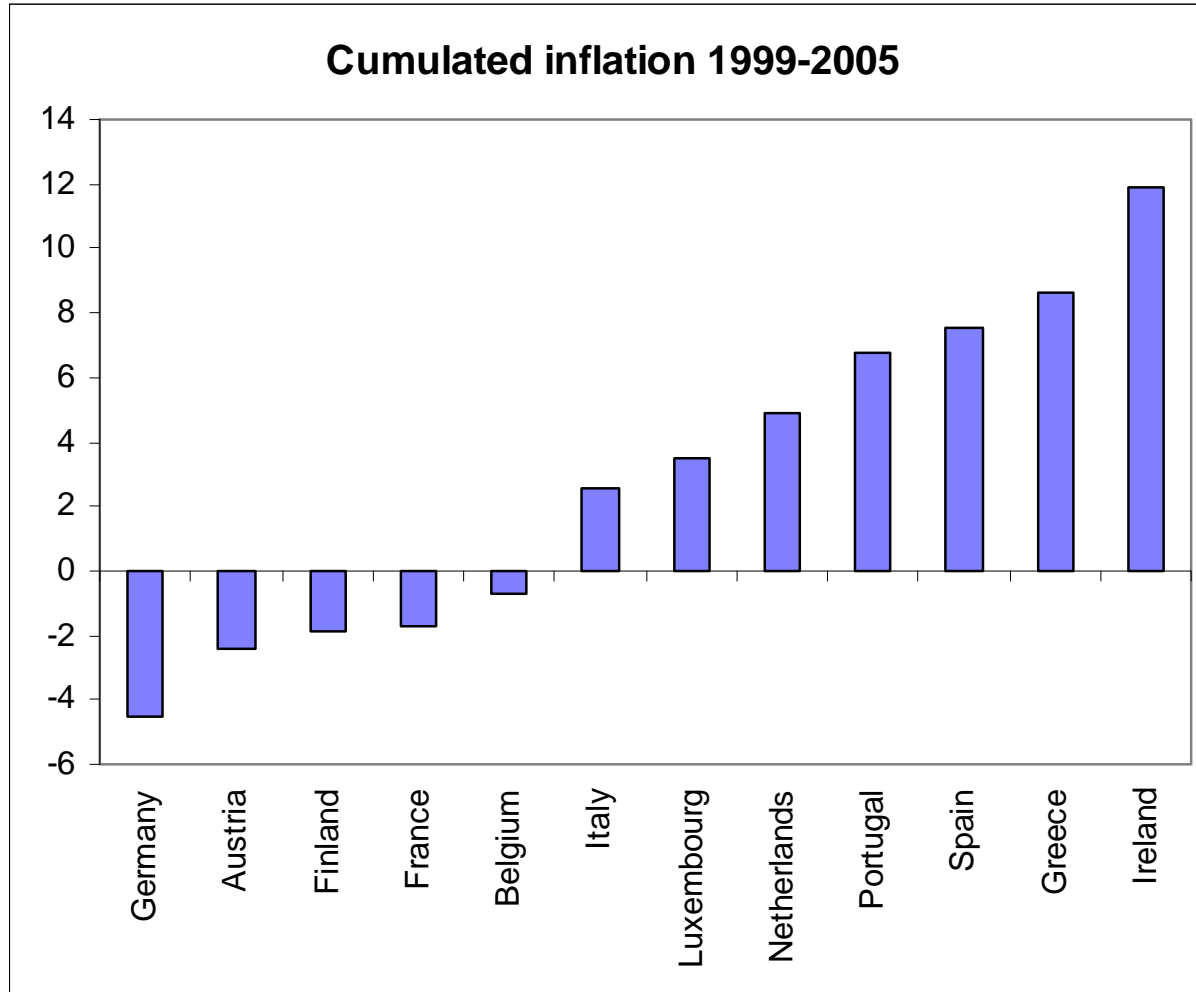


But No Seriously Asymmetric Shocks





Although inflation has not fully converged





Architecture of EMU: fiscal rules



The Fiscal Policy Instrument

- In a monetary union, the fiscal instrument assumes greater importance:
 - the only macroeconomic policy instrument left at the national level
 - its effectiveness is increased (a result from the Mundell-Fleming model).
- A substitute to transfers.
- Yet, many questions arise regarding its effectiveness and use.



Limits on Effectiveness

- The crucial role of private expectations:
 - a deficit today but a debt tomorrow: who will pay?
 - a tax cut, but how permanent?
- Slow implementation:
 - agreement within government
 - agreement within parliament
 - spending carried out by bureaucracy
 - taxes not retroactive.
- Result: countercyclical actions moves can have countercyclical effects.



Crucial Distinction: Automatic vs Discretionary

- Automatic stabilizers:
 - tax receipts decline when the economy slows down, and conversely
 - welfare spending rise when the economy slows down, and conversely
 - no decision, so no lag: nicely countercyclical
 - rule of thumb: deficit worsens by 0.5 per cent of GDP when GDP growth declines by 1 per cent.



Automatic Stabilizers

Sensitivity of government budget balances to a 1 per cent decline in economic growth

Germany	-0.5	Austria	-0.5	Greece	-0.6	Portugal	-0.4
France	-0.5	Belgium	-0.5	Ireland	-0.4	Spain	-0.5
Italy	-0.4	Denmark	-0.7	Netherlands	-0.6	Sweden	-0.5
UK	-0.6	Finland	-0.5				

SOURCE: OECD (1997).

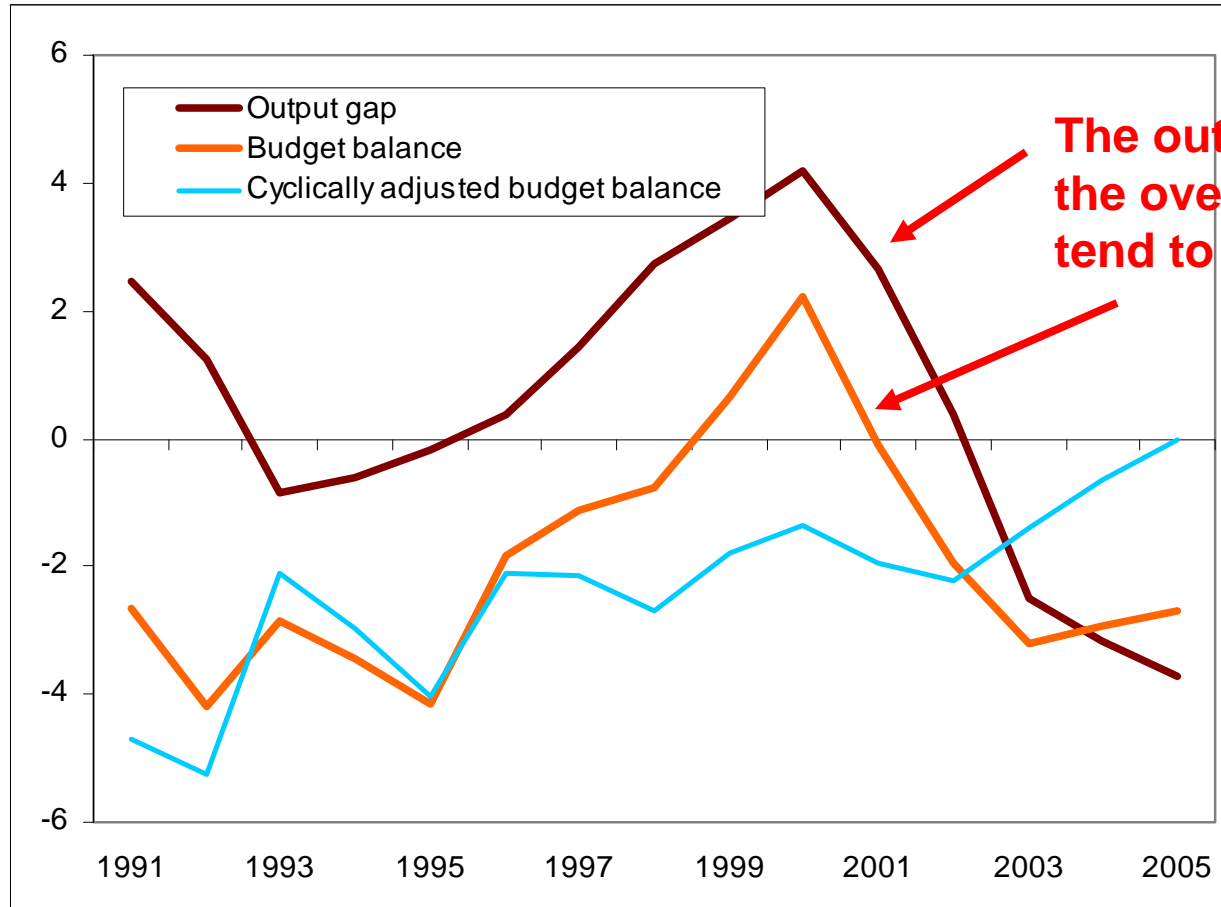


Crucial Distinction: Automatic vs Discretionary

- Discretionary actions: a voluntary decision to change tax rates or spending.
- Technically: a change in the structural budget balance.
- But no automatic correction of deficits, so a problem of discipline.



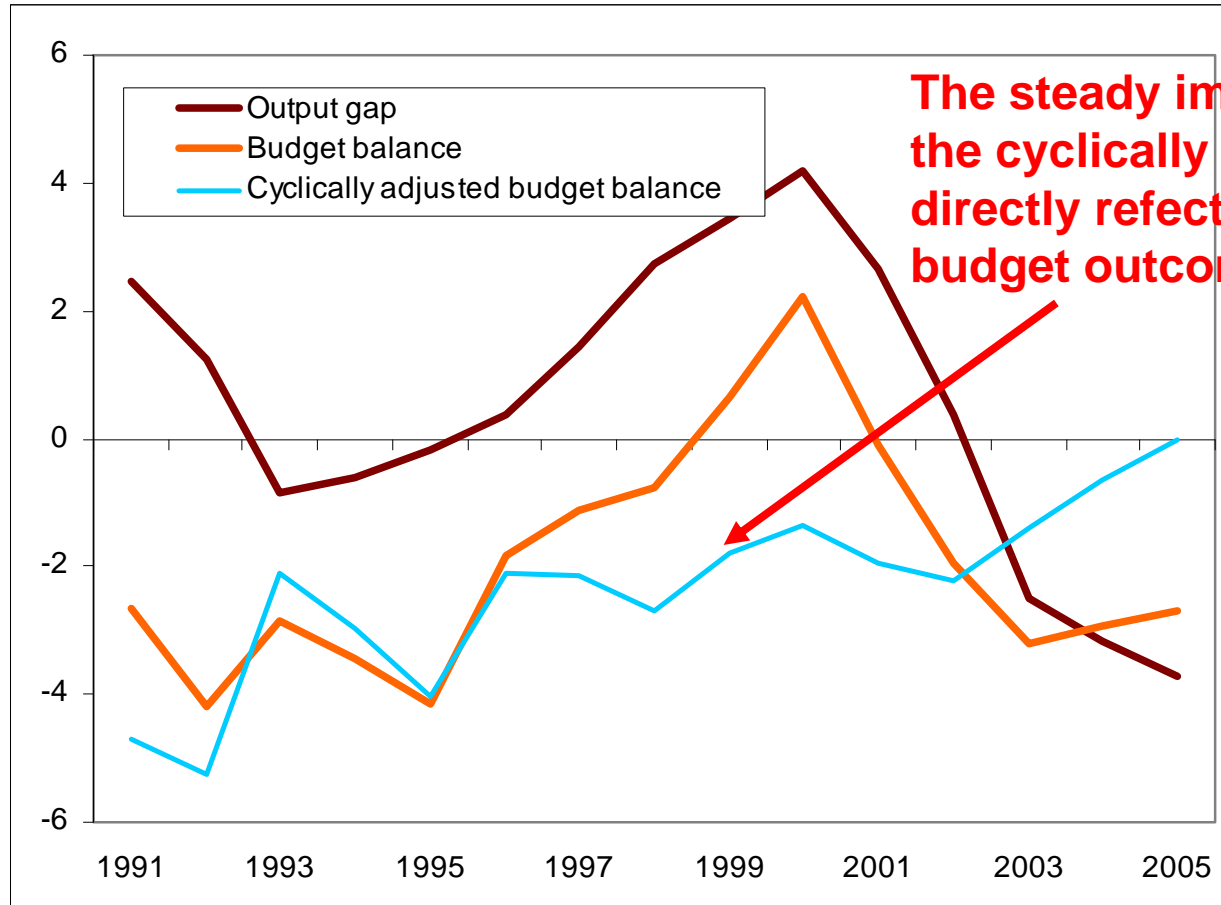
Example: the Netherlands



The output gap and the overall budget tend to move together



Example: the Netherlands



The steady improvement of the cyclically adjusted is not directly reflected in the actual budget outcomes



Should the Instrument be Subjected to Some Form of Collective Control?

- Yes, if national fiscal policies are a source of several externalities.
- Income externalities via trade:
 - important and strengthened by monetary union
 - a case for some coordination.
- Borrowing cost externalities:
 - one common interest rate
 - but euro area integrated in world financial markets.



In the End, Should Fiscal Policy Independence be Limited?

- The arguments for:
 - serious externalities
 - a bad track record, anyway.
- The arguments against:
 - the only remaining macroeconomic instrument
 - national governments know better the home scene.

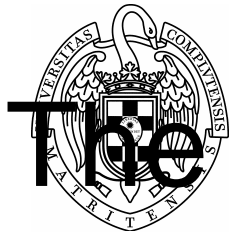


3. THE STABILITY AND GROWTH PACT



The Stability and Growth Pact

- Formally, the implementation of the Excessive Deficit Procedure (EDP) mandated by the Maastricht Treaty.
- The EDP aims at preventing a relapse into fiscal indiscipline following entry in euro area.
- The EDP makes permanent the 3 per cent deficit and 60 per cent debt ceilings and foresees fines.
- The Pact codifies and formalizes the EDP.



The Pact's short but tumultuous life

- Original Pact: 1999 – November 2003
- Limbo: November 2003 – March 2005
- Adapted Pact: March 2005 - ?



How the Pact Works

- A limit on acceptable deficits: 3% of GDP
- A preventive arm
 - Aims at avoiding reaching the limit in bad years
 - Calls for surpluses in good years
- A corrective arm
 - Aims at encouraging prompt action when deficit is above limit
 - Sanctions applied if limit repeatedly breached



How the Pact Works

Recognition that the budget balance worsens with recessions:

- exceptional circumstances when GDP falls by 2 per cent or more: automatic suspension of the EDP
- when GDP falls by more than 0.75 per cent, country may apply for suspension
- leniency when slow growth continues over several years
- Precise procedure that goes from warnings to fine.



The Procedure

When the 3% is not respected:

- the Commission submits a report to ECOFIN
- ECOFIN decides whether the deficit is excessive
- if so, ECOFIN issues recommendations with an associated deadline
- the country must then take corrective action
- failure to do so and return the deficit below 3 per cent triggers a recommendation by the Commission
- ECOFIN decides whether to impose a fine
- the whole procedure takes about two years.



The Fine Schedule

- The fine starts at 0.2 per cent of GDP and rises by 0.1 per cent for each 1 per cent of excess deficit.

Size of deficit (% of GDP)	Amount of fine (% of GDP)
3%	0.2%
4%	0.3%
5%	0.4%
6% and above	0.5%



How is the Fine Levied

- The sum is retained from payments from the EU to the country (CAP, Structural and Cohesion Funds).
- The fine is imposed every year when the deficit exceeds 3 per cent.
- The fine is initially considered as a deposit:
 - if the deficit is corrected within two years, the deposit is returned
 - if it is not corrected within two years, the deposit is considered as a fine.



The Broad Economic Policy Guidelines

- Emphasis on precautionary measures to avoid warnings and fines.
- The stability programmes are embedded in the wider BEPG, a peer-monitoring process that includes the Lisbon strategy.
- Each year, each country presents its planned budget for the next three years, along with its growth assumptions.
- The Commission evaluates whether the submission is compatible with the Pact.



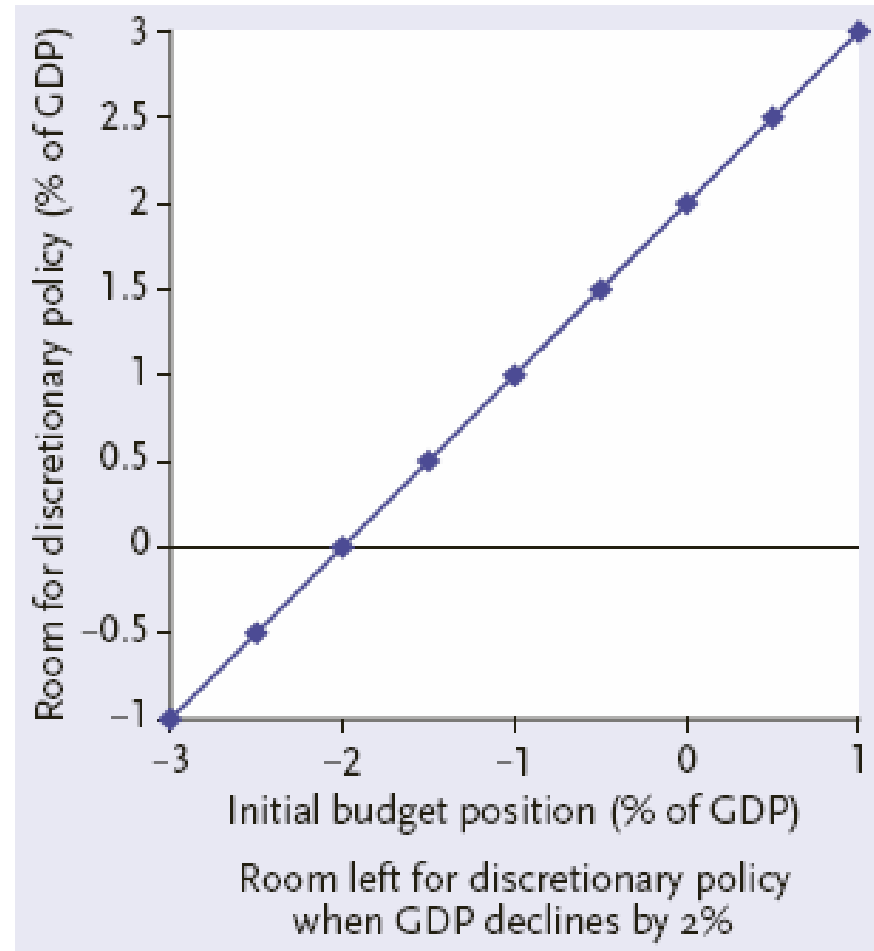
Issues Raised by the Pact

- Does the Pact impose procyclical fiscal policies?:
 - budgets deteriorate during economic slowdowns
 - reducing the deficit in a slowdown may further deepen the slowdown
 - a fine both worsens the deficit and has a procyclical effect.
- The solution: a budget close to balance or in surplus in normal years.



Issues Raised by the Pact

- What room left for fiscal policy?:
 - if budget in balance in normal years, plenty of room left for automatic stabilisers
 - some limited room left for discretion action.



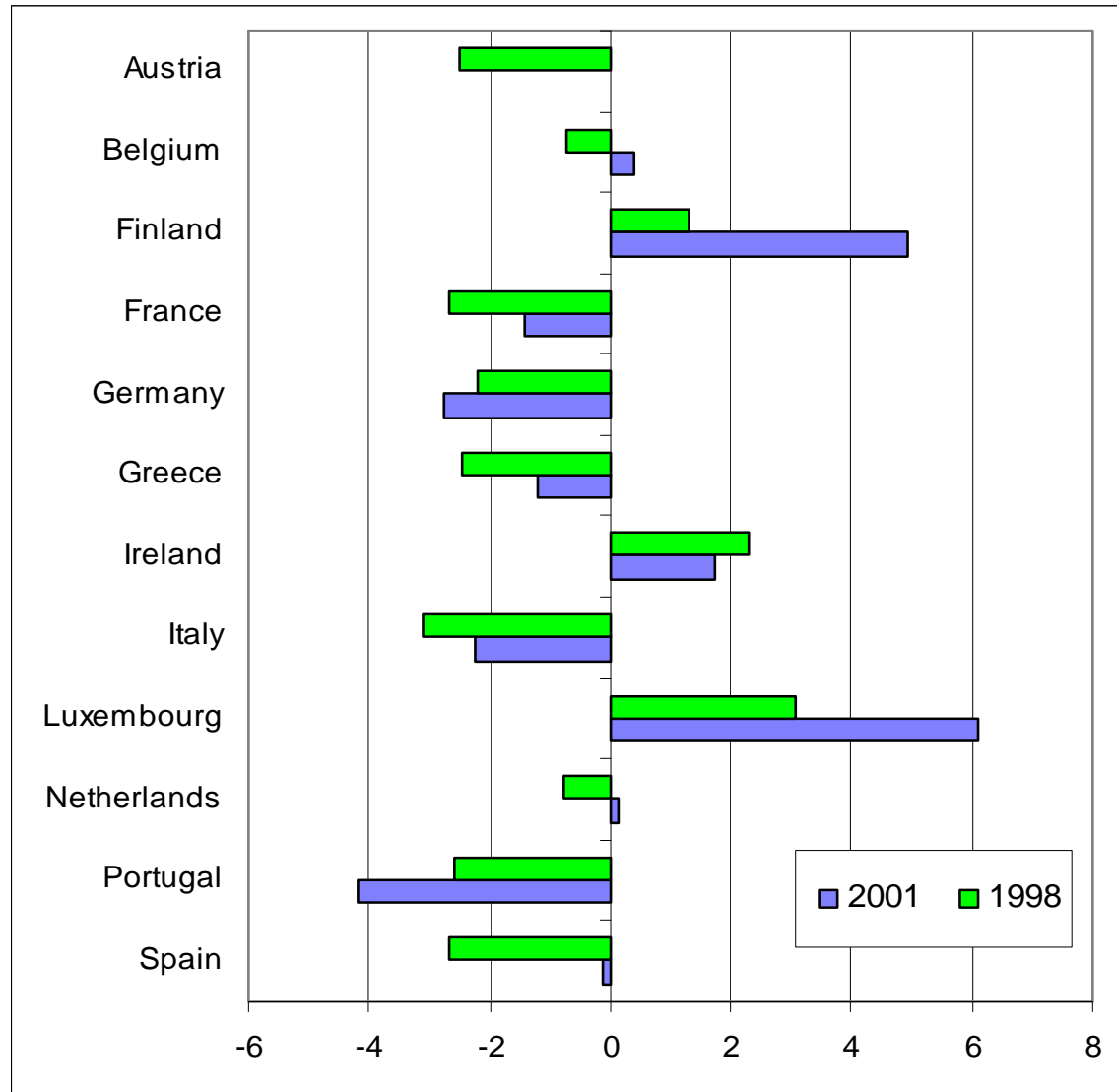


Issues Raised by the Pact

- What room left for fiscal policy?:
 - if budget in balance or surplus in normal years, plenty of room left for automatic stabilisers
 - some limited room left for discretion action.
- In practice, the Pact encourages:
 - aiming at surpluses (so public debts will disappear)
 - giving up discretionary policy.
- The early years are hardest:
 - takes time to bring budgets to surplus.

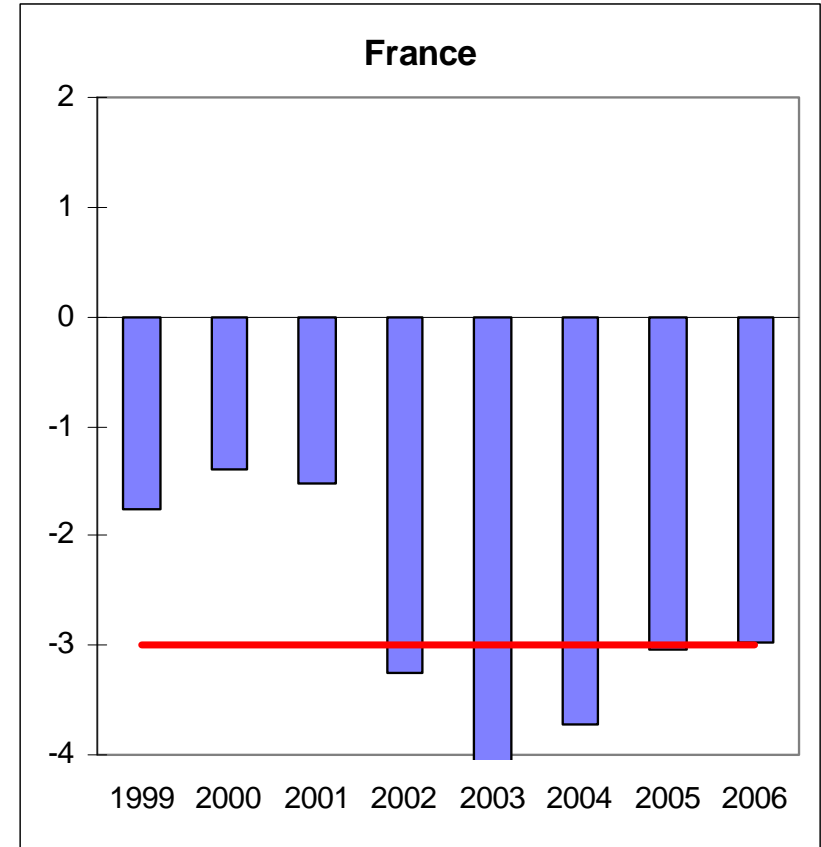
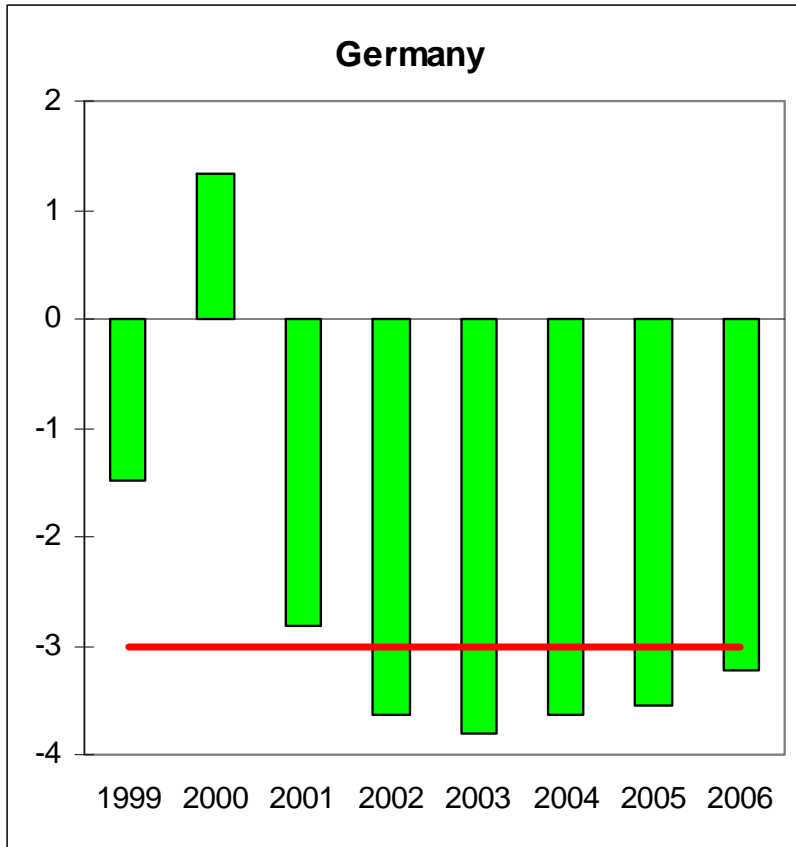


The Early Years (Before Slowdown)





The November 2003 decision





The November 2003 decision

- ECOFIN decides to suspend the Pact
- The European Court of Justice:
 - recognizes the right of ECOFIN to interpret the pact
 - considers that the suspension decision is illegal
- The governments commit to re-examine the pact



Why did the pact go wrong?

- **Economic flaws**
 - Annual deficits are endogenous
 - Annual deficits tell little about fiscal discipline
 - Evolution of debt is more important
- **Political flaws**
 - Fiscal policy remain national sovereignty
 - Large vs. small countries



The March 2005 decision

- Principles of the pact of upheld
 - 3 % deficit limit
 - fines, to be decided by ECOFIN
- Flexibility introduced
 - Will take into account debt level
 - Will take into account growth over recent years
- Pact strengthened
 - Add preventive arm (when growth is high) to corrective arm (when growth is slow)
- Pact undermined
 - Allows excess deficit when spending is "good" (long list)



And now?

- ECOFIN free to apply or not the pact
 - Will large countries always escape?
- Serious reform has been put off
- If pact is dead, how bad is it?