

Economics of European Integration

Lecture # 10

Monetary Integration II

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The EMS: Past and Present

- The EMS was originally conceived as the solution to the end of the Bretton Woods System.
- Over the years, its nature changed and it became a kind of DM area, with the Bundesbank very much in command.
- This, and the speculative crisis of 1993, made the monetary union option attractive.
- Now the EMS is mostly the entry point for future monetary union members.

Preview: The Four Incarnations of the ERM

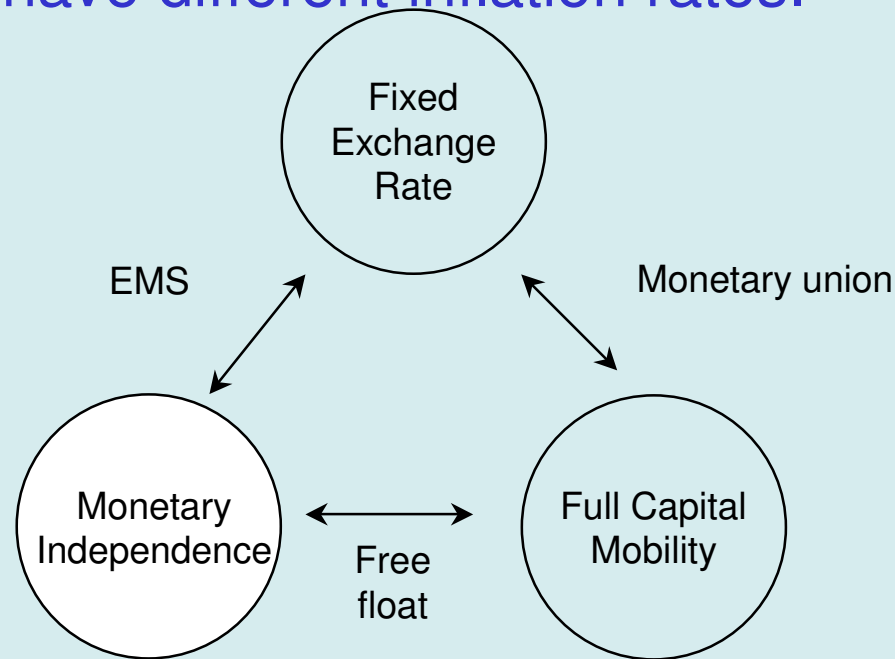
- 1979-82: ERM-1 with narrow bands of fluctuation ($\pm 2.25\%$) and symmetric.
- 1982-93: ERM-1 centered on the DM, shunning realignments.
- 1993-99: ERM-1 with wide bands ($\pm 15\%$).
- 1999- : ERM-2, asymmetric, on the way to euro area.

The ERM-1: Key Features

- A parity grid:
 - bilateral central parities
 - associated margins of fluctuations.
- Mutual **unlimited** support:
 - exchange market interventions
 - short-term loans.
- Realignments:
 - tolerated, if not encouraged
 - require unanimity agreement.
- The E.C.U.:
 - not a currency, just a unit of account
 - took some life on private markets.

The ERM: Interpretation and Assessment

- Is monetary policy independence lost?
- The Impossible trinity:
 - widespread capital controls to preserve at least the ability to have different inflation rates.



Evolution: From Symmetry to DM Zone

- But: realignments:
 - barely compensated accumulated inflation differences
 - were easy to guess by markets
 - put weak currency/high inflation countries on the spot:
 - Continuing current account deficits
 - Speculative attacks.
- The symmetry was broken *de facto*.
- The Bundesbank became the example to follow.

The DM Zone

- What shadowing the Bundesbank required:
 - giving up much what was left of monetary policy independence
 - aiming at a low German-style inflation rate
 - avoiding realignments to gain credibility.

Breakdown of the DM zone

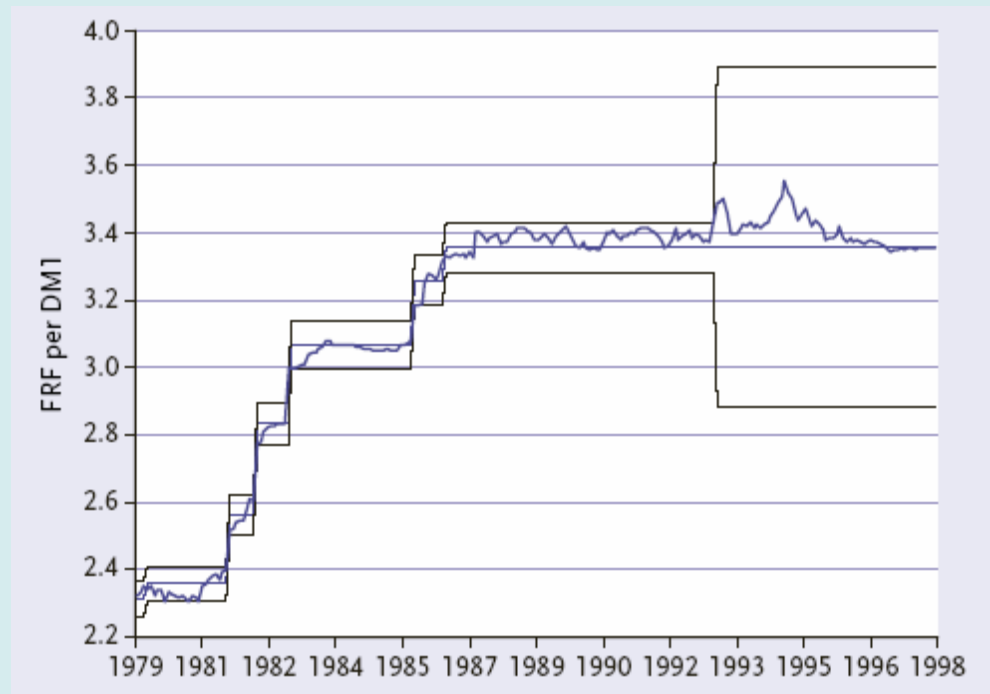
- Bad design:
 - full capital mobility established in 1990 as part of the Single Act: ERM in contradiction with impossible trinity unless all monetary independence relinquished.
- Bad luck:
 - German unification: a big shock that called for very tight monetary policy
 - the Danish referendum on the Maastricht Treaty.
- A wave of speculative attacks in 1992-3:
 - the Bundesbank sets limits to unlimited support.

Lessons From 1993 (1)

- The two-corner view:
 - even the cohesive ERM did not survive
 - go to one of the two corners (pick one!).
- The ERM should be made even more cohesive:
 - the monetary union is the way to go.
- The ERM was a bad idea:
 - float is the future.
- Unlimited interventions cannot be unlimited:
 - need more discipline and less support.

The Wide-Band ERM

- Way out of crisis:
 - wide band of fluctuation ($\pm 15\%$)



The Wide-Band ERM

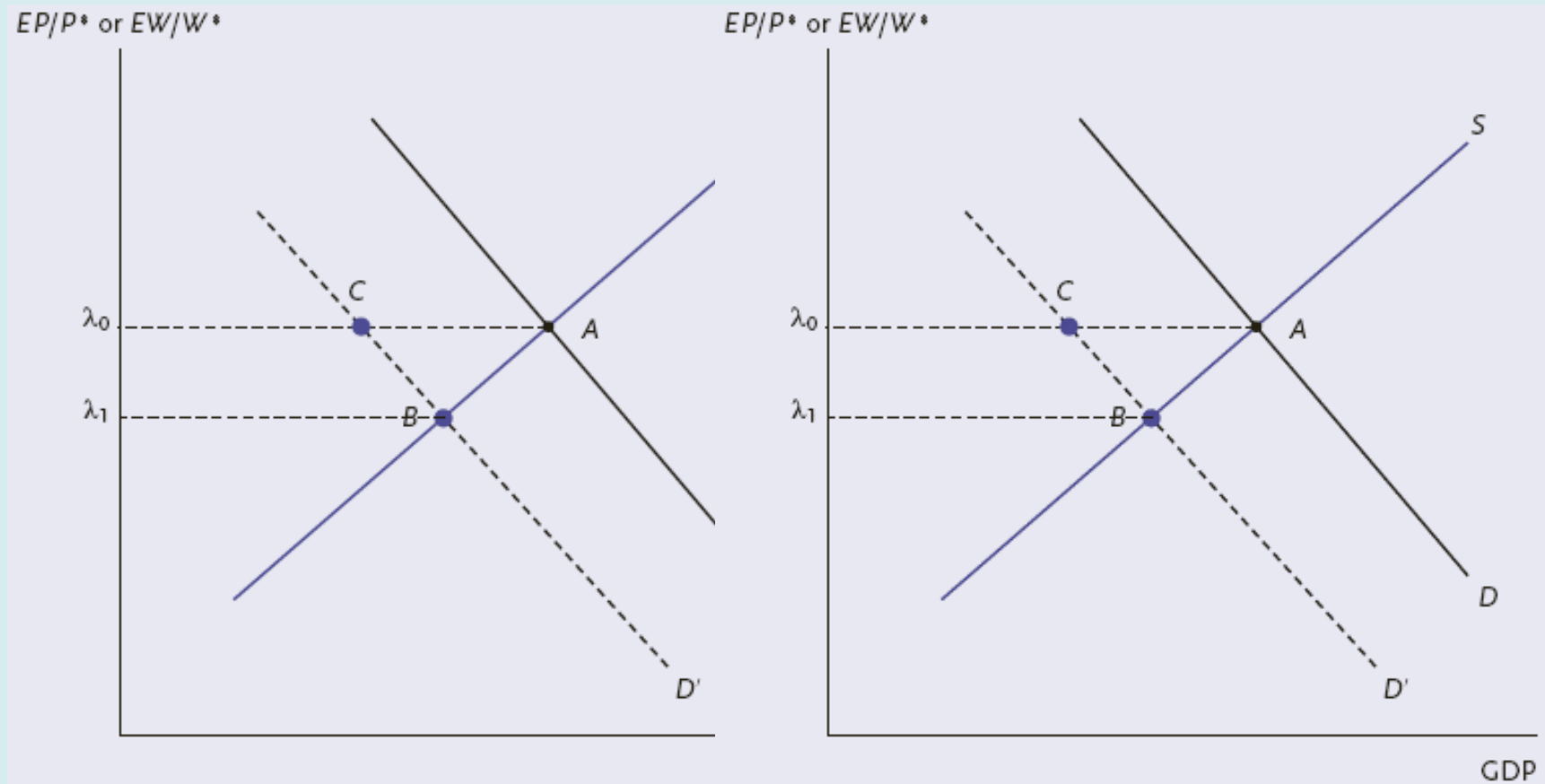
- Way out of crisis:
 - wide band of fluctuation ($\pm 15\%$)
 - a soft ERM on the way to monetary union.

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?

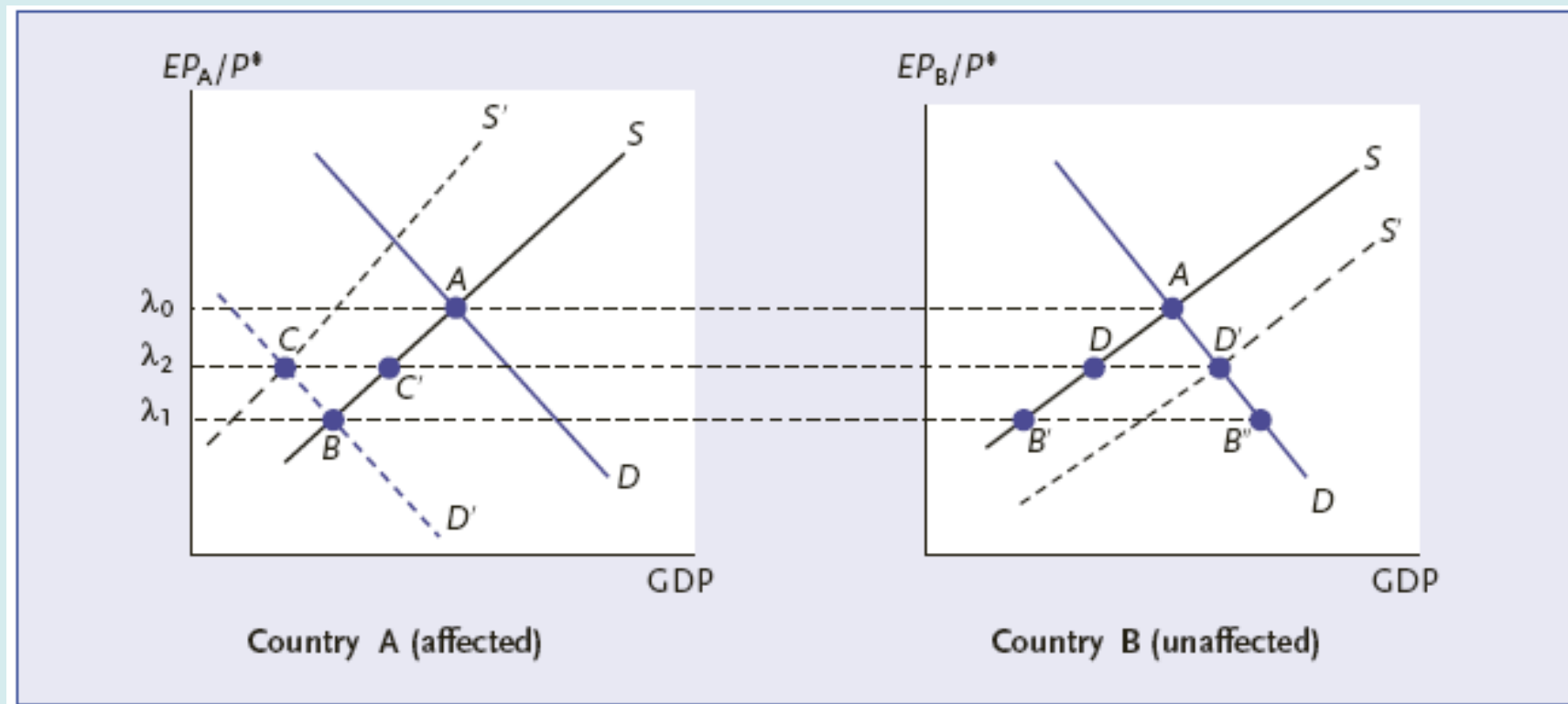
Symmetric Shock

- Same demand shock in two similar countries that share the same currency and, therefore, exchange rate. **No problem.**



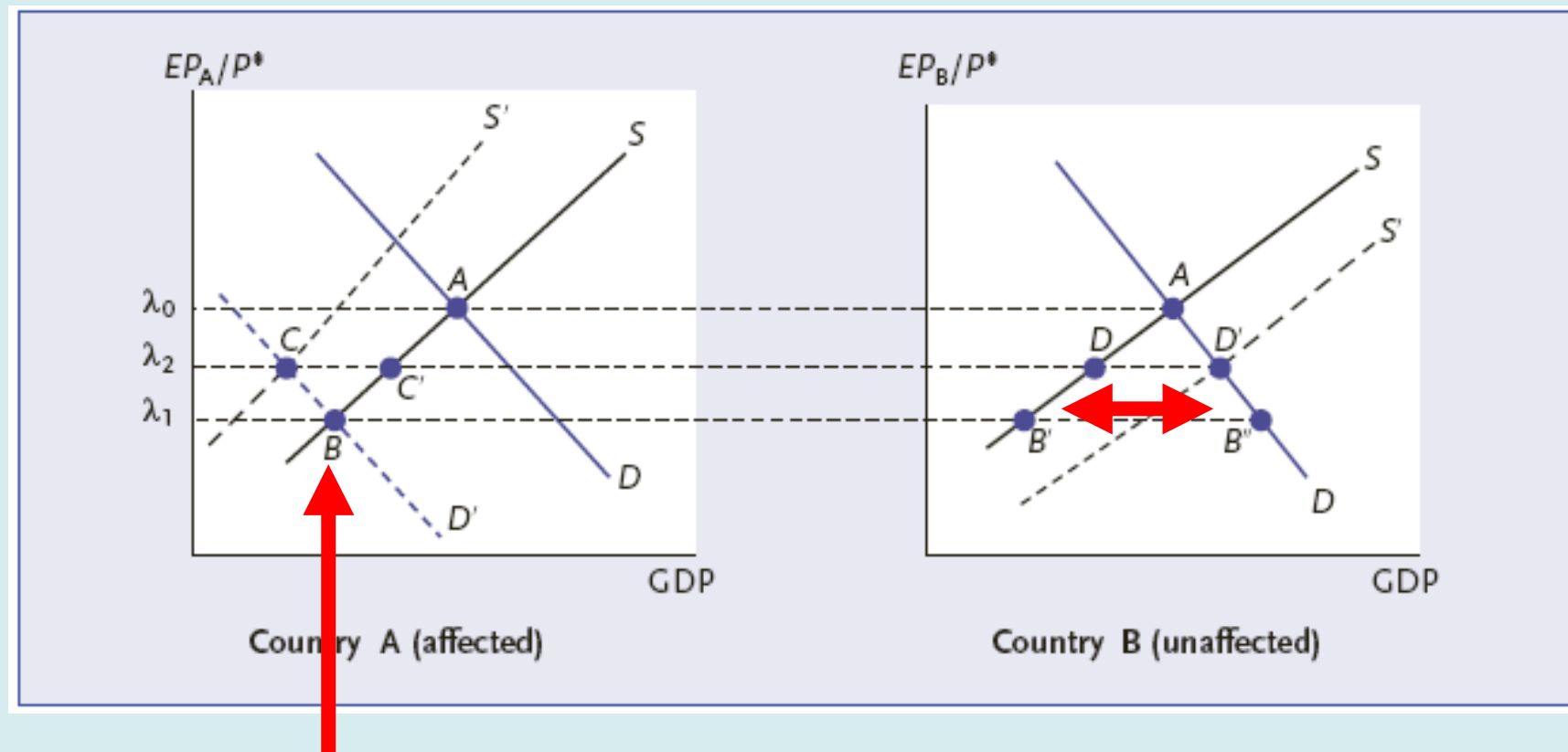
Asymmetric Shock

- Only one country is affected and no common currency: **big problem!**



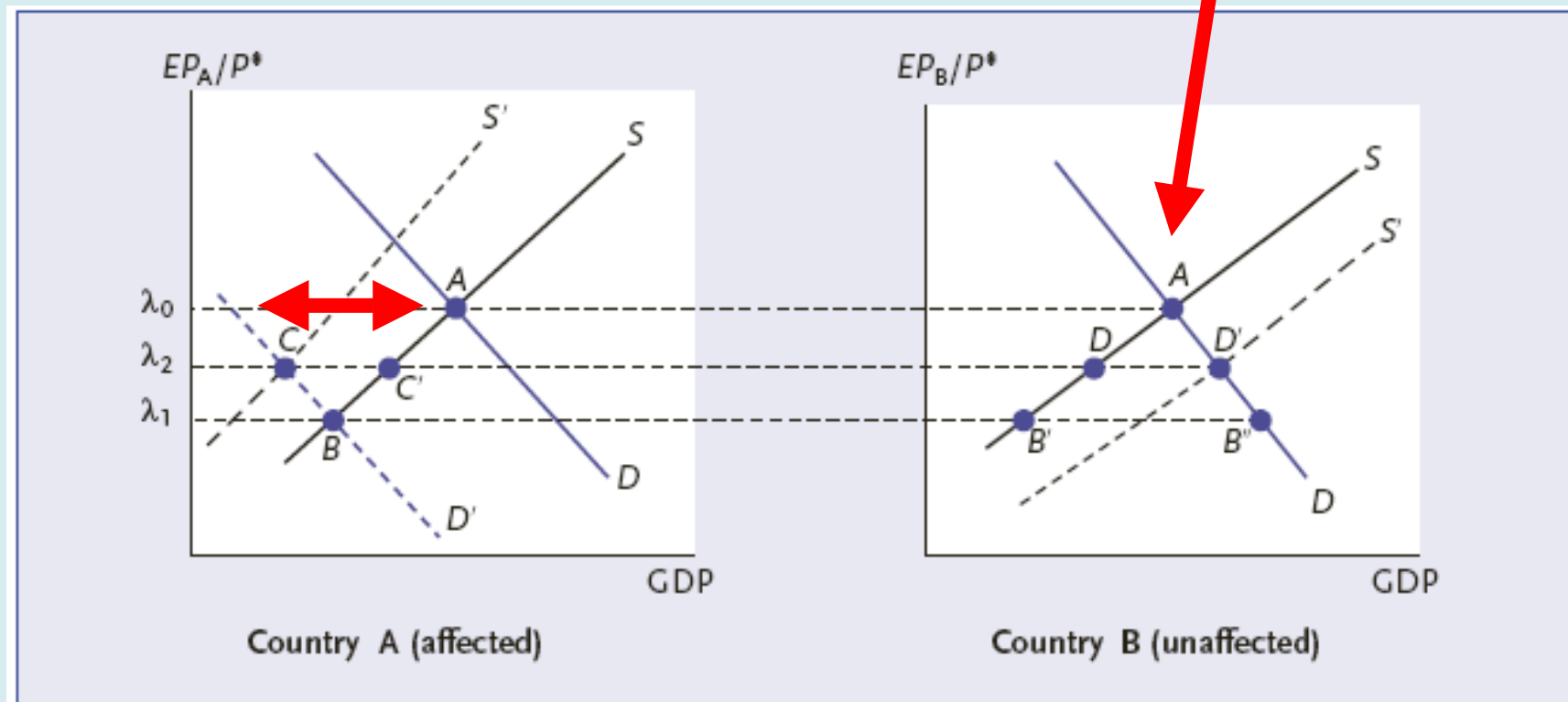
Asymmetric Shock

- Country A wants a depreciation. Country B unhappy.



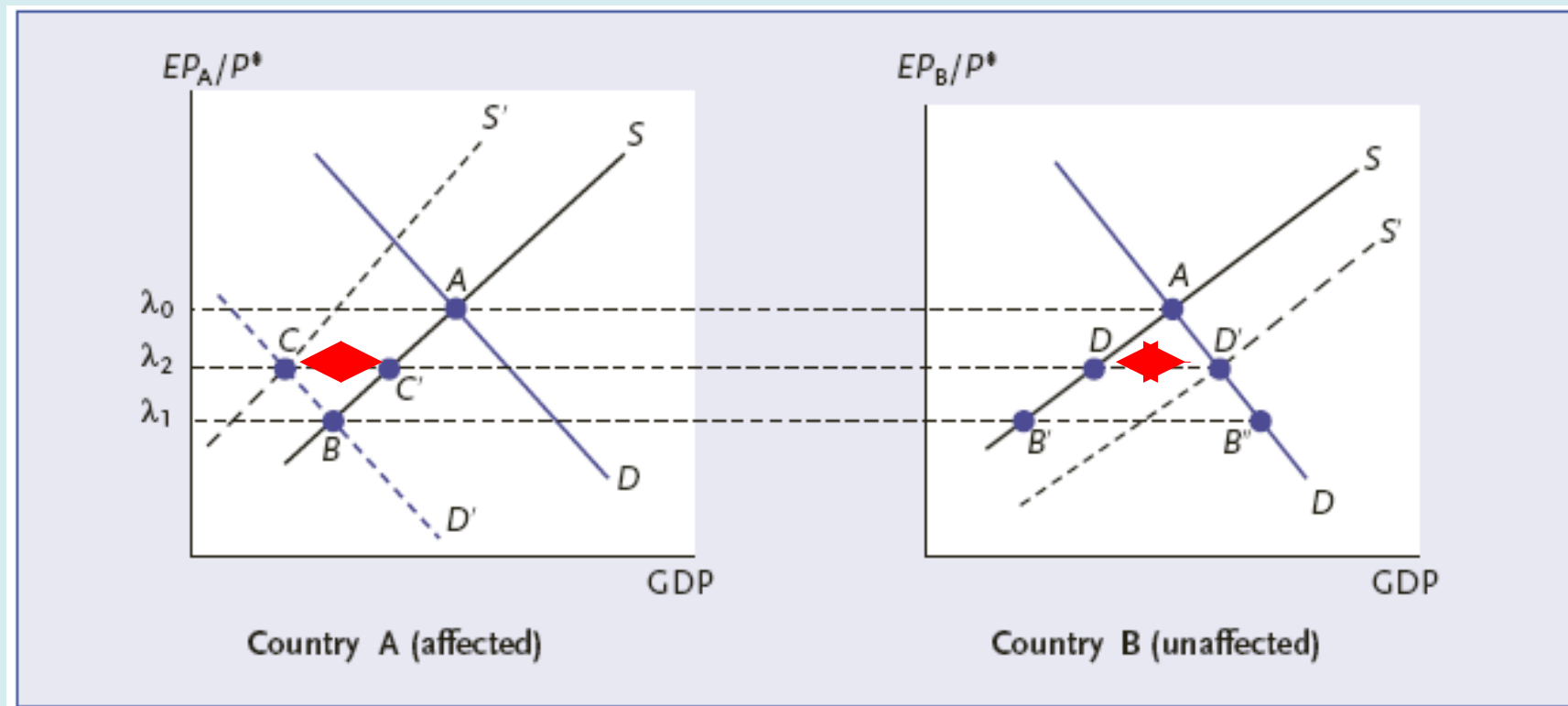
Asymmetric Shock

- Country B wants no change. Country A unhappy.



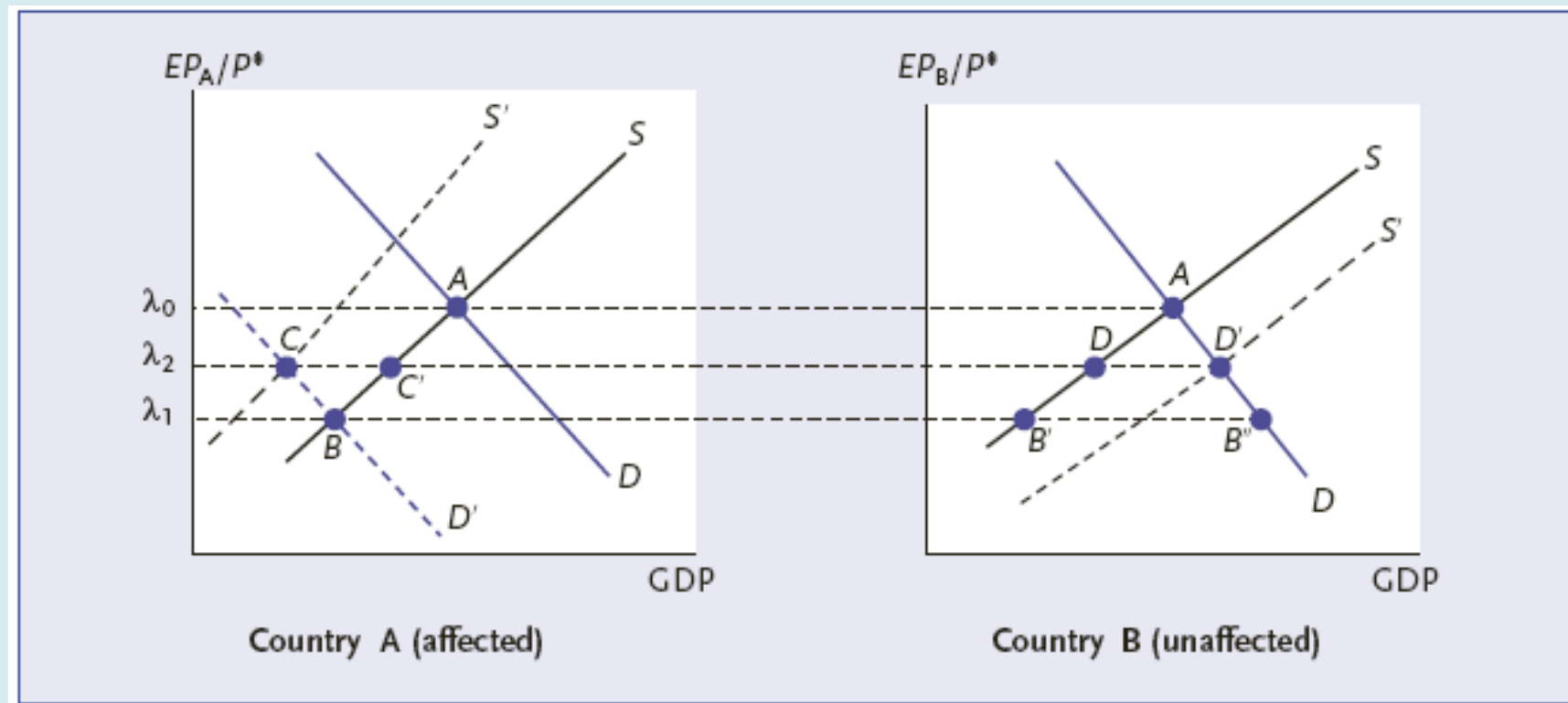
Asymmetric Shock

- Free floating of common currency: nobody's happy



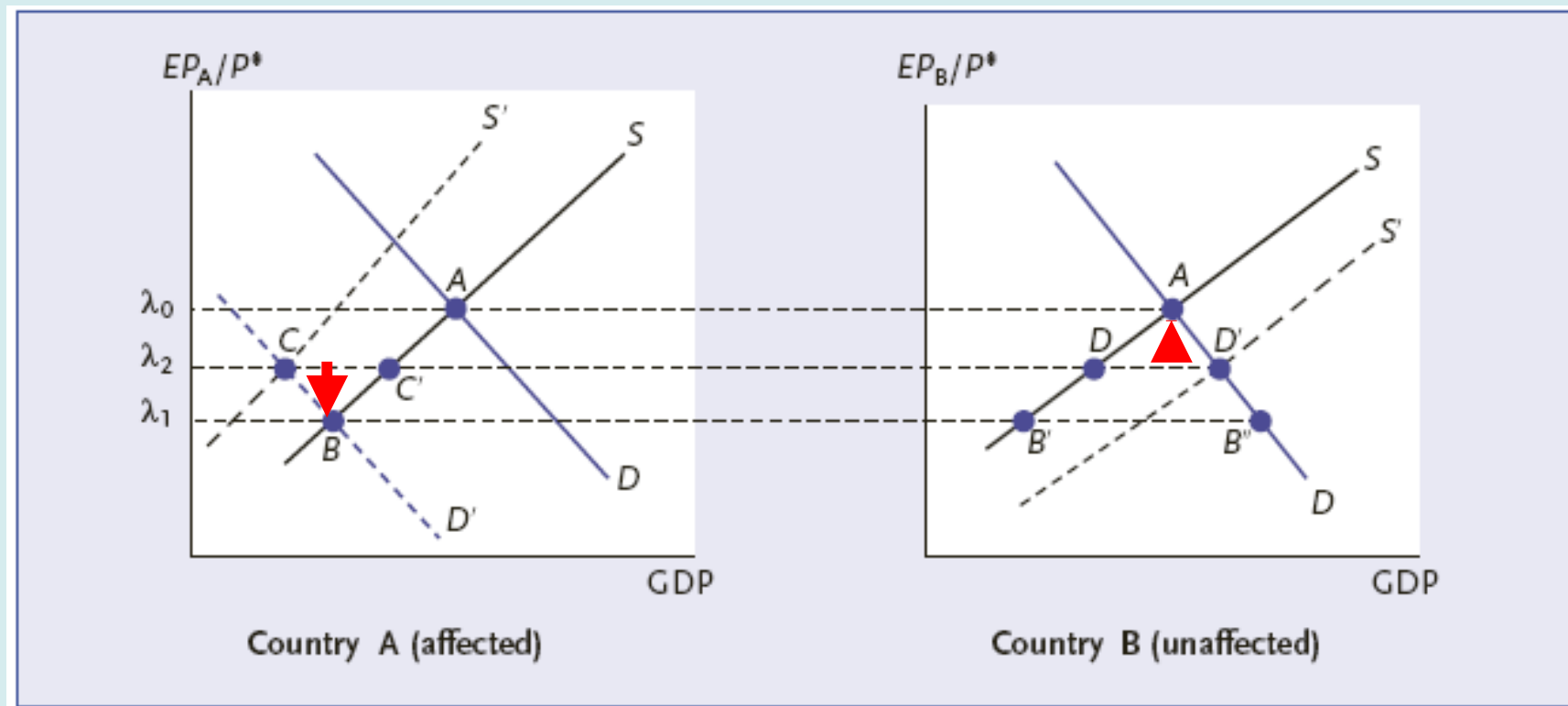
Asymmetric Shock

- Free floating of common currency: in the long, the problem is solved. **How?**



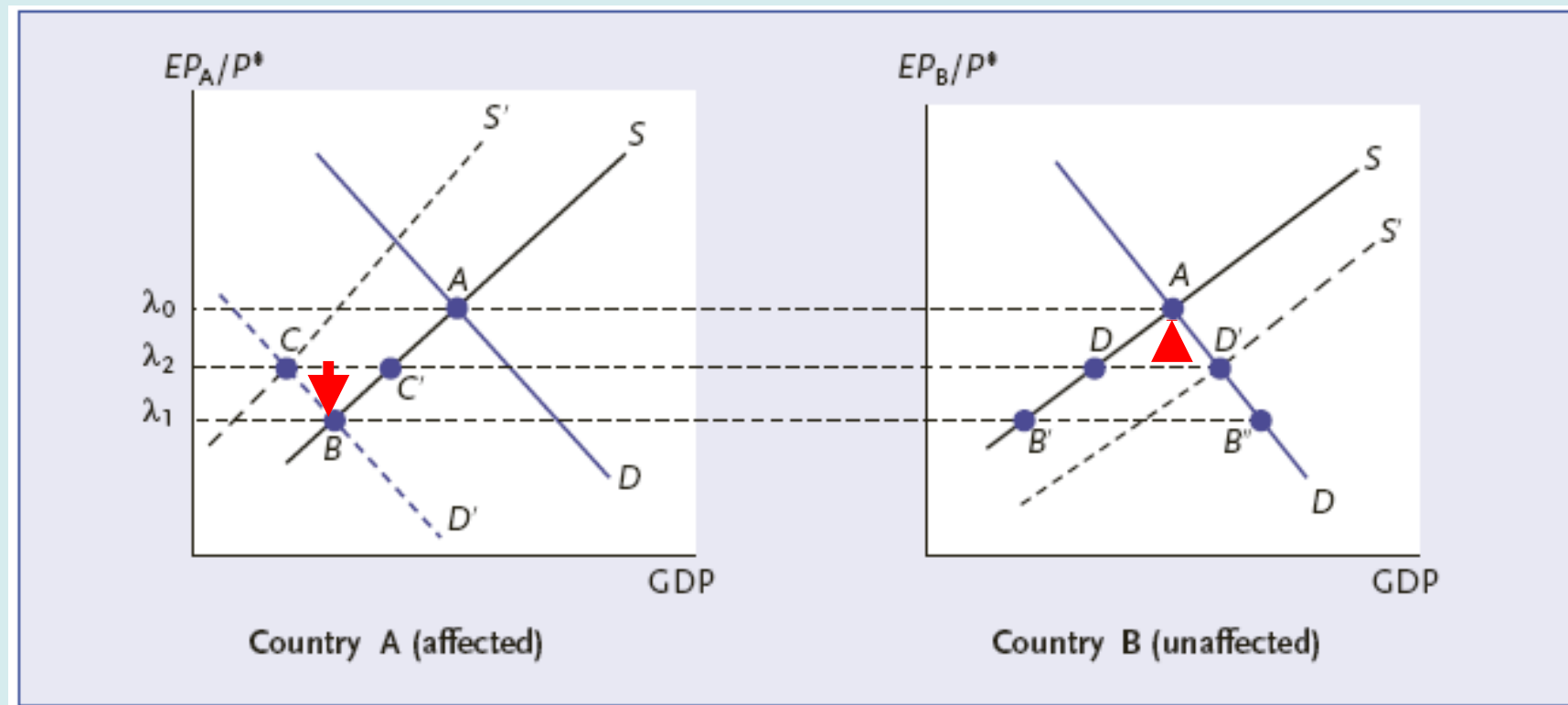
Asymmetric Shock

- Free floating of common currency: in the long, the problem is solved: **prices decline in country A**



Asymmetric Shock

- Free floating of common currency: in the long, the problem is solved: prices decline in country A and rise in country B



Six OCA criteria

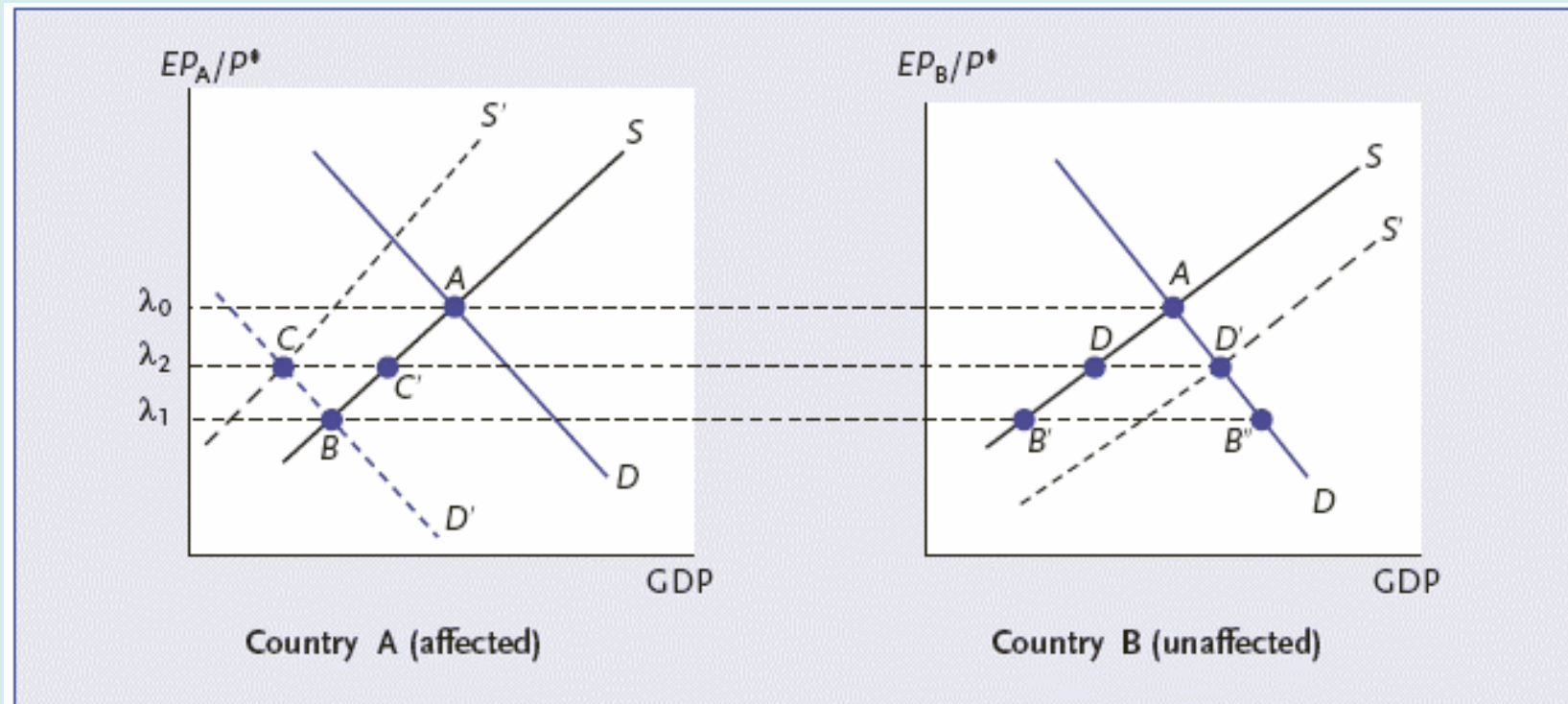
- Three classic (economic) criteria
 - Mundell
 - Kenen
 - McKinnon
- Three political criteria

Criterion 1 (Mundell): Labour Mobility

- In an OCA labour moves easily across national borders.

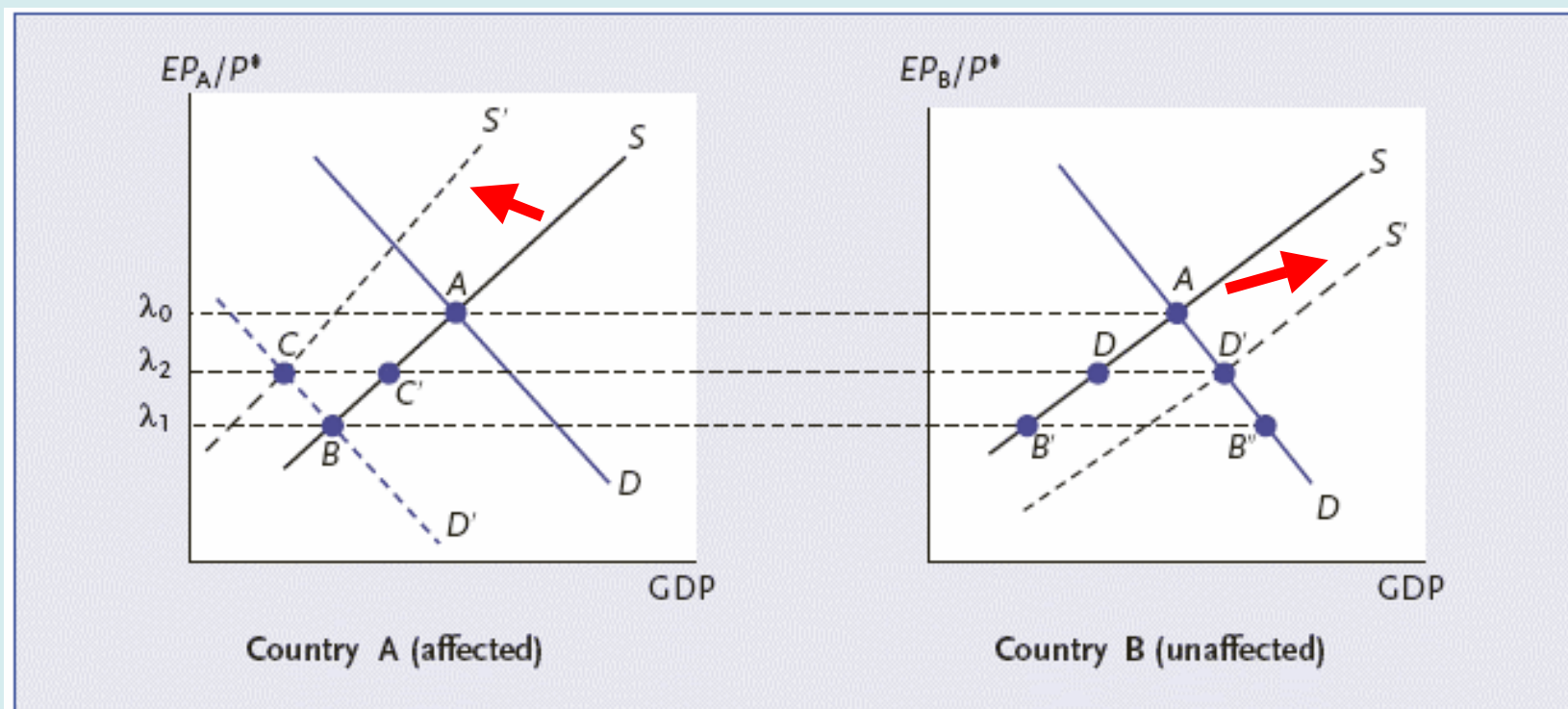
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- In an OCA labour moves easily across national borders.
- Caveats:
 - labour mobility is easy within national borders (culture, language, legislation, welfare, etc.)
 - capital mobility: difference between financial and physical capital
 - in presence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

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- 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.

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- 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.

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.

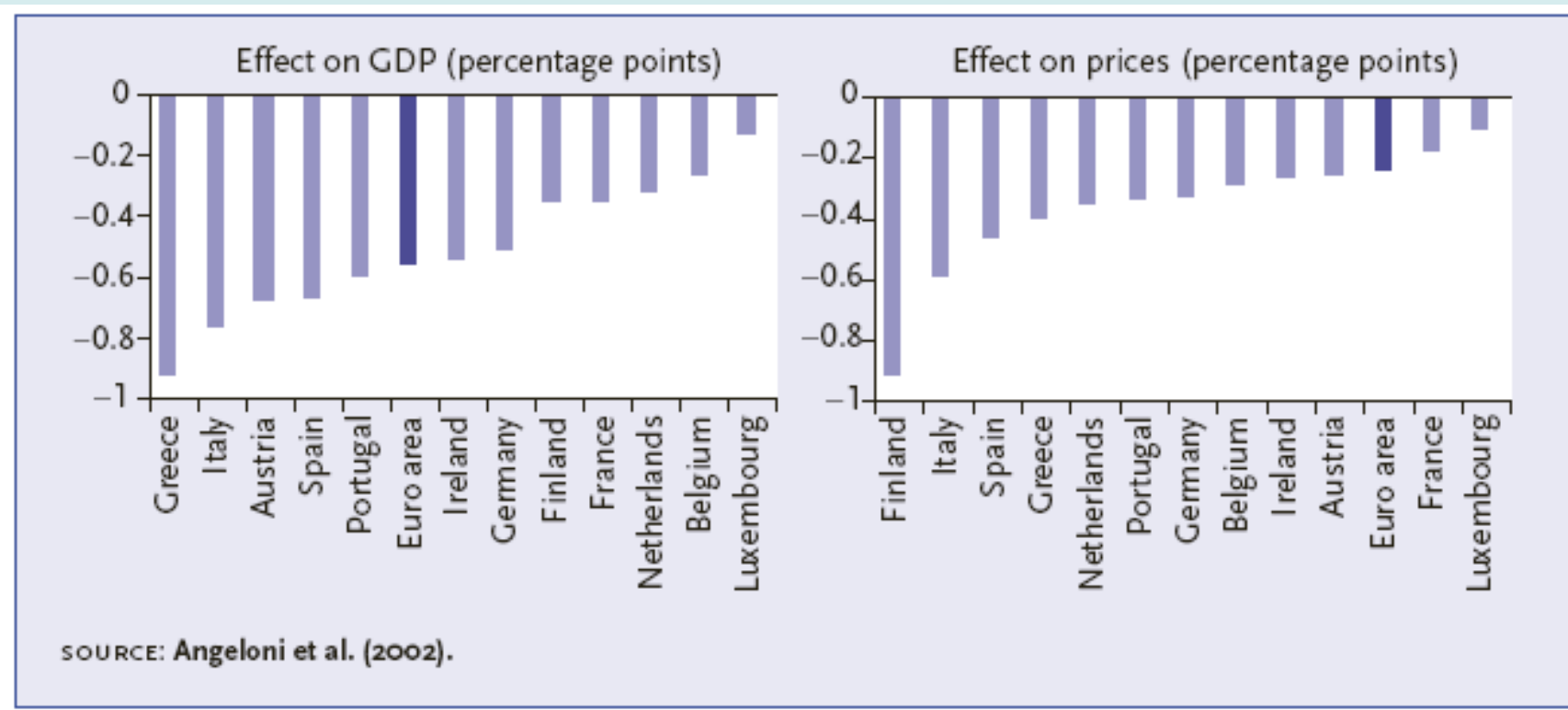
Is Europe An OCA?

- A synthetic OCA index.



Is Europe An OCA?

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



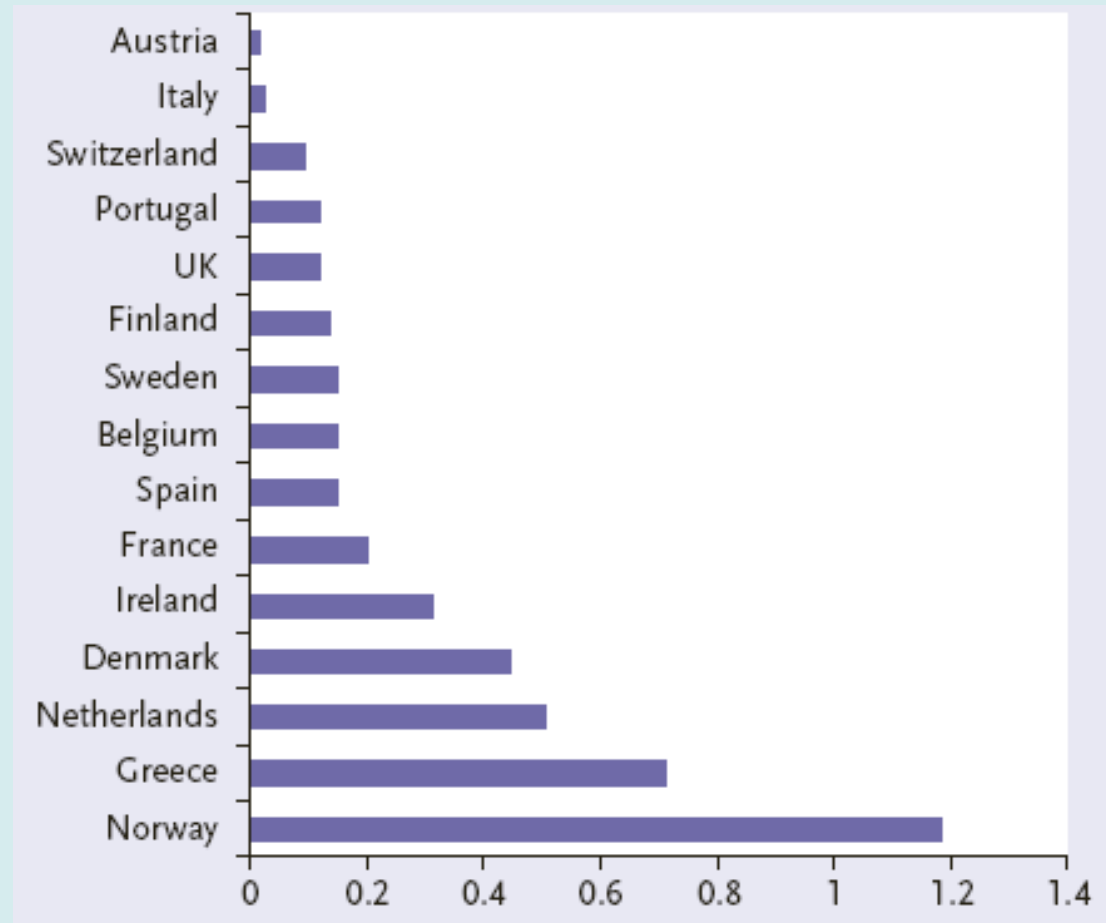
Inside the OCA Index: Openness

- 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.

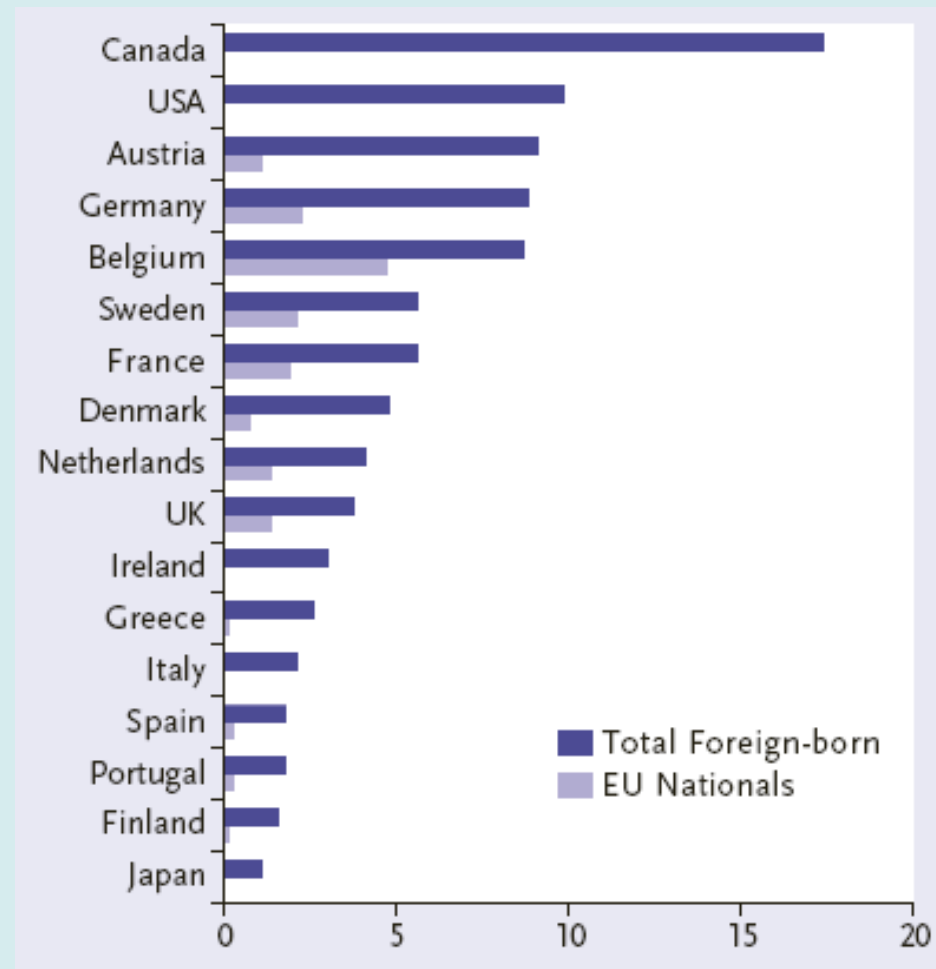


Inside the OCA Index: Labour Mobility (1)

- 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: 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.

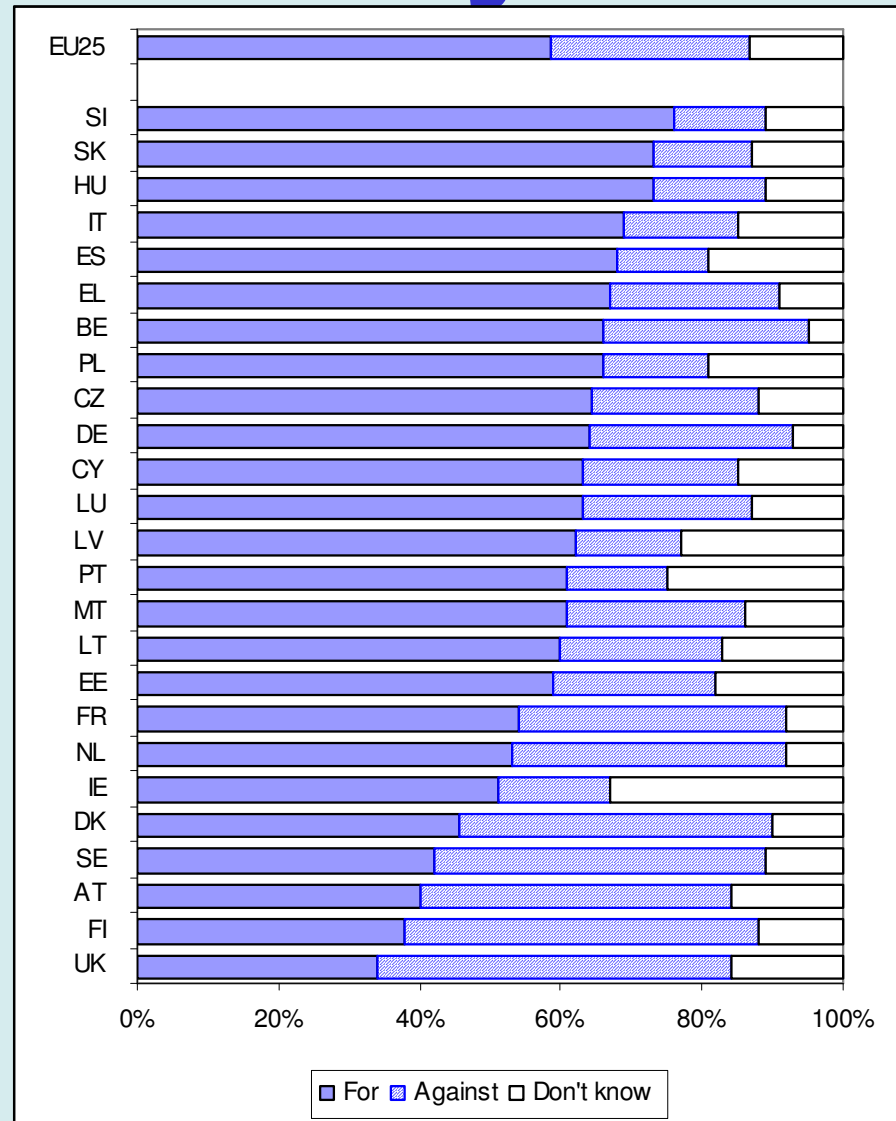
Inside the OCA Index: Homogeneity of Preferences

- 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.