

European Union Politics

SESSION 5: ECONOMIC AND MONETARY UNION

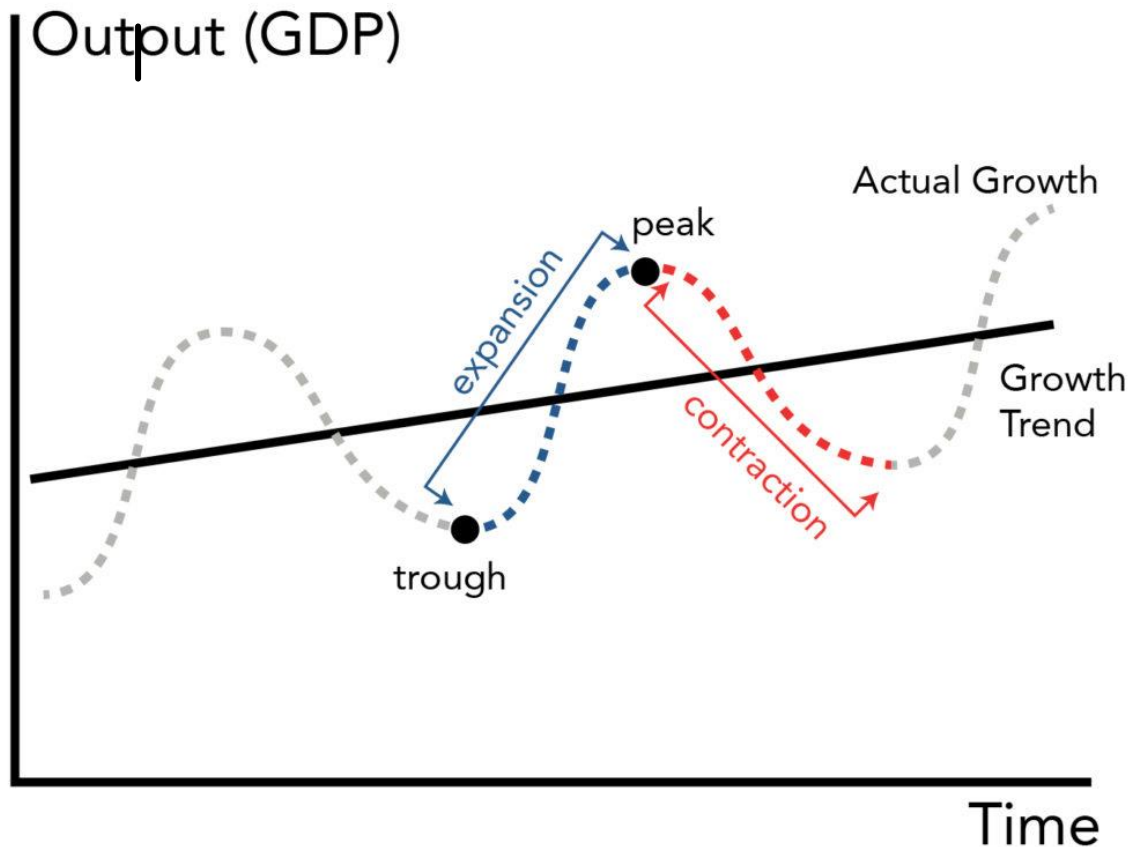
What is what...

- ▶ **Monetary policy** = supply of money (printing) – interest rates (lending/borrowing money), operations to maintain *currency* stability, exchange rate
- ▶ **Fiscal policy** = amount of money (*budget*) – government spending & taxation
- ▶ **Sovereign debt** – *total* public debt owned by governments
- ▶ **Public deficit/surplus** – how much governments lose/earn *annually* (are we in - or in +?)
- ▶ **'Bail-out'** – external financial assistance to bank or government which ran out of money



Economic cycle

GOVERNMENTS aim to:



- ▶ Stimulate **economies in contraction** through $\uparrow$ *money supply*
 - **Fiscal policy:** lower taxes, increase public spending: subsidies, economic stimuli for starting companies, investment (--> increase debt)
 - **Monetary policy:** print money (inflation), cut interest rates – cheap to borrow from the state
- ▶ Control **economies in expansion** from overheating through $\downarrow$ *money supply*
 - **Fiscal policy:** increase taxation, cut spending (save money --> decrease debt)
 - **Monetary policy:** stop money supply (reserve), increase interest rates (expensive to borrow from state)

Fiscal Policy Types, Objectives, and Tools

EXPANSIONARY
FISCAL POLICY

VS

CONTRACTIONARY
FISCAL POLICY

Government
spending

Taxes

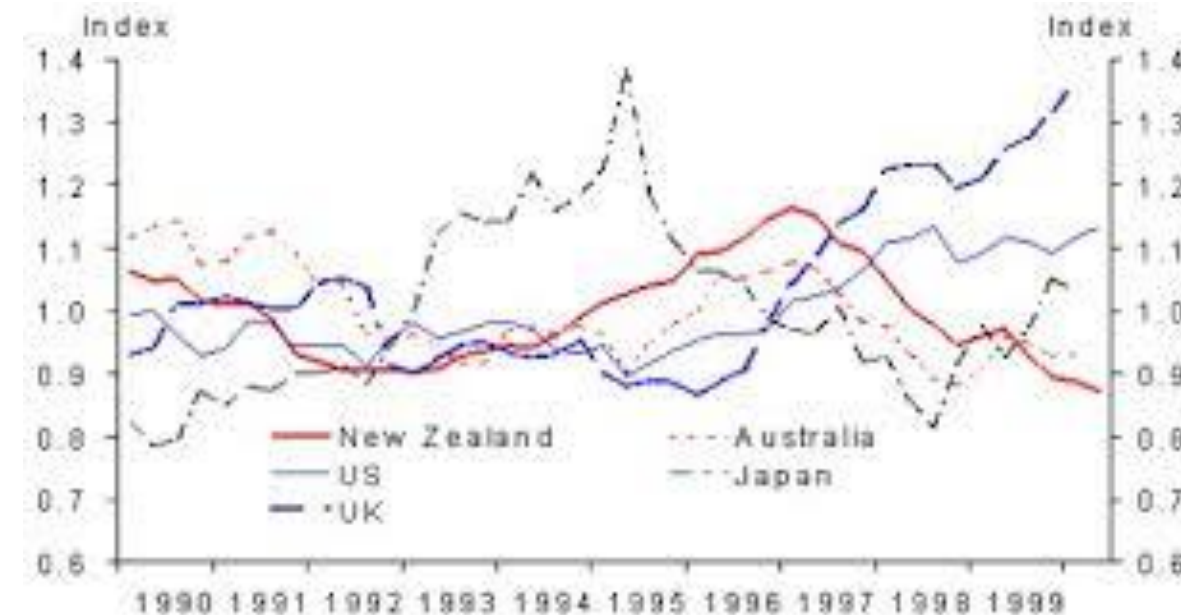
Government
spending

Taxes



National economic cycles and inter-national trade

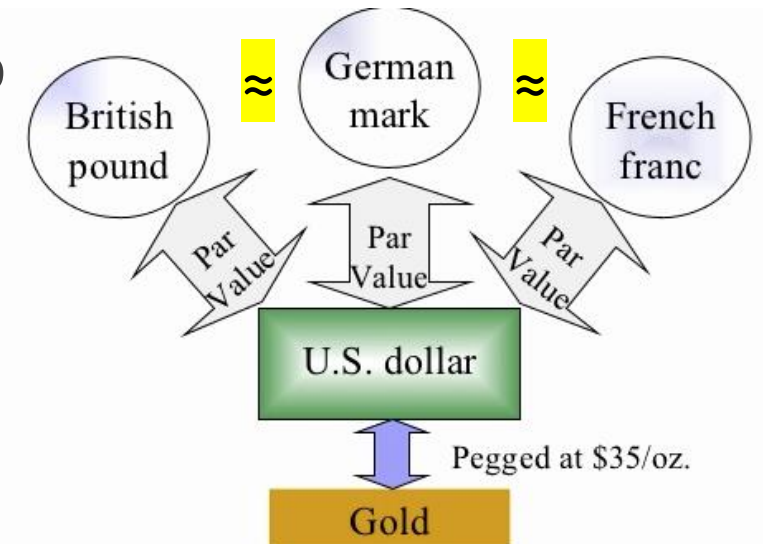
- ▶ At any one time: **different countries** are in --> **different phases of the economy cycle**
- Country 1 with a contracting economy will conduct the opposite fiscal and monetary policies of country 2 with a booming economy
- **Country 1 in contraction = “cheaper” money**
- **Country 2 in expansion = “expensive” money**
- ▶ **Diverging exchange rates** = problem
for international trade
- ▶ **TOO MUCH RISK TO TRADE** when I can't estimate
if I'll **profit** or **lose money** once I convert foreign
currency to my own $\backslash(\text{ツ})/_/$



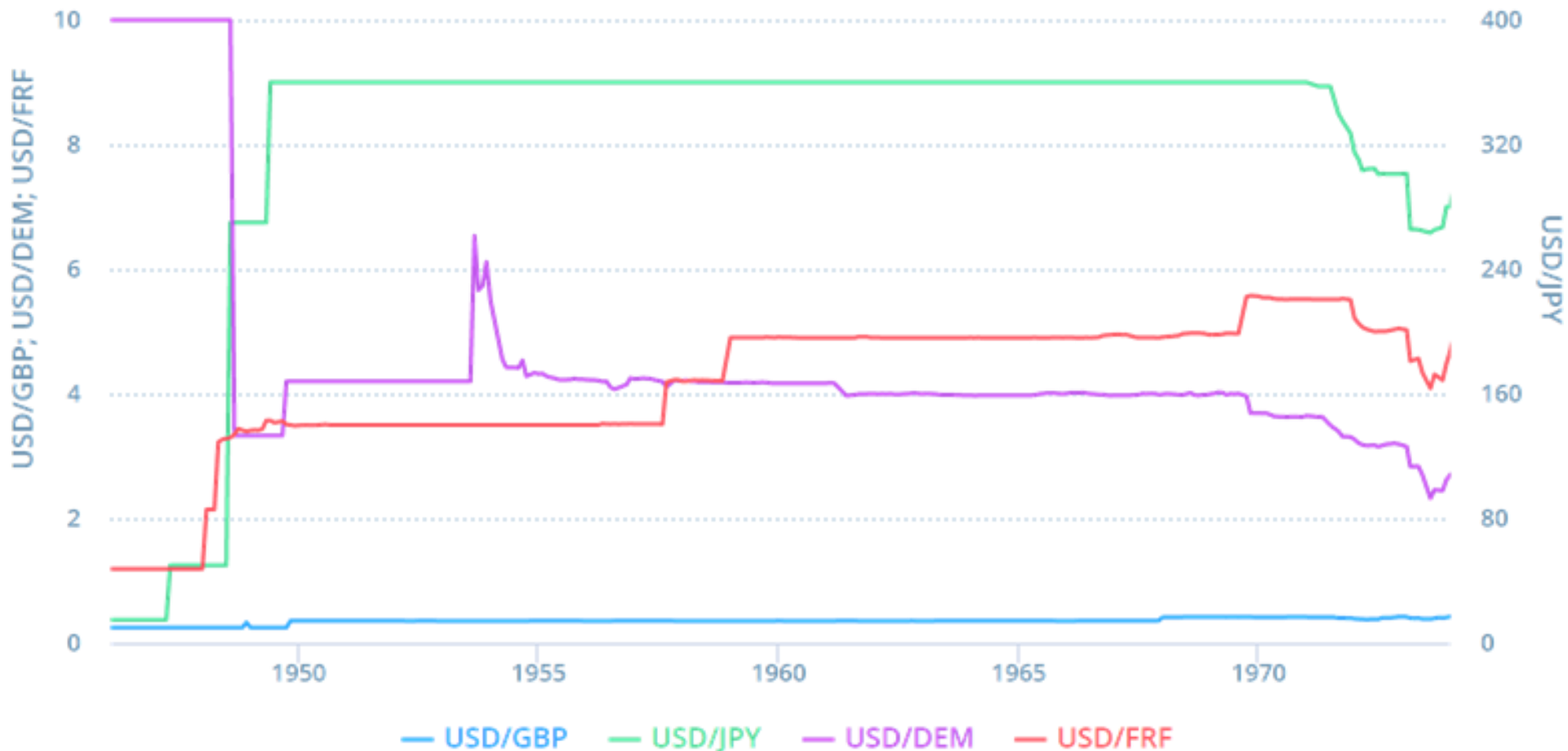
Post-WWII international trade

► The Bretton Woods system

- Principles and institutions to regulate international monetary regime
 - Currencies tied to **gold standard** with **USD \$ as the anchor**
 - States to keep their exchange rates +/- 1% currency value to USD
 - **RESULT:** all currencies in the system “pegged” to the dollar have **exchange rate convergence** ≈ pretty stable
 - Institutions to help manage deficiencies: IMF, World Bank
- US \$ **free-floated** in 1971 as an aftermath of Middle East oil shocks



Stable exchange rates under the Bretton Woods system

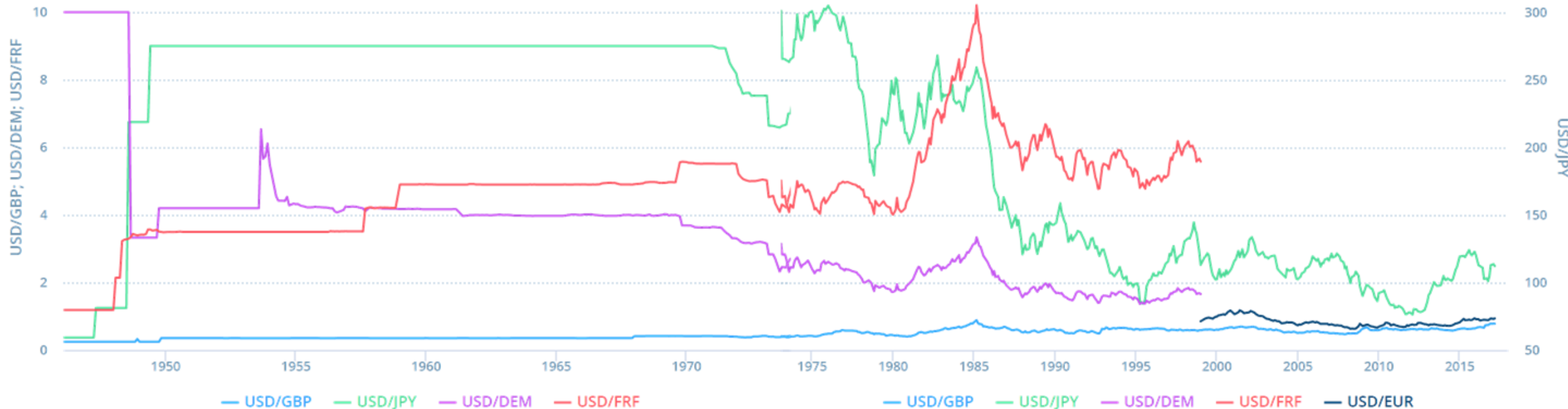


US \$
= price stability

--> Other countries
intervene to
maintain a **“fixed”**
exchange rate to
dollar

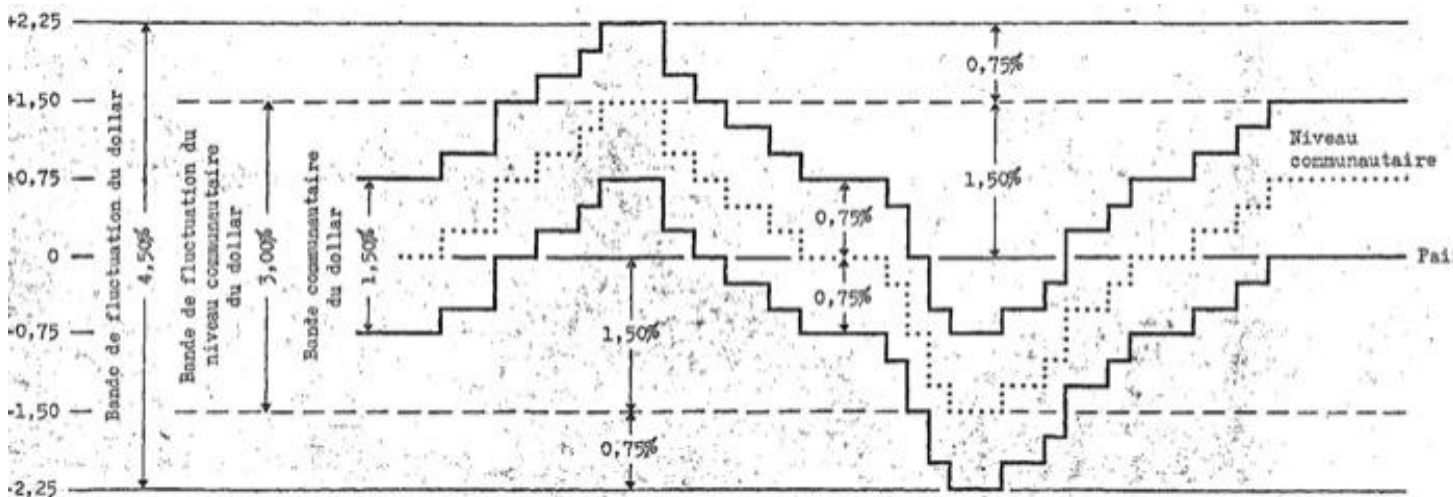
End of Bretton Woods system 1971

-- > Free float currencies and exchange rates



“Snake in the tunnel” (Basel agreement) ended in 1972-1973

- ▶ After Bretton Woods system collapse – **Smithsonian agreement** +/- 2.25% to \$ (possible 4.5% difference, over time 9%!!!)
- ▶ Too excessive for EEC --> “**Snake in the tunnel**”
- ▶ Follow **American \$ “peg”** within a **tighter BI-LATERAL** range of 2.25 (possible 2.25% difference, over time max 4.5%)



1979 European Monetary System

- ▶ Creation of a **European “peg”!!!**
- ▶ An artificial accounting unit – **ECU** –
European currency unit
- **weighted average** = internal “peg” for regional currency movements (not external American \$)
- based on a “**basket of currencies**” weighted according to their values
- **de facto**, anchored by the **Deutsche Mark**
- ▶ **Exchange Rate Mechanism (ERM)**
- fixed exchange rate **margins $\pm 2,25\%$**
- counted from a grid of bilateral rates calculated on the basis of these central rates expressed in ECUs / consensual

13-Mar-1979 through 16-Sep-1984			
ISO	Currency	Value	Weight (%)
BEF	Belgian Francs	3.80	9.64
DEM	German Marks	0.828	32.98
DKK	Danish Kroner	0.217	3.06
FRF	French Francs	1.15	19.83
GBP	British Pounds	0.0885	13.34
IEP	Irish Punt	0.00759	1.15
ITL	Italian Lira	109	9.49
LUF	Luxembourg Francs	(*)	(*)
NLG	Dutch Guilders	0.286	10.51
ECU			100%

Optimal currency area (in theory) aka common currency

In theory “countries will form an OCA if benefits exceed the costs”

COST:

- ▶ **Loss of monetary policy independence** – due to hard fixed exchange rates
- ▶ **“One size fits all” monetary policy** – **not good** for countries in asymmetric economic cycles..

HOWEVER, these asymmetries could be addressed by other means:

- ▶ **Labour mobility** between countries (free movement of labour)
- ▶ **Capital mobility** (and wage flexibility) between countries
- ▶ **Fiscal transfers** between richer and poorer regions
- ▶ **Budget deficits**

1989 Delors' Report



► 4 elements of an economic union

1. Single market ✓
2. Competition policy ✓
3. Cohesion ✓
4. **Macroeconomic policy coordination** (needed)

Depth of integration



Stages of **ECONOMIC INTEGRATION**:

- Preferential trading area
- Free trade area
- Customs union
- **Common market**
- **Economic and monetary union**
- Complete economic integration

Economic and Monetary Union (EMU):

“the assurance of total and irreversible convertibility of currencies; the complete liberalization of capital transactions and full integration of banking and other financial markets; and the elimination of margins of fluctuation and the **irrevocable locking of exchange rate parities**” ([p.14](#))

Economic and Monetary Union

► PROS:

- elimination of **exchange rate uncertainty** = **stability**
- saving on **transaction costs** (of doing business in several countries)
- increased **price transparency** – spurs competitiveness across the internal market

► CONS:

- European Union is **NOT** an **optimal currency area!**
- economic disturbances affect different member states differently
- **the labour and goods market** is not as flexible as it would be desirable
- **European Union budget is too small** to cover large **fiscal transfers**



Delors' Report: steps towards EMU

▶ Economic and Monetary Union in three stages!

1. Stage I: liberalization of capital movement (begin July 1990)
2. Stage II: margins in ERM progressively narrowed to 1% + ECB (est. 1994-5)
3. Stage III: **fixation of exchange rate parities** and transfer of responsibilities onto EC institutions ▶ **European Central Bank**

▶ European Central Bank

- Be a single, **independent** institution
- Maintain **price stability**
- Manage foreign exchange operations and foreign reserves of the MS, ensure smooth operation of payments system

▶ Germany insisted on **economic convergence!**

...to optimize the currency area

Macroeconomic convergence

fiscal policies coordination

Maastricht (treaty) criteria 1993

Also known as the “*convergence criteria*,” harmonizing macroeconomic performance of countries wishing to enter into *Stage III* of EMU:

1. **Price stability:** inflation not higher than **1.5%** above the best three MS's annual average
2. **Annual government deficit:** must not exceed **3% of GDP**
3. **National debt:** ratio of gross government **debt to GDP** must not exceed **60%**
4. **Exchange rate:** joining the ERM II for two consecutive years without currency devaluation
5. **Interest rate:** long-term interest rates (on 10-year govt. bonds) must not be more than 2% higher than the three lowest MS



Steps towards EMU



European level: **monetary policy**

- ▶ Responsibilities of **ECB**
 - **Independent**
 - **Maintain price stability** - *keep inflation below but close to 2% - and euro's purchasing power*
 - Money supply: **authorize issuing of euro notes and coins** (through national central banks)
 - Formulate and implement **monetary policy**
 - Formulate and execute exchange-rate policy
 - **Manage foreign reserves of MS**
 - Set basic **interest rate** for the Eurozone
 - Monitor, assess and advise national authorities



European level: monetary policy

- ▶ NOT responsibilities of ECB
 - **NOT a lender of last resort** – ECB cannot wield system-wide debt instruments; Maastricht treaty contains an explicit ‘**no bail-out**’ clause!
 - **Does NOT create or issue EU-wide ‘bonds’** (treasury bills) as there is no collateral – **national banks issue bonds** in Euro denomination
 - **Does NOT have exclusive control over economic stability** in the Eurozone – shared together with MS

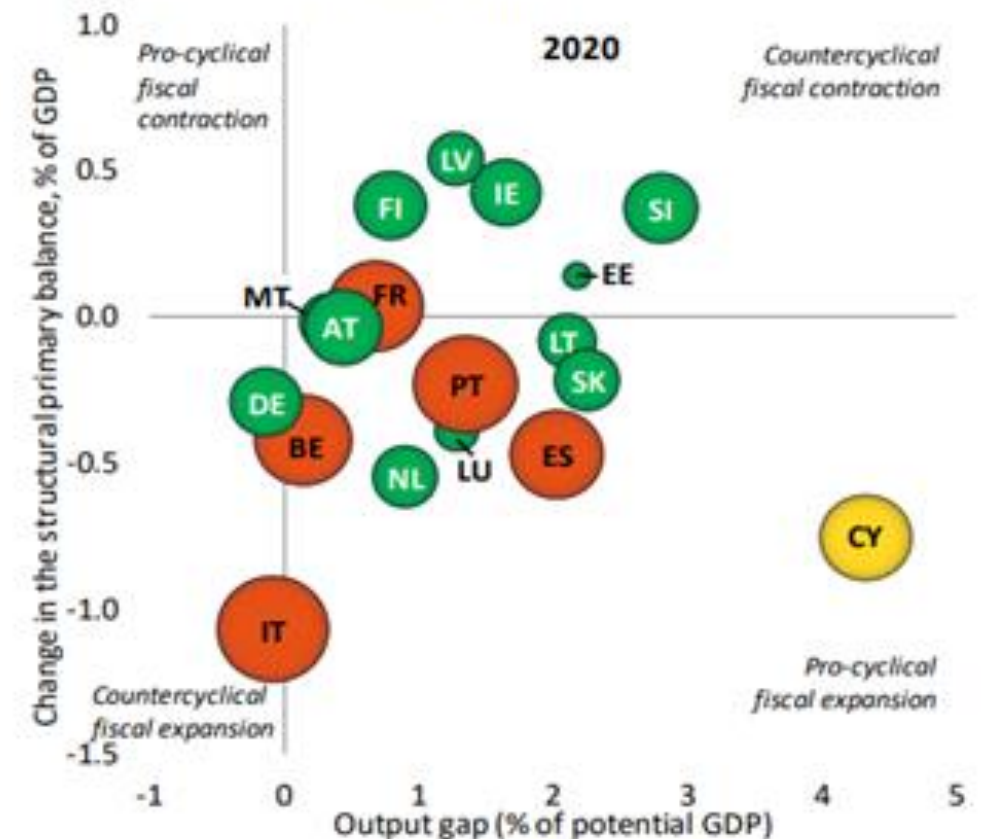


Member state level: 27 fiscal policies

27 kinds of:

- ▶ **Taxation and public spending** (employment, social policies, welfare, investment etc.)
- ▶ Sale of national **treasury bonds** (borrowing in international financial markets)
- ▶ **Regulatory oversight of the banking sector** (licenses, stock, competition)

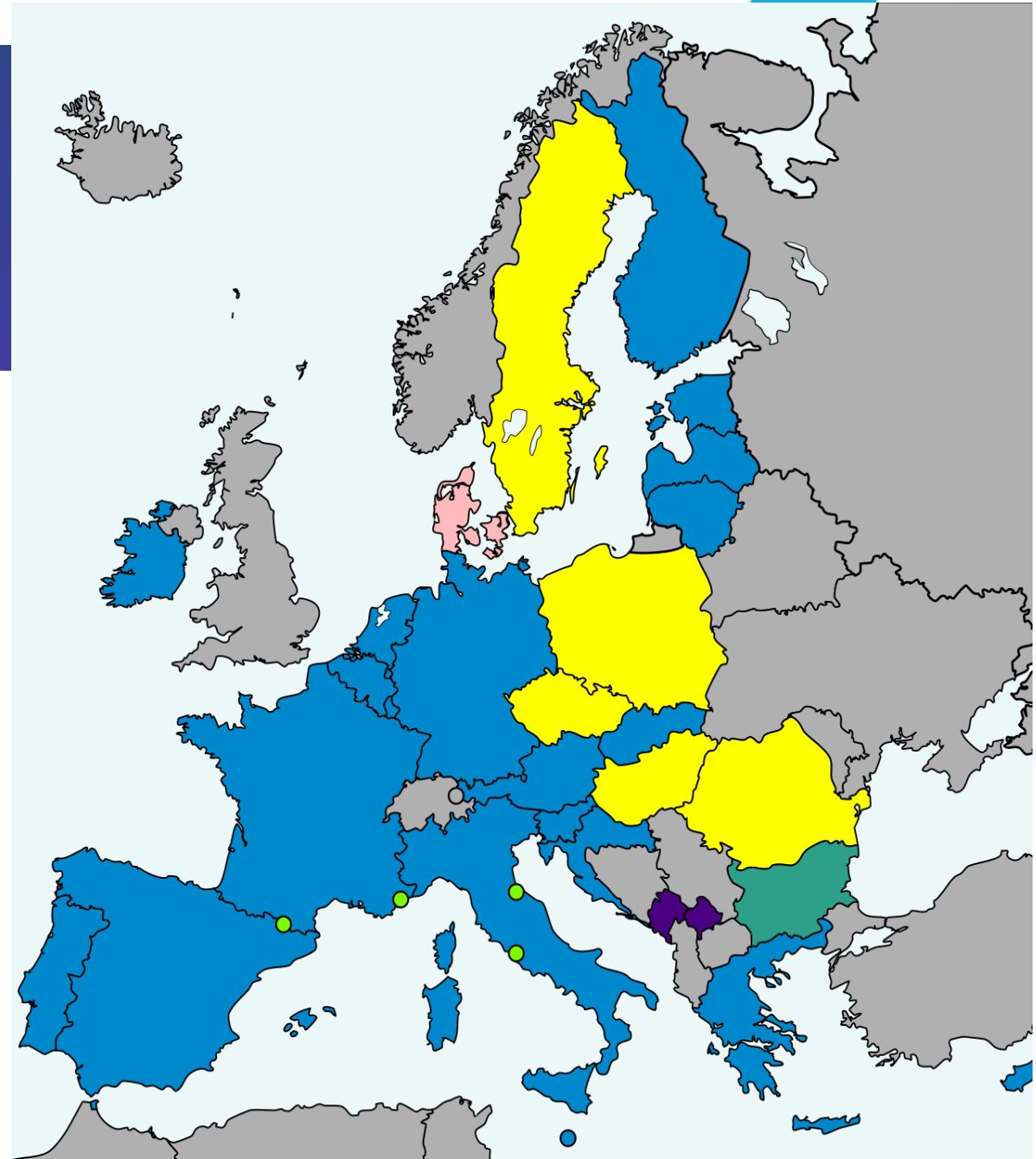
Fiscal stance, cyclical conditions and sustainability in euro area Member States in 2019/2020



1999 Eurozone

(banknotes and coins since 2002)

- ▶ 11 countries in 1999
- ▶ **20 countries today**
- ▶ 20 Eurozone members
- ▶ 1 member in ERM II (Bulgaria)
- ▶ 1 member in ERM II (Denmark with opt-out)
- ▶ 5 members not in ERM II (obliged to join)
-
- ▶ 4 microstates
- ▶ 2 states unilaterally using the Euro





Euro impact

- ▶ Coins and banknotes introduced in January 2002
- ▶ Logistical and informational challenge (print & distribution, adjusting ATMs, prevent counterfeiting, double price tags etc.)
- ▶ **Euro 'brought home' the extent of European integration**

- ▶ Touchy legitimacy of the ECB
- ▶ Modest economic growth followed since its launch
- ▶ Cross-border shopping increased



- ▶ **Benefits to transnational trade were exaggerated**
- ▶ Business and consumer spending did not rise dramatically
- ▶ Nor did prices converge across the Eurozone (vastly different taxation policies across the zone)



ECB **monetary** policy

MS **fiscal** policies



- ▶ In economic theory, **monetary policies** tend not to work if separated from **fiscal policies**
- ▶ **Only together** can they balance among **price stability** (inflation), **employment** and **economic growth** (stagnation)
- ▶ **‘One size fits all’?** The same monetary policy affects Germany, Italy and Slovakia differently (economies of different size, cycle and composition)
- ▶ European Union is **NOT a transfer union**! Its **budget** is just 1.5% GDP, money spent in CAP and Cohesion is not enough to truly boost growth
- ▶ **Labour mobility** is not enough either



Stability and Growth Pact (1997)

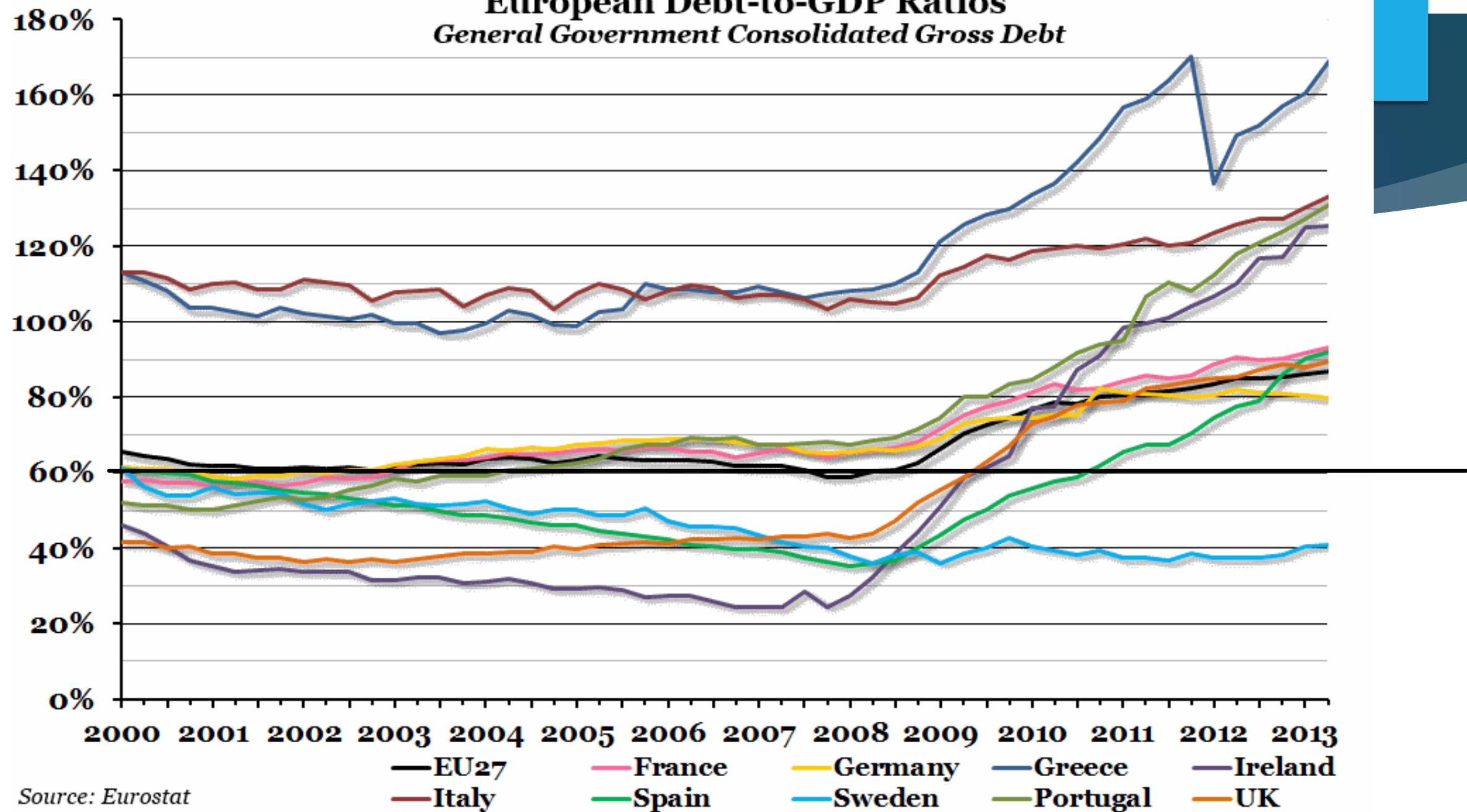
..in the Treaty of Amsterdam



- ▶ Rules to **keep compliance with the Maastricht convergence criteria even after adoption of the Euro** – to keep economies of the Eurozone aligned
 - ▶ Intended to ensure the **sustainability of the single currency** by continuation of **budgetary discipline** – good fiscal health
- **Budgetary ‘peer review’ in Eurogroup (Council of EU)**
- Annual government **deficit < 3% GDP, debt < 60% GDP**
 - ECOFIN Council may invoke an ‘**excessive deficit procedure**’ by QMV --> European Commission should have **fined EU members sporting a big national debt!**

European Debt-to-GDP Ratios

General Government Consolidated Gross Debt

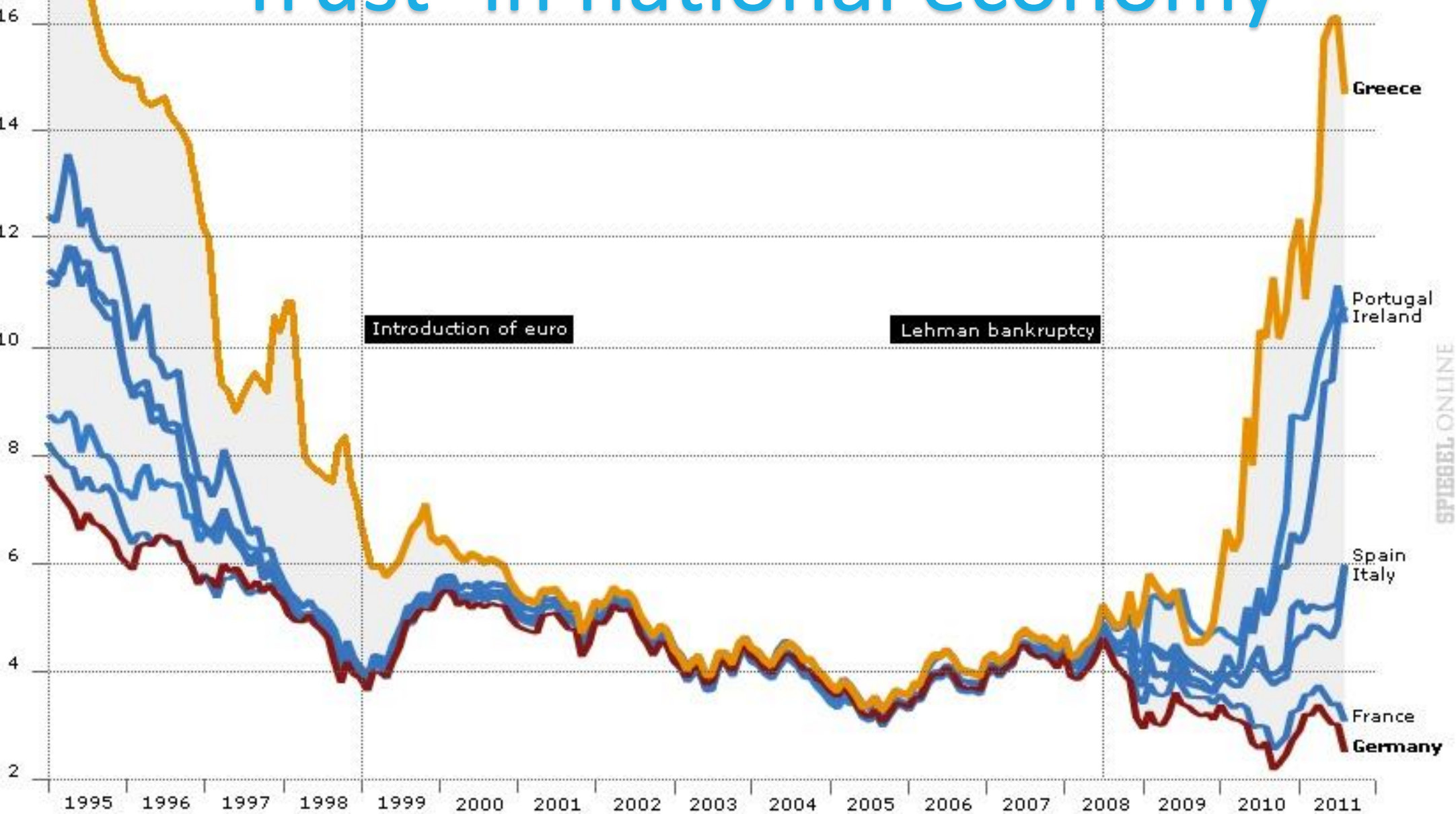


Source: Eurostat

Development in Interest Rates on 10-year Government Bonds

in percent

'Trust' in national economy



SPIEGEL ONLINE

The Stability and Growth Pact

2002/3 recession

- ↑ **Ireland:** budgetary surplus of 4.6% ↓ **Germany:** strained budget - unification was still an issue
- 2001 – Commission criticised Ireland for having loosened its fiscal policy
 - 2002 – Commission criticised Portugal for sporting a deficit of 4.2%
 - 2003 – Even France and Germany ‘broke’ the SGP through rising national deficits to more than 3%

Romano Prodi (Commission President at the time):

“in times of recession, governments should be able to spend and borrow money to promote growth, rather than having to abide by the strictures of the pact” + he called the Pact **stupid...**

- 2004 – ECJ overturned the Council decision not to sanction but **damage was done**
- 2004 – it was revealed Greeks cheated in statistics to get into the Eurozone...





2008 financial
crisis spills
over from the
US to EU

The Crisis in EMU

- ▶ Global recession triggered in the US when a housing bubble burst in 2008 causing ----> a **global “credit crunch”** (= shortage of credit/money supply)
- ▶ Eurozone was/is **only partially integrated!**
- ▶ Some members (GER, FR) broke the rules of the ***Stability and Growth Pact*** (Maastricht criteria) even before the crisis (because they themselves voted against their own punishment on ECOFIN Council!)
- ▶ Not all heavily indebted countries are the same!

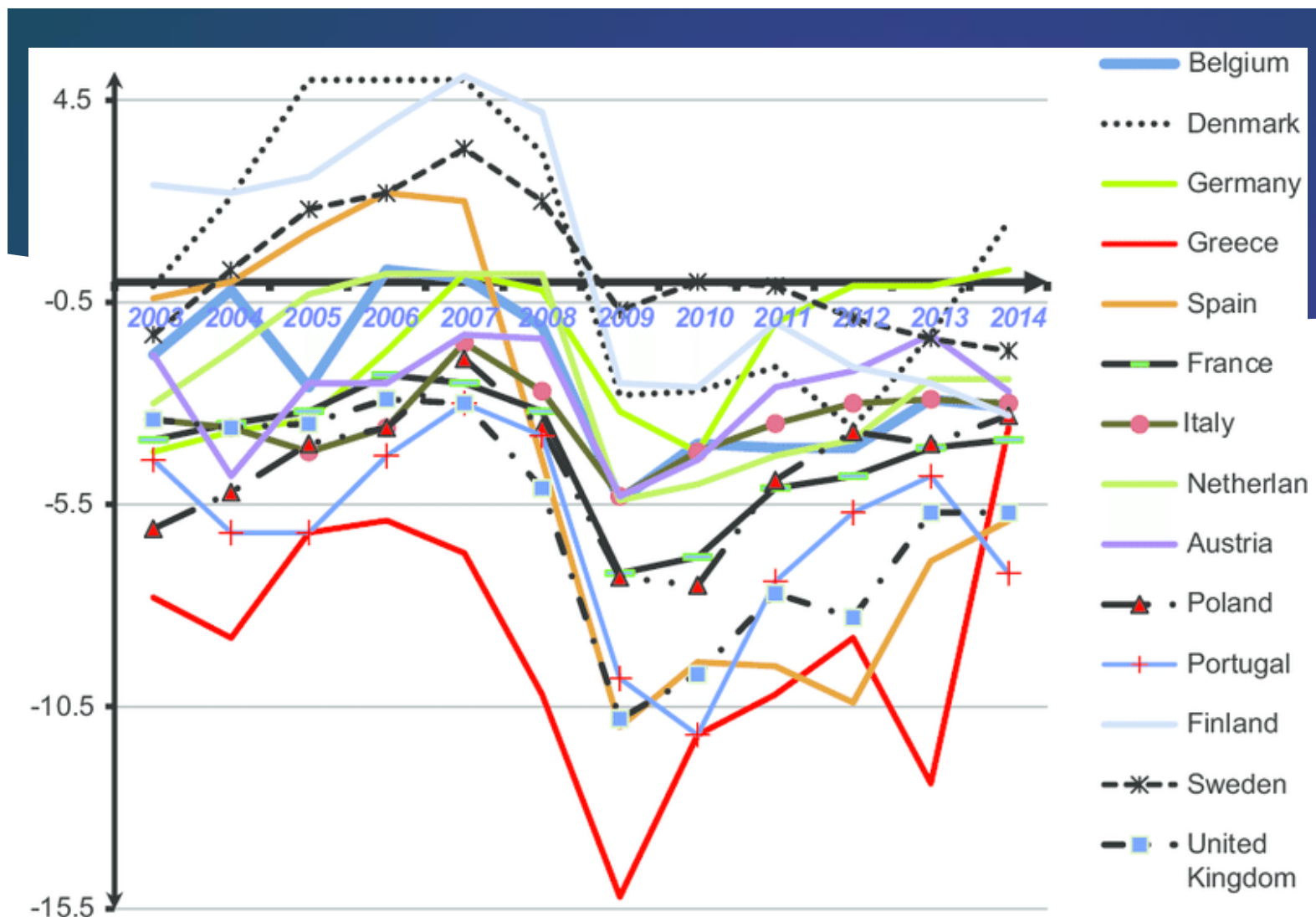


Recession

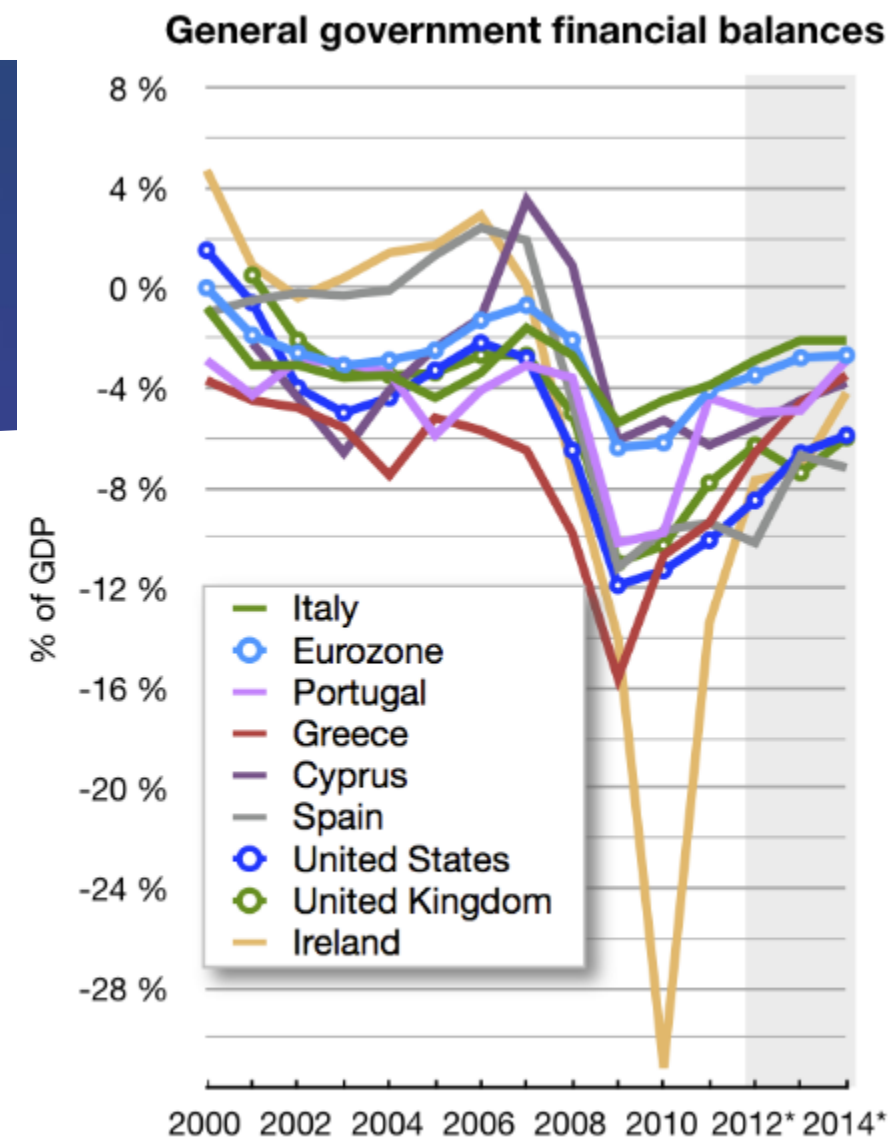
--> contracting economies

- ▶ 2008 US housing bubble burst – triggering a round of **recession** – hit Europe in 2009
- ▶ Slow growth in the North, **no growth** in the South
- ▶ Rising unemployment
- ▶ Rising household debts
- ▶ **Exceptional expenses** - bailing-out national banks (IRL, Belgium, FR, GR, UK) and supplying liquidity put a **strain on national budgets** increase deficits, debts
- ▶ **Masking of deficits!** (i.e. Greece)
- ▶ Inability to pay back their **debts + interests!!!!**





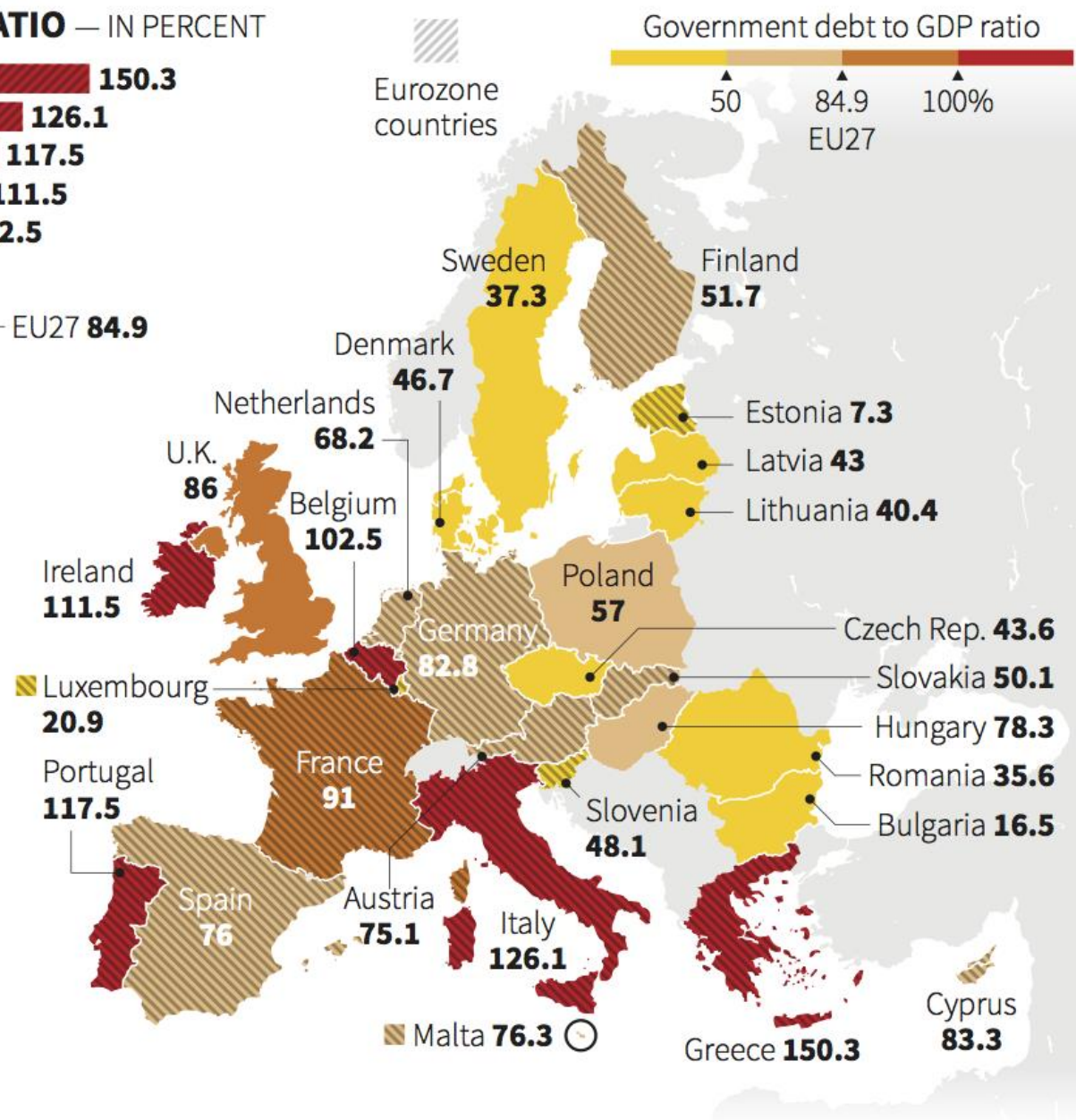
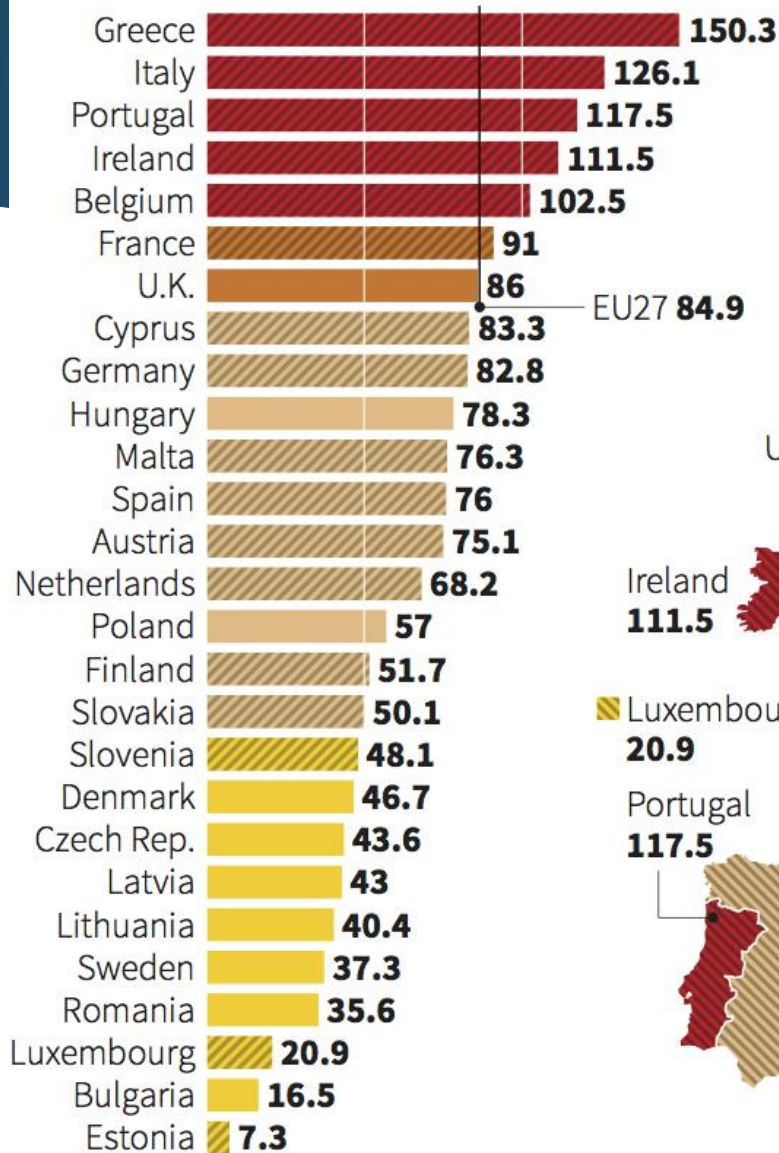
**General government deficit/surplus
as a % of GDP**



Source: Eurostat and OECD

* 2012-2014 Eurostat estimates from January 2013

GOVERNMENT DEBT TO GDP RATIO — IN PERCENT



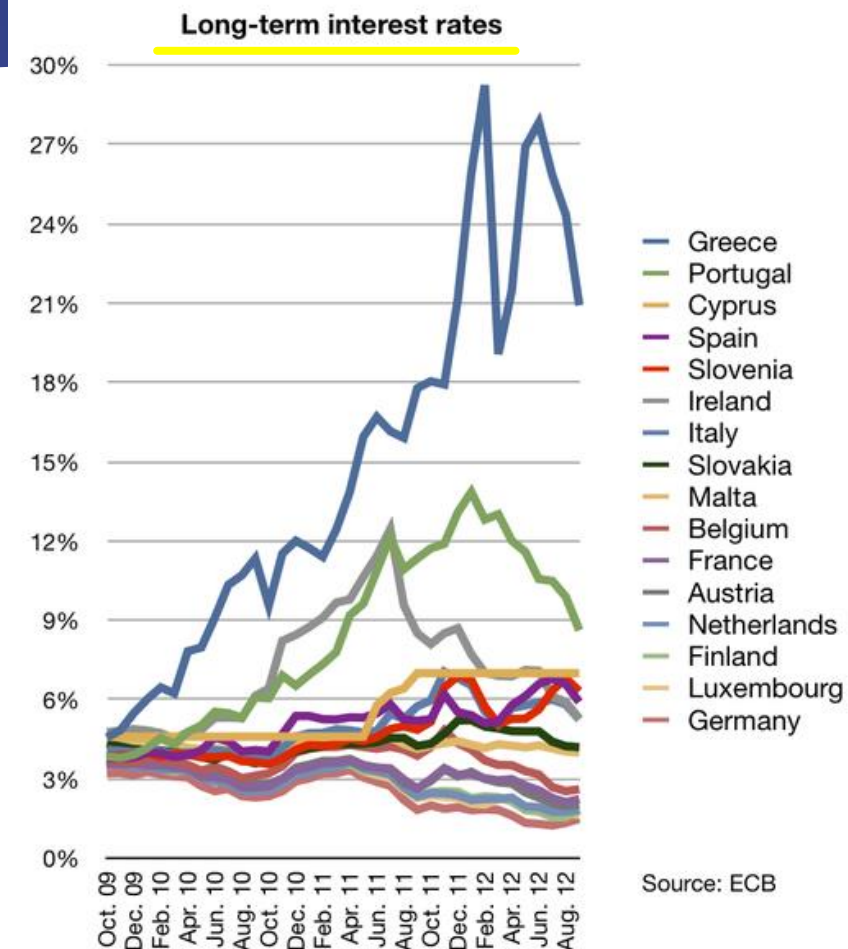
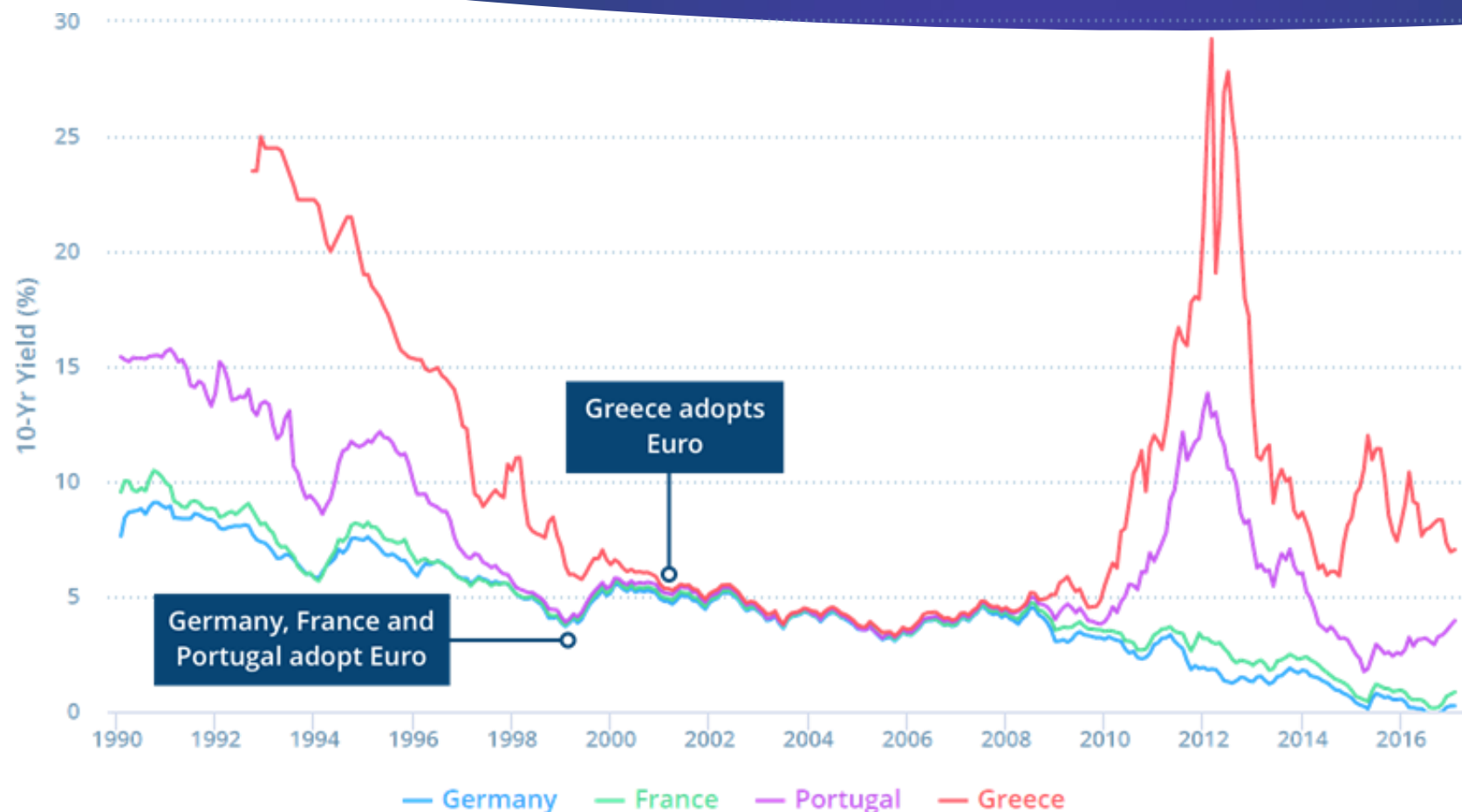
Source: Eurostat

Government debt as % of GDP

2012

Data 2016

Trust in some countries disappeared like a ... in the wind



Source: ECB

Case: **Greece** small economy, big impact

2010 – **deficit** of 13(!)% national **debt** of 171% in 2011

- ▶ Country **cannot repay its debt** without assistance from a third party
- ▶ As they are **members of the Eurozone**, they **cannot default their currency**, support export and pay the creditors off
- ▶ Very low competitiveness
- ▶ Low and inefficient revenues (tax yields)
- ▶ Greek GDP depends on tourism, it's not an export economy
- ▶ **Borrowing cheaply, paying dearly**
- ▶ Germany : “Greeks partied when they should have been saving”



The Debt

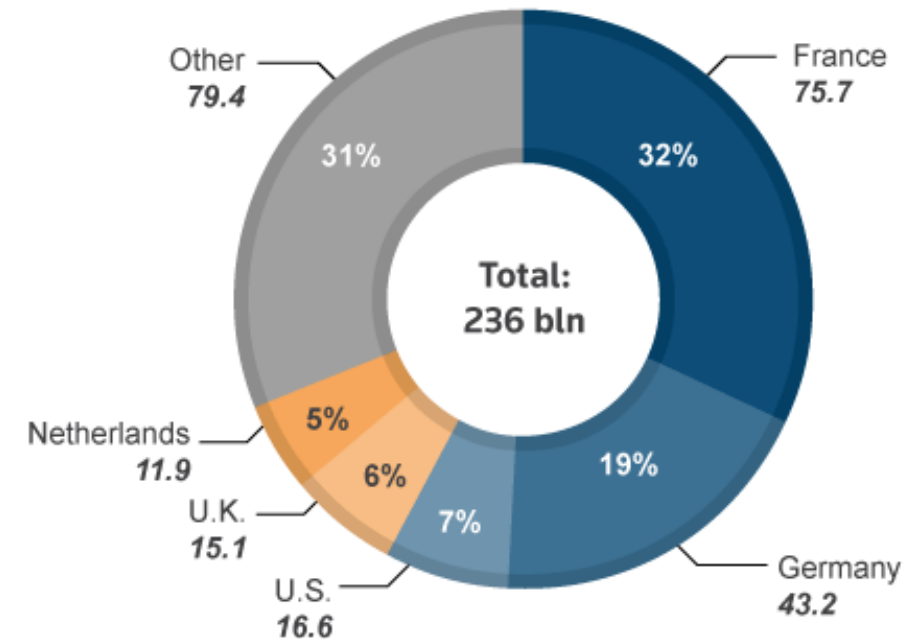
- ▶ PIIGS together owe – 3 trillion €
3 000 000 000 000

Who owns the debt?

- ▶ **Creditors** – mostly other European banks!!
- ▶ Danger of **contagion**!
- ▶ Debt of Eurozone **combined** is still smaller than that of the US $\sim \backslash (\text{ツ}) _ / \sim$

Greece debt in world banks

Bank holdings of Greek sovereign debt by country – \$ billions



Source: Bank for International Settlements

Reuters graphic/Stephen Culp



30/04/10

A bucket-load of problems

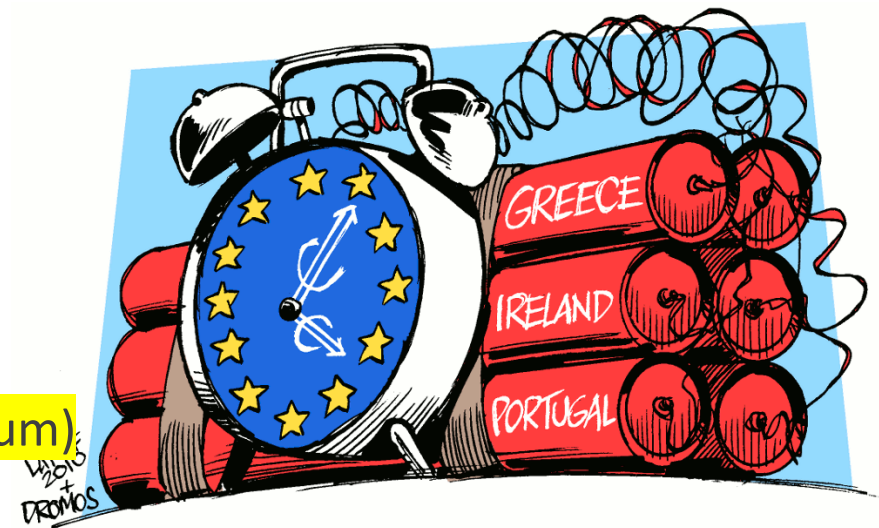
- ▶ **Intertwined EU banking sector** → exposed to “toxic” bonds and papers while separate national regulation authorities don’t cooperate
- ▶ **Who is going to pay it all back?**
- ▶ **Open up** the economies **or protect** them?
- ▶ What could be the possibilities for Europe as a whole?
- ▶ **Would an ECB bond – ‘Eurobond’ - solve anything?**
- ▶ What about **Greece?**
 - Arguments **PRO default**: match currency value with economic performance
 - Arguments **AGAINST default**: be first pebble that starts an avalanche ultimately leading to Eurozone disintegration
- ▶ **Regulation** of the global financial system?
- ▶ Curb the role of **rating agencies**...?



Or is this crisis of capitalism as such?!?

Structural problems of the Eurozone

- ▶ **EU monetary union** (money supply) only loosely connected to **MS fiscal policies** (taxes, pensions etc.)
- ▶ Coordination of MS fiscal policies - *Stability and Growth Pact* rules – weak and/or **disregarded**
- ▶ **Differently performing economies**, but high interdependence and **monetary policy centralisation by ECB**
- ▶ **Slow response** of the Eurozone members – any new measures (bonds) need a **unanimous agreement!**
- ▶ Peripheral states = **low interest rate ‘free riders’** in good times
- ▶ **No banking union** – no European banks’ oversight
- ▶ **No ECB lender of last resort**
- ▶ No EU taxation = no transfer union = **no solidarity**
- ▶ **EU budget** not big enough to cover the losses (€140 billion per annum)
- ▶ **ECB stock capital** not big enough €5 billion in NCB shares



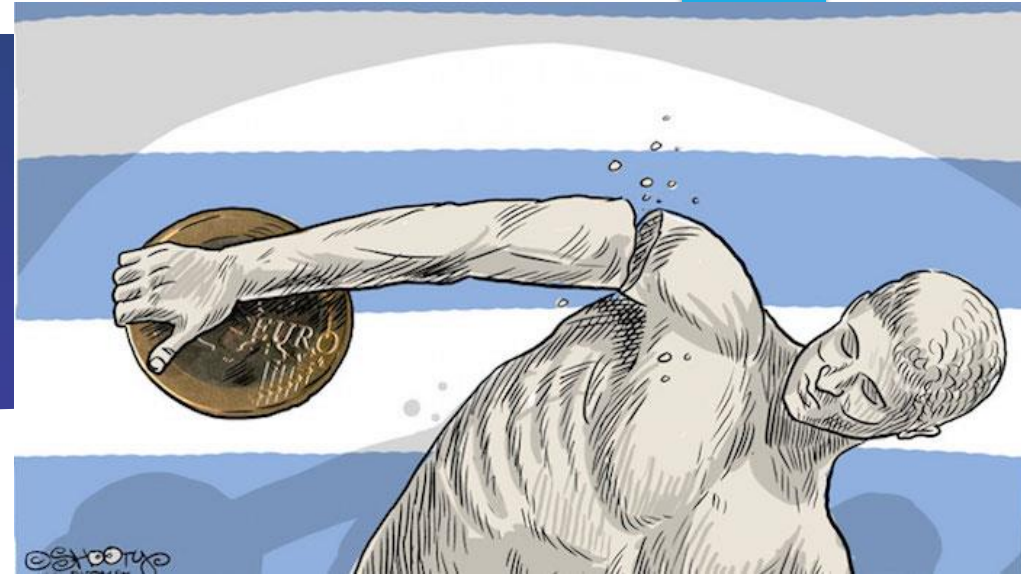


Thomas Friedman:

*In Europe, hyper-connectedness both exposed just how **uncompetitive** some of their economies were, but also how **interdependent** they had become. It was a deadly combination.*

*When countries with such different cultures become this interconnected and interdependent — when they **share the same currency but not the same work ethics**, retirement ages or budget discipline — you end up with German savers seething at Greek workers, and vice versa...*

Bail-outs



► From the 'Troika' (European Commission, ECB, IMF)

- May 2010 – **Greece** (€110 billion loan)
- November 2010 – **Ireland** (€67.5 billion) plus lowering interests on bailout loans to below 3%
Ireland returned to financial markets in July 2012
- April 2011 – **Portugal** (€78 billion)
- February 2012 – **Greece II** (€130 billion loan) + 'haircut' + debt restructuring to bring the Greek debt down to 117% of GDP by 2020
- June 2012 – **Spain I** (€100 billion) directly to Spanish banks not to inflate the national debt
- March 2013 – **Cyprus** (€10 billion loan) + another emergency loan from Russia in 2012
- July 2015 – **Greece III** – (€86 billion)

What has been done thus far?

European Financial Stability Facility 2010

- a **“special purpose entity”** to euro area members
- issue of bonds worth **€440** (for sale in financial markets) **guaranteed by Eurozone member states** in proportion to their share in the paid-up capital of the ECB
- **capacity expanded to €1 trillion** in 2011 (combined bonds of EFSF + EFSM and IMF help of €250 billion) (Slovak gov. fell over this)
- used in Irish, Portuguese and 2nd Greek bail-out



European Financial Stabilisation Mechanism 2010

- **emergency funding program** guaranteed by the **European Commission** €60 billion using EU budget as collateral!!!



Austerity measures



- ▶ Bail-out loans **conditioned** on strict **austerity**
- **Privatisation** of anything that could be privatised
- **Cuts** in public spending
 - welfare
 - salaries of state employees
 - decreased investment
 - less money for healthcare

Unusual ECB activity

- ▶ Aim: to keep 'liquidity' – keep currency flowing to prevent a “credit crunch” (money flow dry up due to lack of trust, fears of risk)
- Buying government bonds (including Greek ‘debt’)
- Buying private (bank) bonds – quantitative easing
- 2012 **LTRO** (Long Term Refinancing Operations)
loans to banks for 1% interest rate (3-6-12 months)
- In 2014 inflation was just 0.5 – ECB tried out a **negative interest rate** of -0.10%!!



US did something similar

What has been done thus far?

European Stability Mechanism 2012

- **a permanent** 'bail-out' **mechanism** to replace the *EFSSF + EFSM*
- intergovernmental organisation based in Luxembourg
- in **force** since May **2013**, a step towards a **banking union**
- force €500+ billion
- ratified by all 17 (at the time) Eurozone members
- needed amendment of the Lisbon treaty to authorize the establishment of the mechanism under EU law

Addition to Art. 136 TFEU

*"The member states whose currency is the euro may establish a **stability mechanism** to be activated if indispensable **to safeguard the stability of the euro area** as a whole. The granting of any required financial assistance under the mechanism will be made **subject to strict conditionality**"*



European Stability Mechanism

→ for **member states** unable to fulfill their financial obligations -> paid directly to the financial sector (as not to increase the national debt)

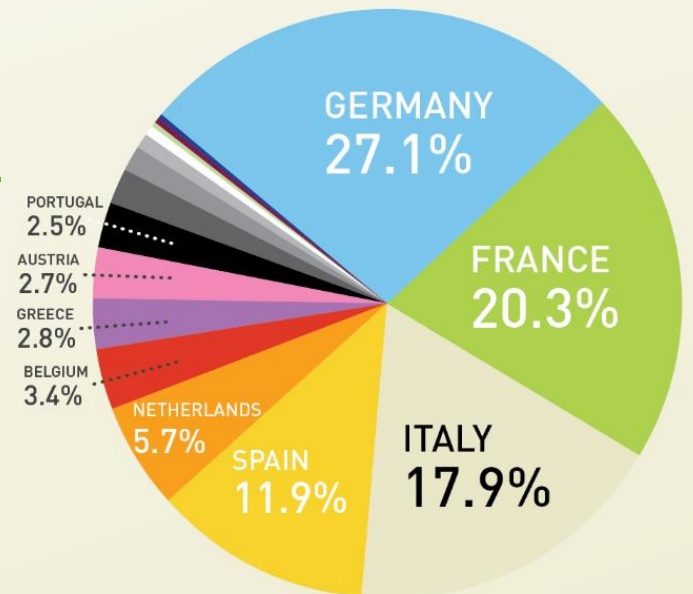
→ conditional on country's ratification of the Fiscal Compact (fiscal reforms)

→ analysis and evaluation by the "Troika": European Commission, ECB & IMF

→ recipients include **Spain, Ireland, Cyprus and Greece**

ESM CONTRIBUTIONS

What are the contributions of individual Member States?



Critics: ESM severely confines state **sovereignty** – it's a product of short-term consensus

The European Fiscal Compact 2012

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

Strengthen *Stability and Growth Pact* rules = coordination and surveillance of fiscal policies

- ✓ Building on the so called “Six-Pack” from 2011
- ✓ Intergovernmental treaty formally **outside** the EU primary law (after UK veto in Dec. 2011) in line with EU treaties, some “own” institutions (Euro Summits, Eurogroup / Council)
- ✓ 25 signatories (neither CR nor Croatia; only Title V), binding for the 20 Eurozone members

► **Embryonic fiscal union!! Eurozone’s economic governance**

- marginal role for the European Parliament, but European Commission’s oversight and advisory role
- European Court of Justice - arbiter

Fiscal Compact



- ‘**Balanced budget rule**’, ‘**Debt brake rule**’, automatic correction mechanisms
 - ‘**Balanced budget rule**’ and ‘**automatic correction mechanism**’ be transposed into national legislation (preferably by a constitutional provision)
 - Only countries with these rules are eligible for bail-outs!!!
-
- ▶ **Countries in excessive deficit have to propose and implement structural reforms to ensure correction** – these measures shall be submitted to the Council of the European Union and to the European Commission for endorsement (!) and monitoring
 - ▶ **Ex-ante reports on public debt issuance – the European semester – consultations of national budgets within the EU (European Commission and Council of the EU)**
- Sanctions for non-compliance with European Court of Justice’s judgments up to 0,5% GDP

Phoenix rises from the ashes



Reforming macro-economic coordination

- ▶ **Better enforcement of *Stability and Growth Pact*** limits of 3% of GDP for deficits and 60% of GDP for debt
- ▶ ...through the so-called '**Six pack**' – (5 regulations + 1 directive) aiming at keeping in check MS spending (fiscal policies), structural macroeconomic imbalances and budgetary surveillance coordination
- ▶ MS can be placed in a so-called '**excessive deficit procedure**' if they have debt ratios above 60% of GDP that are not being sufficiently reduced (deficient budgets)
- ▶ '**Two pack**' – extra layer of **budgetary coordination** for the Eurozone members
- ▶ Coordination of MS budgeting in a '**European Semester**'

Who does what in the European Semester?

Nov
Preparatory phase
ANALYSIS OF THE SITUATION
and follow up to the previous year

Dec

Jan

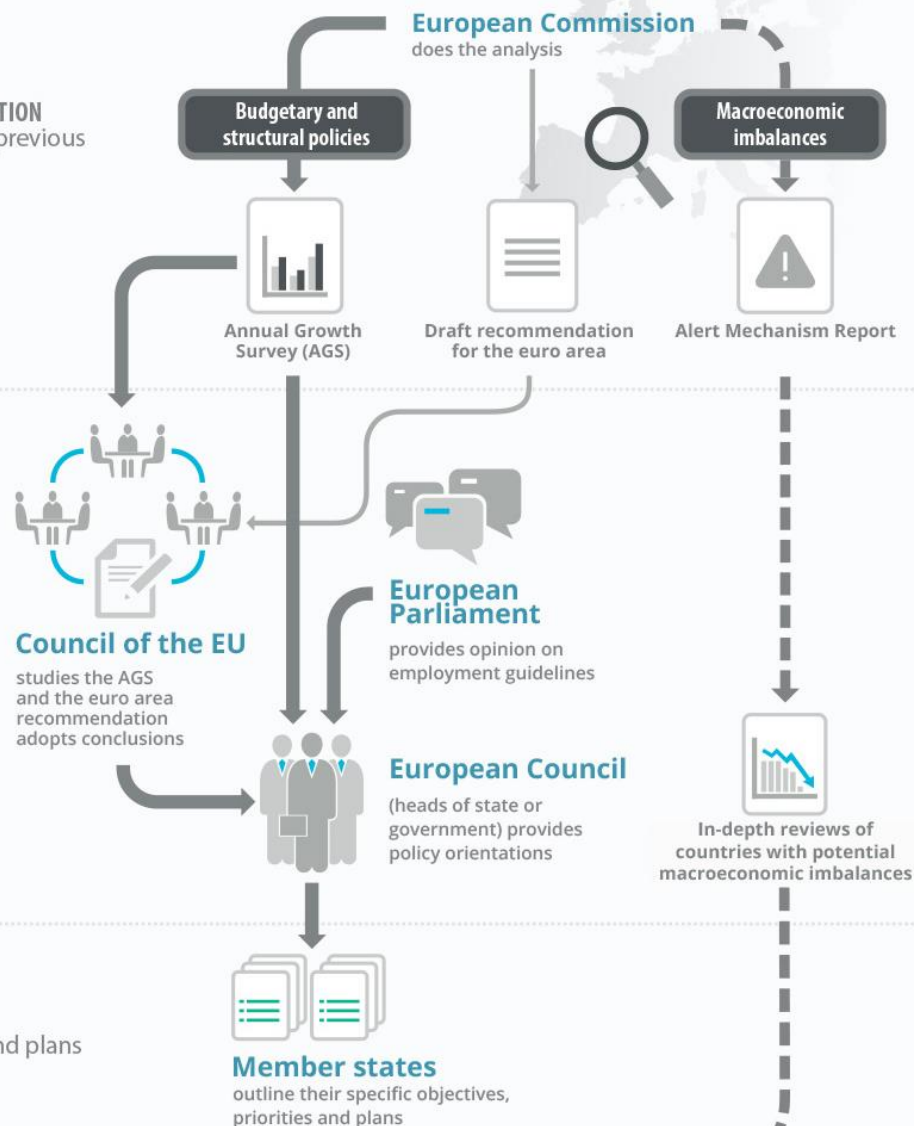
Phase 01
POLICY GUIDANCE
at the EU level

Feb

Mar

Apr

Phase 02
COUNTRY-SPECIFIC
objectives, policies and plans



Apr

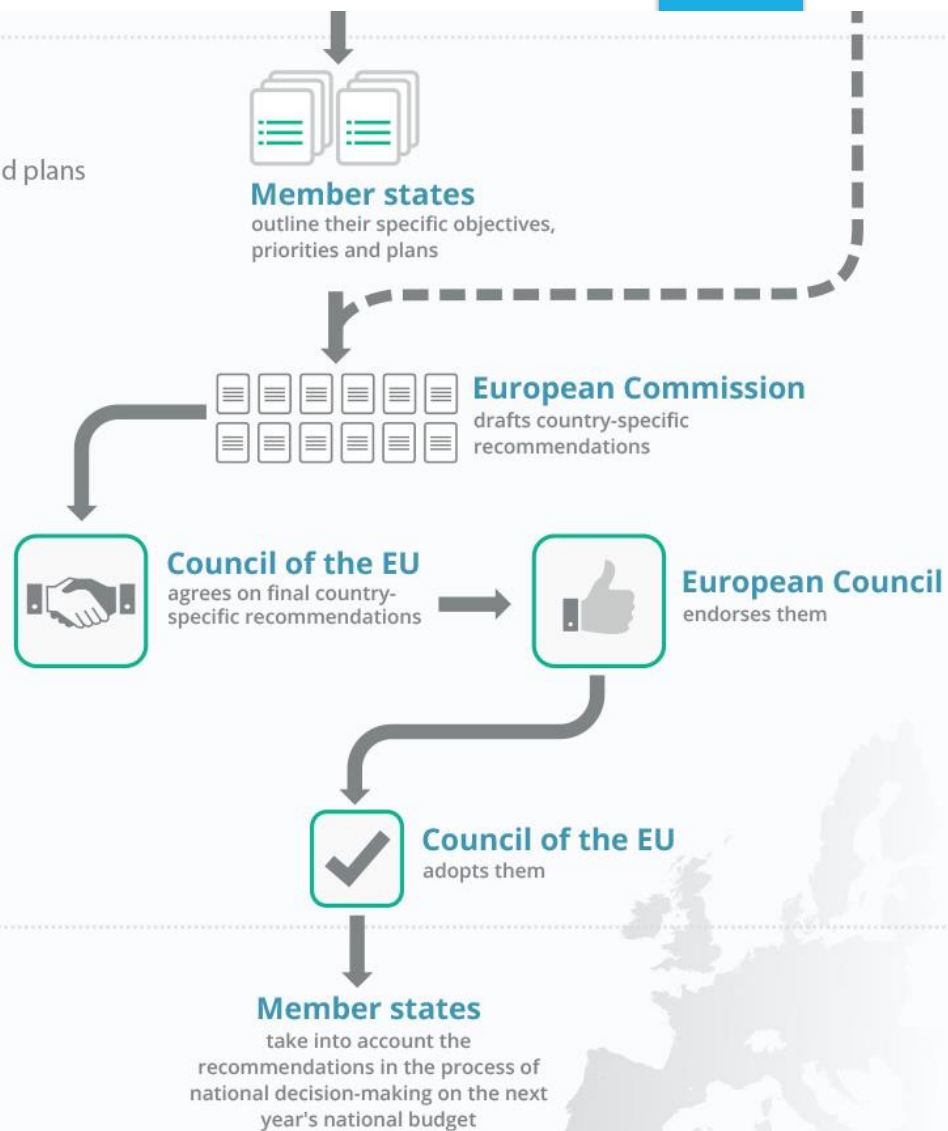
Phase 02
COUNTRY-SPECIFIC
objectives, policies and plans

May

Jun

Jul

Phase 03
IMPLEMENTATION



A new cycle starts again towards the end of the year, when the Commission gives an overview of the economic situation in its Annual Growth Survey for the coming year.

EUROPEAN SEMESTER 2016

May 2016

Situation under the Macroeconomic Imbalances Procedure and the Stability and Growth Pact

Category under Macroeconomic Imbalances Procedure as of March 2016
(for Cyprus: April 2016)

Stability and Growth Pact

Countries in Excessive Deficit Procedure (corrective arm)

Countries not in Excessive Deficit Procedure (preventive arm)

No in-depth review

No imbalances

Imbalances

Excessive imbalances

Excessive imbalances with corrective action



Commission recommends to abrogate Excessive Deficit Procedure - May 2016

€ = euro area

EUROPEAN SEMESTER 2019

Updated June 2019

STABILITY AND GROWTH PACT

Countries in Excessive Deficit Procedure (corrective arm)

Countries not in Excessive Deficit Procedure (preventive arm)

No in-depth review 2019

No imbalances

Imbalances

Excessive imbalances

Excessive imbalances with corrective action

Commission recommends to abrogate Excessive Deficit Procedure - June 2019

€ = euro area



The Banking union

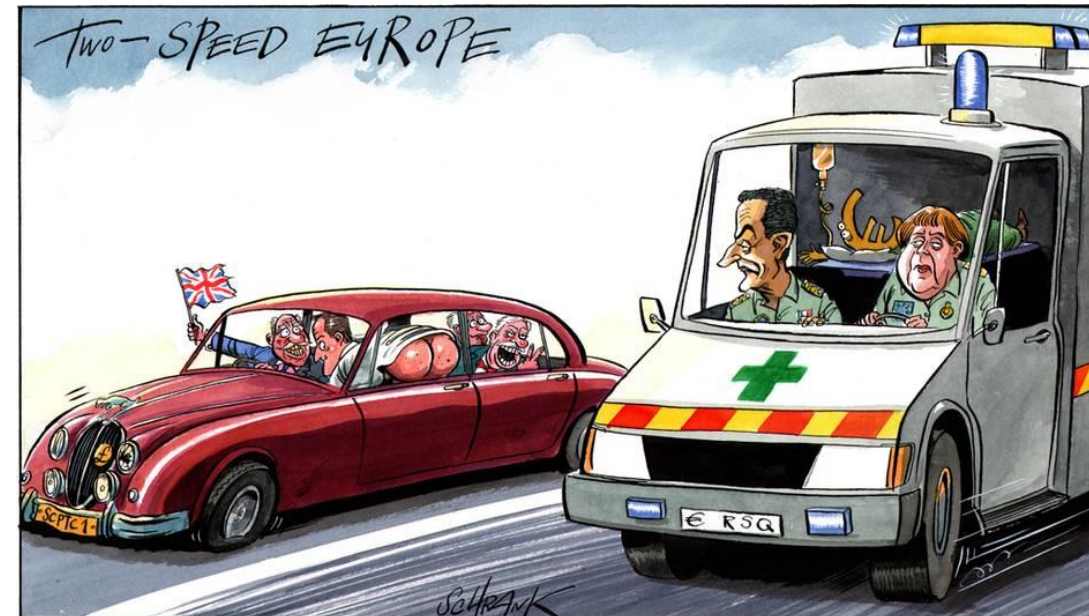
- ▶ Called **Single Supervisory Mechanism (SSM)**
- ▶ Supervision and stability of Europe's biggest and most important banks (about 150 of them)
- ▶ A single rulebook for capital requirements, deposit protection schemes etc.
- ▶ A Eurozone **bailout fund** (to stop using taxpayers' money) collected from insurance
- ▶ Common supervision by the ECB



Crisis fallout

- ▶ Multiple-speed Europe
- ▶ EU institutions overstepping their authority (ECB)
- ▶ Public protests in the 'Periphery,' rise of populists and radicals
Public refusal to contribute in the 'Core'
- ▶ **Integration outside the treaties**
- ▶ **More intergovernmentalism?**

No European identity
=
No solidarity?



Crisis fallout

- ▶ Concerns about **democracy** – vs “dictate from Brussels”
- ▶ Economic impact – austerity leading to unemployment
- ▶ German domination of EU O_o?
- ▶ Quantitative easing leading to high inflation (2022 -)
- ▶ 5 president’s report: [Completing EMU](#)
 - Political, fiscal, democratic recommendations (p. 20-21)

