

The European Monetary Union

The European Union is at a crossroads. This book analyzes the historical roots of the EU's monetary and financial institutions in order to better understand its struggle to maintain an economic and monetary union, as well as the ongoing problems facing the euro. The institutions of the EU are based on the operation of free markets, a common monetary policy, and the European Central Bank. These founding policies have created many of the imbalances at the root of the ongoing European recession. Reemerging threats of populism and localism are poised to further disintegrate the European construction and may spark fierce opposition between countries. Nicola Acocella engages with these risks, suggesting detailed actions for reform within the EU and its institutions that may steer it away from further conflict, allowing it to better serve its member states and citizens.

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Europe at the Crossroads

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*Dedicated to Andrew Hughes Hallett, an author of many
books and a coauthor of mine in some of them, who recently
died.*

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Preface

In this book we argue that the institutional setup for any instance of international coordination must be carefully designed in order to ensure effective and consistent working of markets and public institutions. This is a difficult task, as differences in terms of visions and interests are likely to be more pronounced between countries than at local levels. In fact, the policy orientation of different countries may diverge, also as a result of differences in past history and the weights of interest groups, whereas at least the common past history tends to reduce differences in policy orientations and the institutional choice within a country.

The book follows this line of argument. In Part I (Chapters 1, 2, and 3) we describe the historical and institutional background for the analysis of the imbalances – the object of Part II – that emerged over time, which are central to our inquiry. After having traced the path of European institutions built since the 1950s, we sketch those of the European Monetary Union (EMU) and the roots of the institutions in terms of the theories and the interests shaping them. This makes it possible to understand in Part II (Chapters 4–7) the imbalances that arose in the Union, descending from preexisting asymmetries as well as its institutions and the policies that were implemented. These imbalances led to the specific European features that compounded the financial crisis and its bad management in the Union. The final part of the book (Part III, which includes Chapters 8–11) first deals with the theoretical advances of the recent decades and then indicates our proposals for institutional and policy changes that descend from them.

In contrast to a common tradition and culture, based on largely similar philosophical and religious foundations, Europe has a history of fierce opposition and wars among national states that culminated in World War II. An important impulse to some kind of

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European cooperation came exactly from the attempt to counter this tradition of conflicts, even if the past was still weighing.

This largely explains the long process through which European institutions have reached their current state as well as their “incompleteness,” from the point of view of a more “mature” one, of the kind of a federalist structure. Incompleteness derives from a strong measure of persistent national and, thus, independent decision-making that interacts and overlaps with the common institutions and often dominates them.

The history of European institutions shows that there was an evolution in their coverage in terms of both content and features, especially with respect to the balance between public and private institutions. The realm of the initial cooperation, through the European Coal and Steel Community (1951), was limited, but this Community was characterized by active inter-country coordination and cooperation, with limits to free market. This orientation evolved into one almost of an opposite kind, the European Economic Community (usually called the Common Market) (1957), christening the predominant role of markets. The change seemed to be turned upside down again with the Werner Plan, which designed a wide spectrum of common policies, but was never implemented. Finally, the free-market orientation in all fields, with the exception of monetary policy and some constraints on national fiscal policies, returned with the Maastricht Treaty (1992). The European history, institutions, and policies until the establishment of the EMU are traced in Chapter 1.

The Maastricht Treaty originated the European Union (EU) and the European Economic and Monetary Union (commonly called the European Monetary Union). The former now gathers twenty-eight countries, pending implementation of the United Kingdom’s decision to withdraw. The latter had only eleven members when it started in 1999 and has now enlarged to nineteen. The institutional architecture of the EU is investigated in Chapter 2, which also underlines its possible faults. The EMU’s design is founded on a few common

institutions, a single currency, and the free operation of markets, as well as some harmonization of rules. All the other policy instruments are to be managed by the member states, with constraints on some policies, especially fiscal policy. Thus, most national borders are maintained. In the mind of the founding fathers of the Union, these common institutions were necessary and sufficient conditions for getting rid of frictions and the uneven distribution of resources and opportunities across the countries, thus resulting in a uniform process of growth of the whole Union.

The monetarist and new classical macroeconomics theories, popular at the time when the institutions of the EMU were devised, played an important role for the choice of the institutional design. However, the existing theories were only partly implemented (e.g., the requirements of the optimal currency theory were not satisfied) and later revisions of the accepted theories – asking for a different orientation of the initial institutions and current policies – have been ignored. Other factors, of the nature of vested interests, added to existing theories and can explain together with them both the institutional design and the policies implemented by the Union (Chapter 3).

This sequence of institutions developing in Europe brought progress in economic integration and possibly also some political success, such as banning of armed conflicts. However, with respect to the former, the increase in growth and employment of the first decades was followed by some kind of relative stagnation, starting in the 1970s and the 1980s (the so-called Euroclerosis). The lasting imbalances in the domestic and external accounts of each country that emerged when the Union began operating laid the ground for a crisis. This had certainly originated elsewhere but developed in forms and with an intensity that appear as built-in in the way European institutions were devised as well as in the different growth strategies pursued by the various countries (Chapter 4).

Then, the Great Recession came in 2008 and lasted – with a double dip – up to 2013–14 in Europe. This was the deepest

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depression suffered by advanced countries since the 1930s. Its consequences on indicators of macroeconomic and microeconomic efficiency and equity are investigated in Chapter 5.

The policies implemented and the differences with the United States are described in Chapter 6, adding to the negative consequences of the institutional differences.

Chapter 7, differently from the previous chapter, focuses on the consequences of the EMU institutional setup. It shows that the signals and information about the imbalances that can arise do not flow clearly and effectively across states, contrary to what happens within them, and are often noisy or carry wrong messages to markets and governments. Thus, they do not offer sufficient incentives for change in the right direction.

Chapter 8 starts from the observation that the theoretical foundations are largely outdated and have shown a number of faults. These can be summarized in the fact that there are frictions at work – which mainly derive from existing national borders – and adjustment issues that are not tackled, at least in a reasonably long period, by the single currency, free markets, and constraints on national policies.

The chapter suggests the broad lines along which the EMU could be reformed and indicates different growth and short-term strategies for the institutions as well as macroeconomic and microeconomic policies. It must certainly be realized that the economic performance in Europe has been nourished not only by the inadequacies in the Monetary Union institutions but also by the way European policymakers, at all levels, operated, first in facilitating the development of the Great Recession in Europe and then in compounding its solution. In fact, the policies implemented to face the recession can make it clear why it prolonged beyond the period over which it hit the United States. Thus, the possible benefit of avoiding military confrontation between European countries must be balanced against the rising populism and resentment of some European countries against the others as a consequence of the clear insufficiency of European institutions and policymakers in dealing

with the crisis. Institutions (and policies) can have lasting negative political consequences on the future of the Union. The need then arises for a deep reform of the EMU.

Chapters 9 and 10 outline, respectively, necessary changes to the existing macroeconomic and microeconomic institutions and policies. The reforms should radically change the balance of powers between the Union and the country level as well as reliance on the different policy tools.

Chapter 11 closes the book. It deals with two polar cases in the Union institutions. The first one discusses radical changes in the structure of the EMU, including the possibility of its breakup. The second deals with the prospect of political and institutional changes that reinforce the existing structure, in particular with reference to solutions for overcoming its democratic deficit.

The focus of the book is on institutions, on how they orient and constrain policies as well as on how they determine the economic performance, namely microeconomic and macroeconomic imbalances. As to policies, most attention is devoted to macroeconomic tools, but microeconomic policies also are considered as a necessary complement of macroeconomic instruments. The need for this is clear when one thinks of the complementarity between wage policy and other labor market policies or between microeconomic and macroeconomic regulation, or of industrial and regional policies as instruments for addressing the microeconomic imbalances that are behind the macroeconomic ones, or, finally, of the implications for antitrust legislation of differences in the tax treatment of companies as between different countries.

The book should be easy to follow by any reader having a basic knowledge of economics.

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Abbreviations

AMIF	Asylum, Migration and Integration Fund
APP	Expanded Asset Purchase Programme
ARRA	American Recovery and Reinvestment Act
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CAC	Collection Action Clause
CAP	Common Agricultural Policy
CEEC	Central and Eastern European countries
CF	Cohesion Fund
DMC	Domestic Material Consumption
DSTI	Debt service-to-income ratio
EBA	European Banking Authority
ECB	European Central Bank
ECU	European Currency Unit
EDA	European Debt Agency
EDIS	European Deposit Insurance Scheme
EEC	European Economic Community
EFB	European Fiscal Board
EFSF	European Financial Stability Facility
EFSI	European Fund for Strategic Investments
EIF	European Integration Fund
EMF	European Monetary Fund
EMFF	European Maritime and Fisheries Fund
EMS	European Monetary System
EMU	European Economic and Monetary Union
ERDF	European Regional Development Fund
ERM	European Exchange Rate Mechanism
ESBs	European Safe Bonds

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ESCB	European System of Central Banks
ESF	European Social Fund
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
ETS	Emissions Trading System
EU	European Union
EZ	Eurozone
FEAD	Fund for European Aid to the Most Deprived
FG	Forward Guidance
GSE	Government-sponsored enterprise
ICN	International Competition Network
IMF	International Monetary Fund
LSAP	Large-scale asset purchases
LTRO	Long-term refinancing operations
LTV	Loan-to-value
MBS	Mortgage-backed securities
MFF	Multiannual Financial Framework
MIP	Macroeconomic Imbalance Procedure
NAIRU	Nonaccelerating inflation rate of unemployment
NAWRU	Nonaccelerating wage rate of unemployment
NCBs	National Central Banks
NPL	Nonperforming loans
NTBs	Nontariff barriers
OCA	Optimal currency area
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Cooperation
OMT	Outright Monetary Transactions
QE	Quantitative easing
REs	Rational expectations
RES-E	Renewable energy sources
SBBS	Sovereign bond-backed securities
SEM	Single European Market

SGP	Stability and Growth Pact
SMP	Securities Markets Programme
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TARGET2	Trans-European Automated Real-time Gross Settlement Express Transfer-2
TARP	Troubled Asset Relief Program
TINA	There is no alternative
TLTROs	Targeted longer-term refinancing operations
WTO	World Trade Organization
ZLB	Zero lower bound

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