

Political Economy of European Monetary Integration

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Theory

- Analysis in this lecture for the most part uses **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 expenditure and revenue so as to influence the economy (aggregate demand)
- Almost every country has its own currency and uses both fiscal and monetary policies.
- **Monetary arrangements**
 - Floating
 - Managed floating
 - Fixed exchange rate
 - Currency board
 - Dollarization, euroization

- **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
- **Impossible trilogly**
 - 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 uses alternative approach
 - Maastricht criteria
 - Stability and Growth Pact
 - Broad Economic Policy Guidelines
- Real coordination of economic policies is 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)
 - 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
- 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

Diverse 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
- Assumes away important political considerations (distribution, patriotism etc.)