

# **Lecture**

# **Economics of European Integration**

Fall Semester 2008

Gerald Willmann

# Syllabus

## Administration

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## Overview

This course has two objectives: (i) to familiarize you with the institutional and economic aspects of the European Union and the policy areas it is active in, and (ii) to improve your ability to frame and analyze economic policy questions in a coherent and rigorous way.

## Prerequisites

Basic knowledge of microeconomics and—to a lesser extent—macroeconomics will be required. In addition, we will occasionally look at empirical data, hence some understanding of elementary statistics will be helpful.

## Textbook

main text:

Richard Baldwin and Charles Wyplosz (BW), *The Economics of European Integration*, McGraw-Hill, 2nd edition, April 2006.

additional, useful books:

Paul De Grauwe *Economics of Monetary Union* (4th edition), Oxford 1999,  
J.R. Markusen, J.R. Melvin, W.H. Kaempfer and K.E. Maskus (MMKM) *International Trade: Theory and Evidence* McGraw Hill 1995.

## Grading

Your grade will be based on two exams and one term paper: 25% on the midterm exam to be given in class on November 4, another 25% on the term paper due on Jan 9, and the rest (50%) on the final exam.

## Logistics

- the class meets on Tuesdays, 09–11, in HOG 01.85.
- class website at <http://willmann.com/~gerald/euroecon>

## Course Outline

(BW chpts in parentheses)

1. history, facts and institutions (BW part I)
2. microeconomics of economic integration (BW part II)
3. European Union policies: CAP and competition policy (BW part III)
4. monetary integration (BW parts IV and V)

# The Economics of European Integration



# Chapter 1

## History



# Early Post War Period

- A Climate for Radical Change:
  - Facts:

	Death toll	The Economic Set-Back: Pre-war year when GDP equalled that of 1945
Austria	525,000	1886
Belgium	82,750	1924
Denmark	4,250	1936
Finland	79,000	1938
France	505,750	1891
Germany	6,363,000	1908
Italy	355,500	1909
Netherlands	250,000	1912
Norway	10,250	1937
Sweden	0	GDP grew during WWII
Switzerland	0	GDP grew during WWII
UK	325,000	GDP grew during WWII

- **A Climate for Radical Change:**

- Images



*Reichstag, 1945*



*Frankfurter Allee, 1945*

- **A Climate for Radical Change:**

- Images



*Brandenburg Gate*



- **A Climate for Radical Change:**

- **Images**



*Unter der Linden, 1945*



*Unter der Linden, 1997*

- **A Climate for Radical Change:**

- Images



*Berlin Cathedral, 1945*



*Berlin Cathedral, 1997*

- **A Climate for Radical Change:**

- Images



Canadian soldiers and tanks advance through the streets of Ortona, Italy in this 1943 photo. Canadian Press



- **A Climate for Radical Change:**

- Images



- **A Climate for Radical Change:**

- Images



*Verona 1945*

- **A Climate for Radical Change:**

- Images



*London 1940*

- **A Climate for Radical Change:**

- Images



*London 1940*



- **A Climate for Radical Change:**

- Images



*East London, 1940*



# The prime question in 1945

- “How can Europe avoid another war?”
  - What caused the war? 3 answers
    - Blame the loser
    - Capitalism
    - Destructive nationalism
  - These implied 3 post-war solutions
    - ‘Neuter’ Germany , Morgenthau Plan, 1944
    - Adopt communism
    - Pursue European integration
- European integration ultimately prevailed, but this was far from clear in the late 1940s.

# Emergence of a divided Europe

- Cold War begins.
- USSR pushes communism in the East.
- UK, French and US zones merged by 1948
- Moves towards creation of West German government.
  - Berlin blockade, 1948.
- “Neuter Germany” solution abandoned for strong West Germany + European integration.



Germany & Berlin divided into 4 zones

Berlin blockade



# A divided Europe











*East German Guard Towers*



*Checkpoint Charlie, 1961*



(c) 2002 James B. Osbon, Dailysoft.com



# First Steps

- First Steps: the OEEC and EPU
  - OEEC and EPU set up in conjunction with Marshal Plan, 1948.
  - OEEC coordinated aid distribution and prompted trade liberalisation.
  - EPU facilitated payments and fostered trade liberalisation.

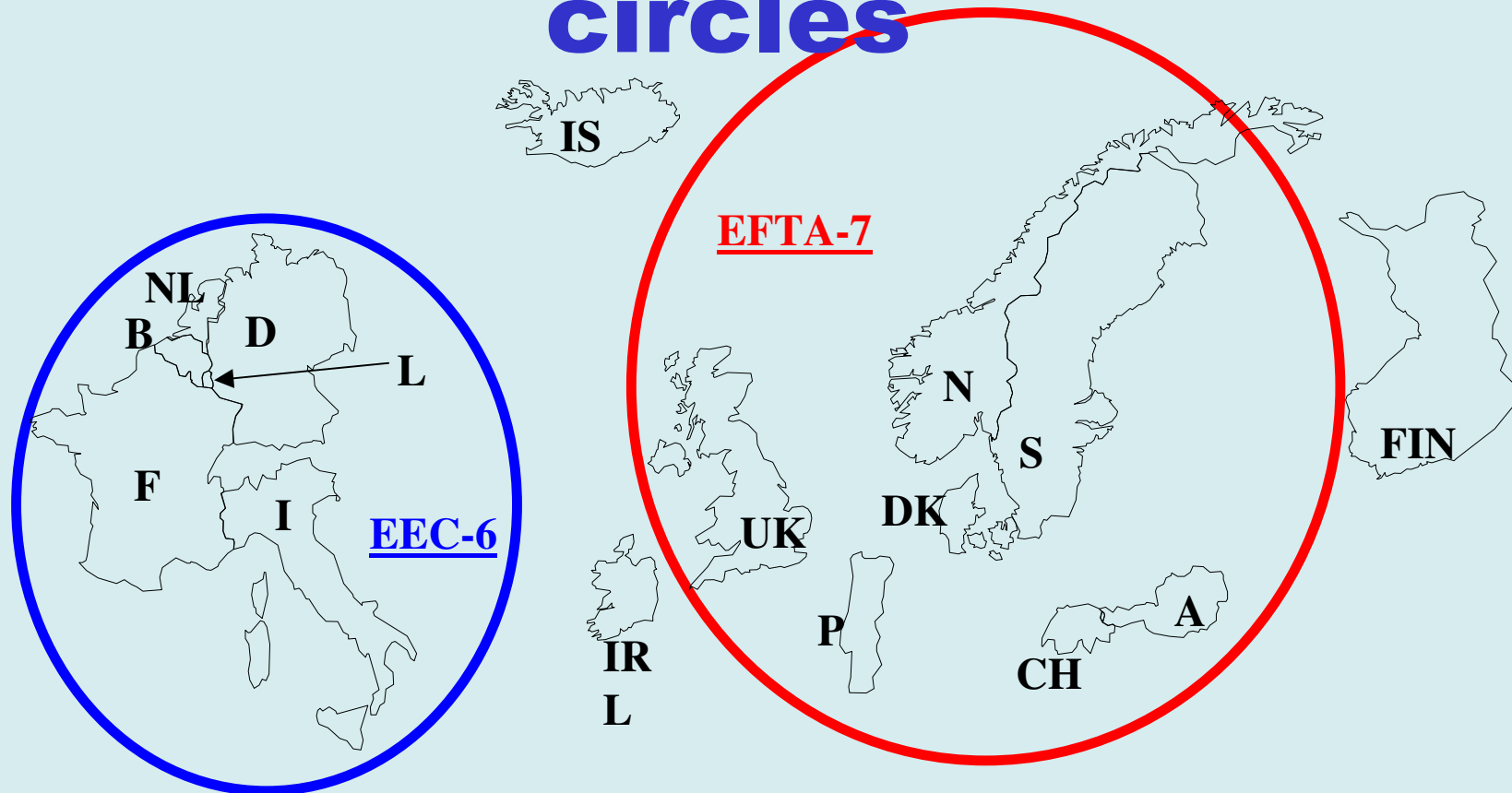
# Need for deeper European integration

- As Cold War got more war-like, West Germany rearmament became necessary.
  - 1949, Fed'l Rep. of Germany established.
  - But strong and independent Germany was a scary thought to many , including many Germans.
  - Wide-spread feeling: best to embed an economically and militarily strong W. Germany in European superstructure.
  - Problem: OEEC was too loose to avoid future war among Western European powers.

# Two strands of European integration

- Federalism and intergovernmentalism
  - Immediate disagreement about depth of European integration
    - Federalism – supranational institutions
    - Intergovernmentalism – nations retain all sovereignty
- Intergovernmental initiatives
  - OEEC (1948), Council of Europe (1949), EFTA (1960)
- Federal initiative
  - ECSC (1951), EEC (1958)

# 1960-1973, two non-overlapping circles



**West European Trade Arrangements in: 1960s**  
**The EFTA-7 and the EEC-6 form two non-overlapping circles.**

# Evolution to Two Concentric Circles

- Preferential liberalisation in EEC and EFTA proceeded
  - (EEC's customs union and EFTA's FTAs completed by 1968)
- Discriminatory effects emerge, leading to new political pressures for EFTAs to join EEC
  - Trade diversion creates force for inclusion
  - As EEC enlarges, force for inclusion strengthens
- When UK decides to apply for EEC (1961), 3 other EFTAs also change their minds.
  - De Gaulle's 'non' (twice)

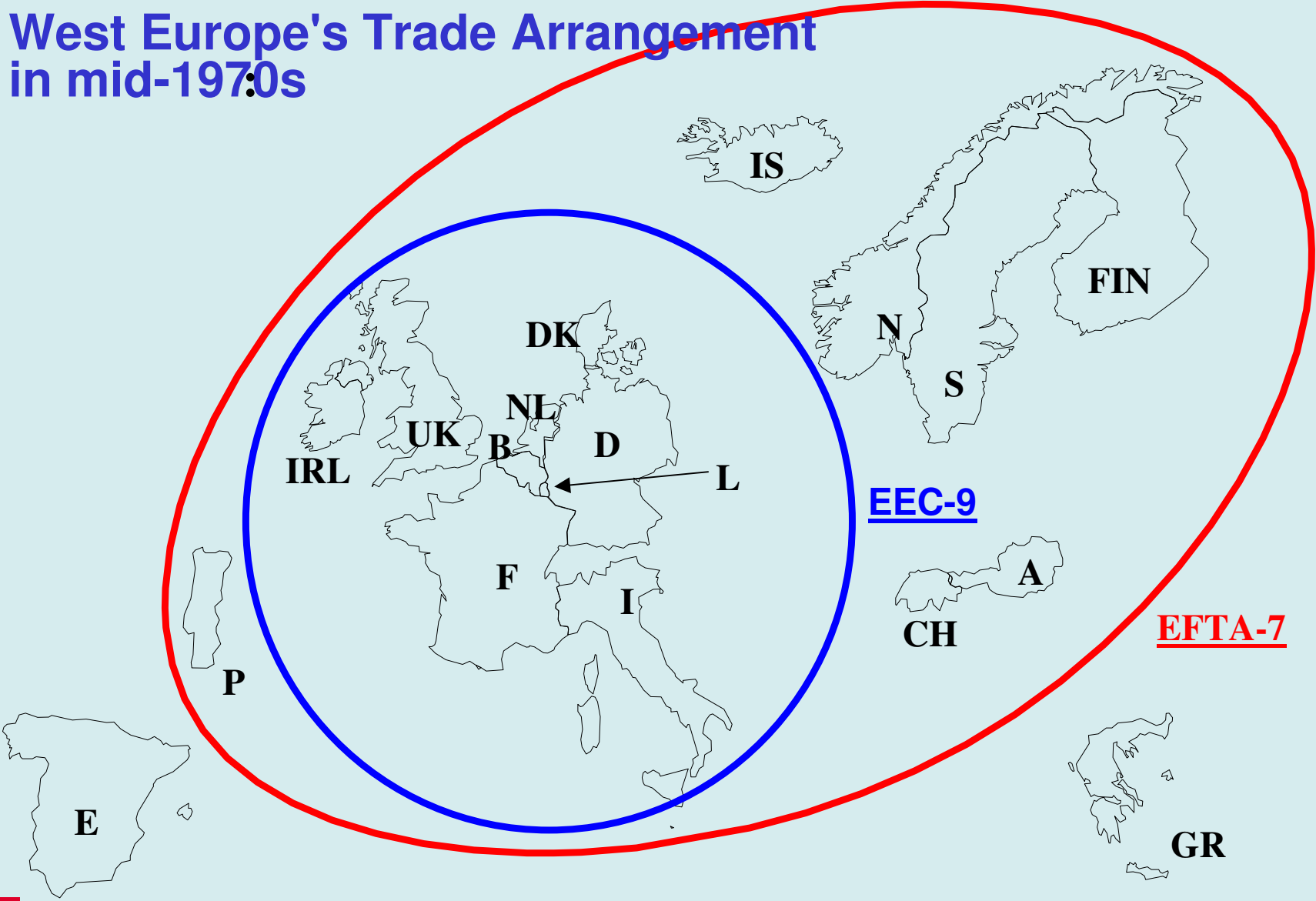


# Evolution to Two Concentric Circles

- First enlargement, 1973
  - UK, Denmark, Ireland & Norway admitted (Norwegians say no in referendum)
- Enlargement of EEC reinforces 'force for inclusion' on remaining EFTAs
  - Remaining EFTAs sign FTA agreements with EEC-9
  - Why weren't the FTA's signed before?
    - Domino-like affect of lowering barriers
    - 1<sup>st</sup> within EEC6 → enlargement → EEC-EFTA FTAs

# Two concentric circles

West Europe's Trade Arrangement  
in mid-1970s



# Euro-pessimism, 1975-1986

- Political shocks:
  - ‘Luxembourg Compromise’ (1966) + enlargement leads to decision-making jam.
- Economic shocks:
  - Bretton Woods falls apart, 1971-1973.
    - Failed monetary integration schemes (except within DM bloc).
  - 1973 and 1979 oil shocks with stagflation.
  - Failure of Deeper Trade Integration.
  - Growing cost of Common Agricultural Policy creates frictions over budget.



# Bright spots

- Democracy in Spain, Portugal and Greece
- Greece joins in 1981
- Spain and Portugal join in 1986 after long a difficult accession talks
- EMS set up in 1979 works well
- Budget Treaties
- 1979 Cassis de Dijon decision built on 1974 Dassonville ruling
  - Challenged validity of national rules that introduce non-tariff barriers to trade.
  - Mutual Recognition Principle introduced.

# Deeper circles: single market programme

- Mutual recognition as threat to national regulatory control; race to bottom?
- How to put member gov't back in charge?
- Delors launches completion of the internal market with Single European Act
  - create "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured".
- Important institutional changes, especially move to majority voting on Single Market issues.
  - Mutual recognition is disciplined by minimum harmonisation
  - More efficient decision making procedures allow agreement on min. standards "New Approach" Directives.

# Single Market Programme, EC92

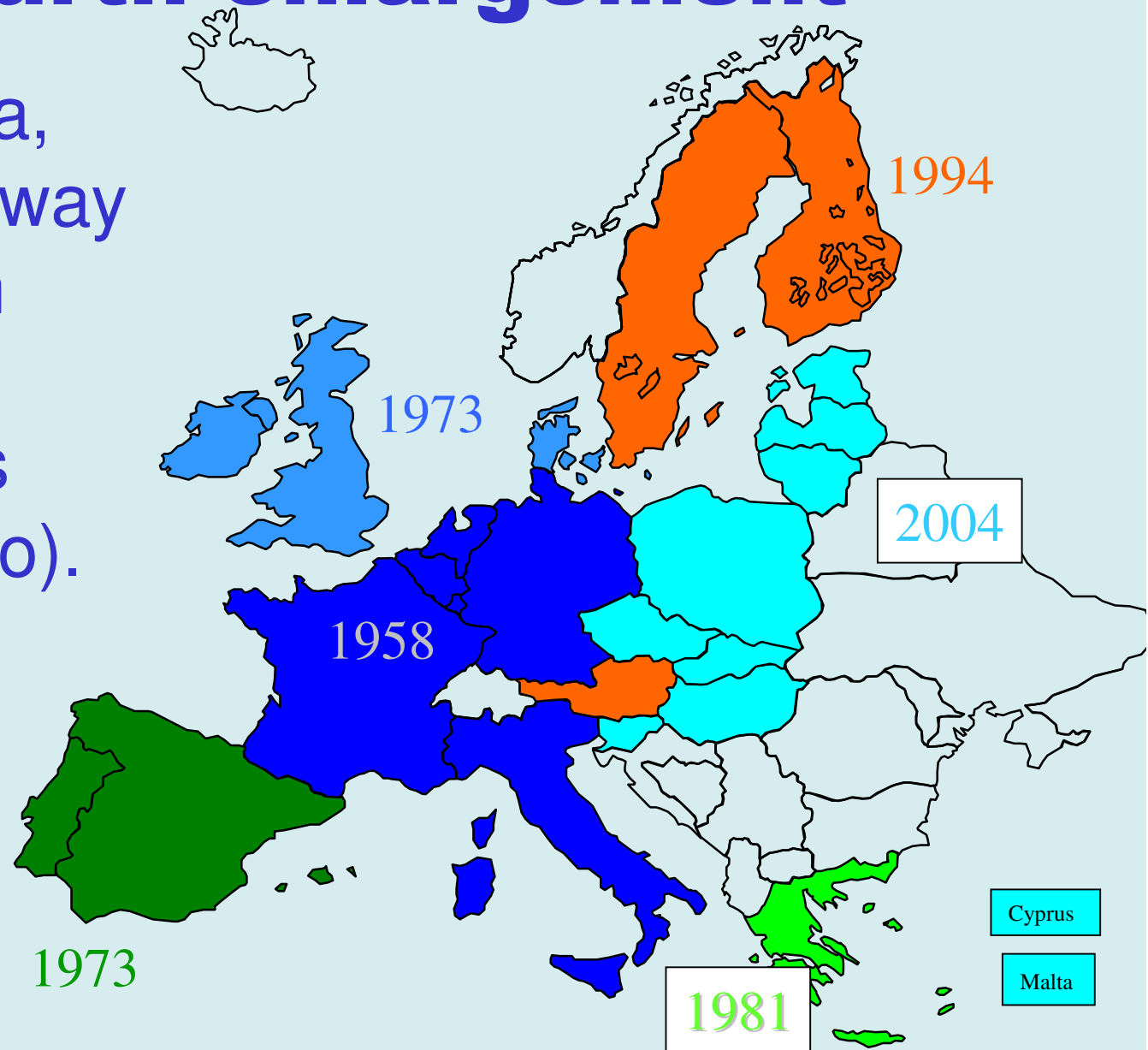
- Basic elements
  - Goods Trade Liberalisation
    - Streamlining or elimination of border formalities,
    - Harmonisation of VAT rates within wide bands
    - Liberalisation of government procurement
    - Harmonisation and mutual recognition of technical standards in production, packaging and marketing
  - Factor Trade Liberalisation
    - Removal of all capital controls (!!!), and deeper capital market integration
    - Liberalisation of cross-border market-entry policies,

# Domino effect, part II

- Deeper integration in EC-12 strengthened the 'force for inclusion' in remaining EFTAs.
- End of Cold War loosened EFTAs' resistance to EC membership.
- Result of 'force for inclusion'
  - EEA – initiative to extend single market to EFTAs.
  - Membership applications by all EFTAs except Iceland.
- Concentric circles, but both deeper.

# Fourth enlargement

- 1994, Austria, Finland, Norway and Sweden admitted (Norwegians again vote no).



# Communism's creeping failure and spectacular collapse

- By the 1980s, Western European system clearly superior due to the creeping failure of planned economies.
- Up to 1980s, Soviets thwarted reform efforts (economic & military pressure).
- Changes in USSR due to inadequacy economic system.
  - timid pro-market reforms (perestroika).
  - openness (glasnost).

# Velvet revolutions in CEECs

- June 1989 Polish labour movement ‘Solidarity’ forced free parliamentary elections & communists lost
  - Moscow accepted new Polish government.
- Moscow’s hands-off approach to the Polish election triggered a chain of events.
  - Reformist in Hungarian communist party pressed for democracy & Hungary opened its border with Austria, 1000s East Germans moved to West Germany via Hungary and Austria.
  - Mass protests in East Germany; Wall falls 9<sup>th</sup> November 1989.
  - End of 1989: democracy in Poland, Hungary, Czechoslovakia and East Germany (unification in 1990).





# USSR collapses

- 1990, Estonia, Latvia and Lithuania – declared their independence from the USSR.
- End of 1991, the Soviet Union itself breaks up.
- Cold War ends without a shot.
- Military division of Europe ended.

# EU reacts

- The European Union reacted swiftly to this geopolitical earthquake by providing emergency aid and loans to the fledgling democracies.
- Signing of 'Europe Agreements' with newly free nations in Central and Eastern Europe
  - These are free trade agreements with promises of deeper integration and some aid

# From Copenhagen to Copenhagen

- EU says CEECs can join the EU (June 1993).
  - Set out famous Copenhagen criteria for membership.
    - stability of institutions guaranteeing democracy,
    - the rule of law,
    - human rights and respect for and, protection of minorities,
    - the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union.
- Copenhagen summit December 2002 says 10 CEECs can join in 2004.
- 5<sup>th</sup> enlargement in May 2004

# German unification and Maastricht

- Pending 1990 unification of Germany opens door to a 'grand bargain' (Mitterrand, Kohl).
  - Germany gives up DM for European Monetary Union & East Germany joins the EU without negotiation.
- Jacques Delors proposes 2<sup>nd</sup> radical increase in European economic integration.
  - the formation of a monetary union.
  - Idea championed by French President Francois Mitterrand and German Chancellor Helmut Kohl.
- Maastricht Treaty, signed 1992
  - a monetary union by 1999, single currency by 2002.
  - Also, sets up EU's 'three pillar' structure to reduce EU's 'competency creep;'
- ERM exchange rate crises, 1992-1994.

# Preparing for Eastern Enlargement

- Impending enlargement required EU to reform its institutions
- Four tries:
  - Amsterdam Treaty, 1997
  - Nice treaty, 2000
  - draft Constitutional Treaty, 2003
    - Reconsidered by IGC 2003
  - Constitutional Treaty, June 2004.

# Amsterdam Treaty

- Failed to reform main institutions
- Tidied up of the Maastricht Treaty
  - More social policy, Parliament powers modestly boosted,
  - flexible integration, ‘closer cooperation’ introduced
- Amsterdam leftovers
  - voting rules in the Council of Ministers,
  - number of Commissioners,
  - Extension of issue covered by majority voting

# Nice Treaty

- Reforms of main institutions agreed, but poorly done
  - Council voting rules highly complex and reduce EU's ability to act with more members
  - No important extension of majority voting
  - Make shift solution for Commissioners
  - No reform of decision making in ECB
- Generally viewed as a failure
- Main changes re-visited in draft Constitutional Treaty, 2003

# Constitutional Treaty

- Improved decision-making rules for Council of Ministers and slightly more majority voting.
- Inclusion of Charter of Fundamental Rights.
- Other things where CT not strictly required:
  - Many ‘gestures’ and tidying up.
  - Moves towards more coherent foreign policy decision making.
  - Many de facto points turned into de jure.



# Constitutional Treaty's Problems

- France and Netherlands reject the Constitutional Treaty in referendums in Summer 2005.
- EU leaders suspend the ratification deadline. Next steps uncertain as of early 2006.

