# European Union Politics

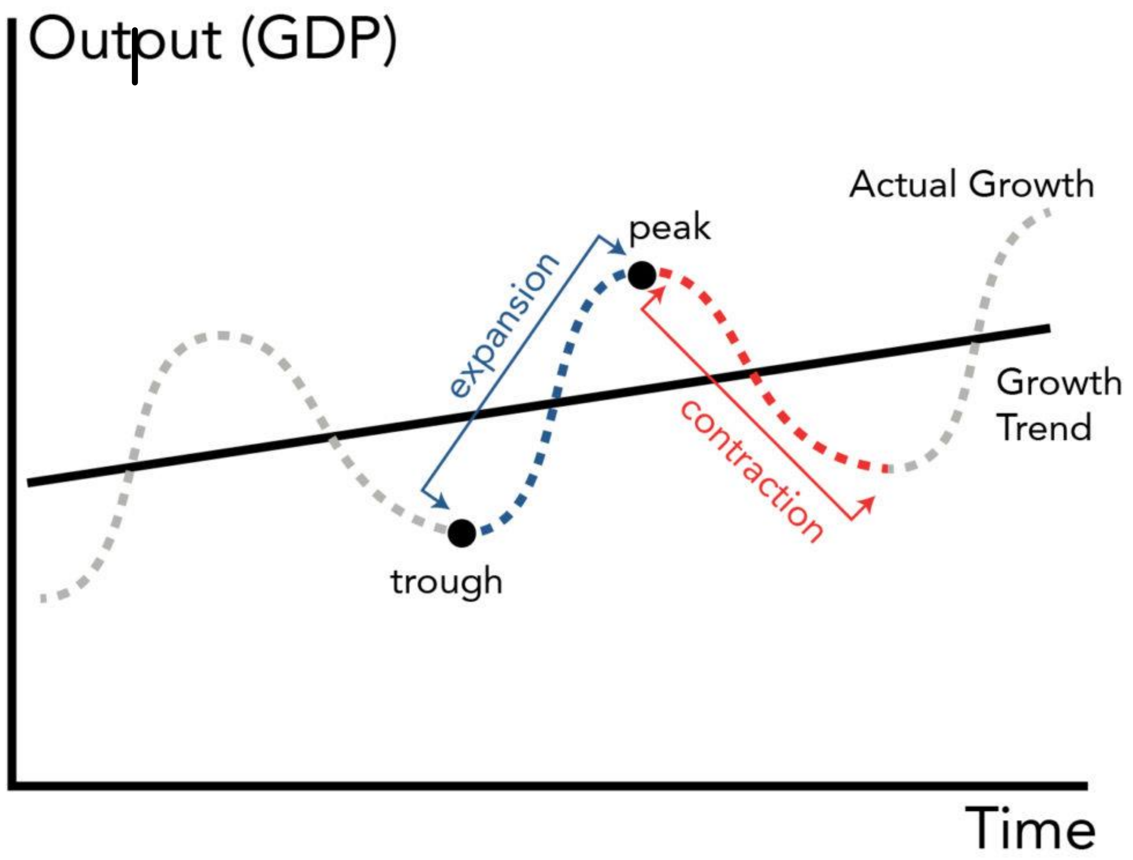
## SESSION 5: **ECONOMIC AND MONETARY UNION**

# What is what…

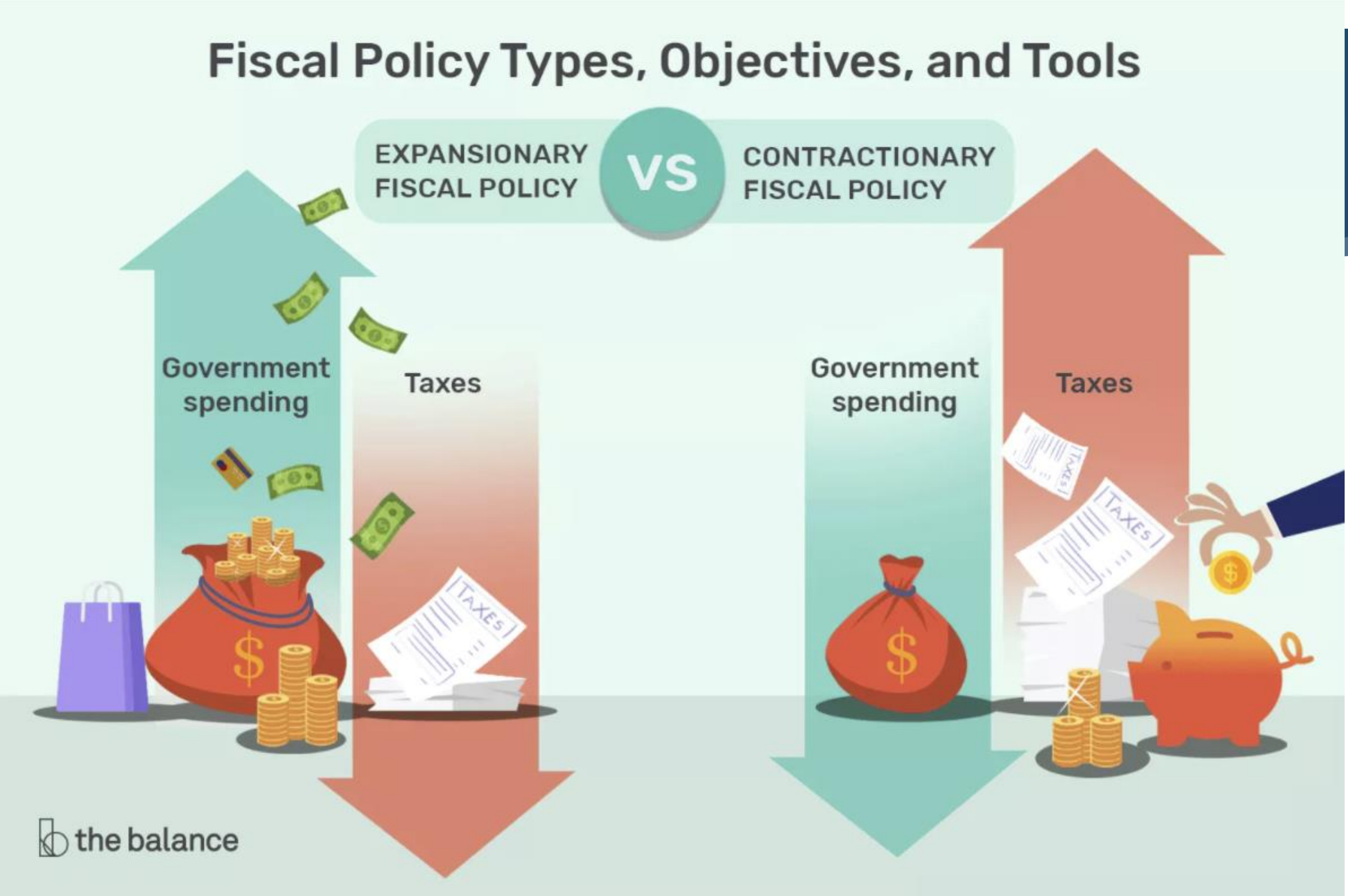
- **Monetary policy** = supply of money (printing) – interest rates (lending/borrowing money), operations to maintain currency stability, exchange rate
- **Fiscal policy** = amount of money (budget) – government spending & taxation
- **Sovereign debt** – *total* public debt owned by governments
- **Public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

# Economic cycle

## GOVERNMENTS aim to:




- Stimulate **economies in contraction** through ↑ ***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 ↓ ***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)

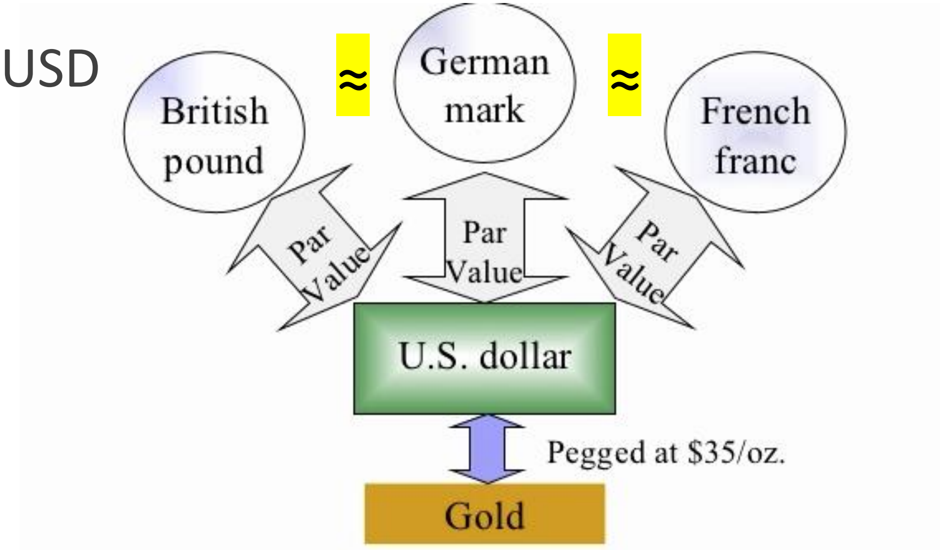

Fiscal Policy Types, Objectives, and Tools
EXPANSIONARY FISCAL POLICY
VS
CONTRACTIONARY FISCAL POLICY
Government spending
Taxes
Government spending
Taxes
the balance

# 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 ¯_(ツ)_/¯

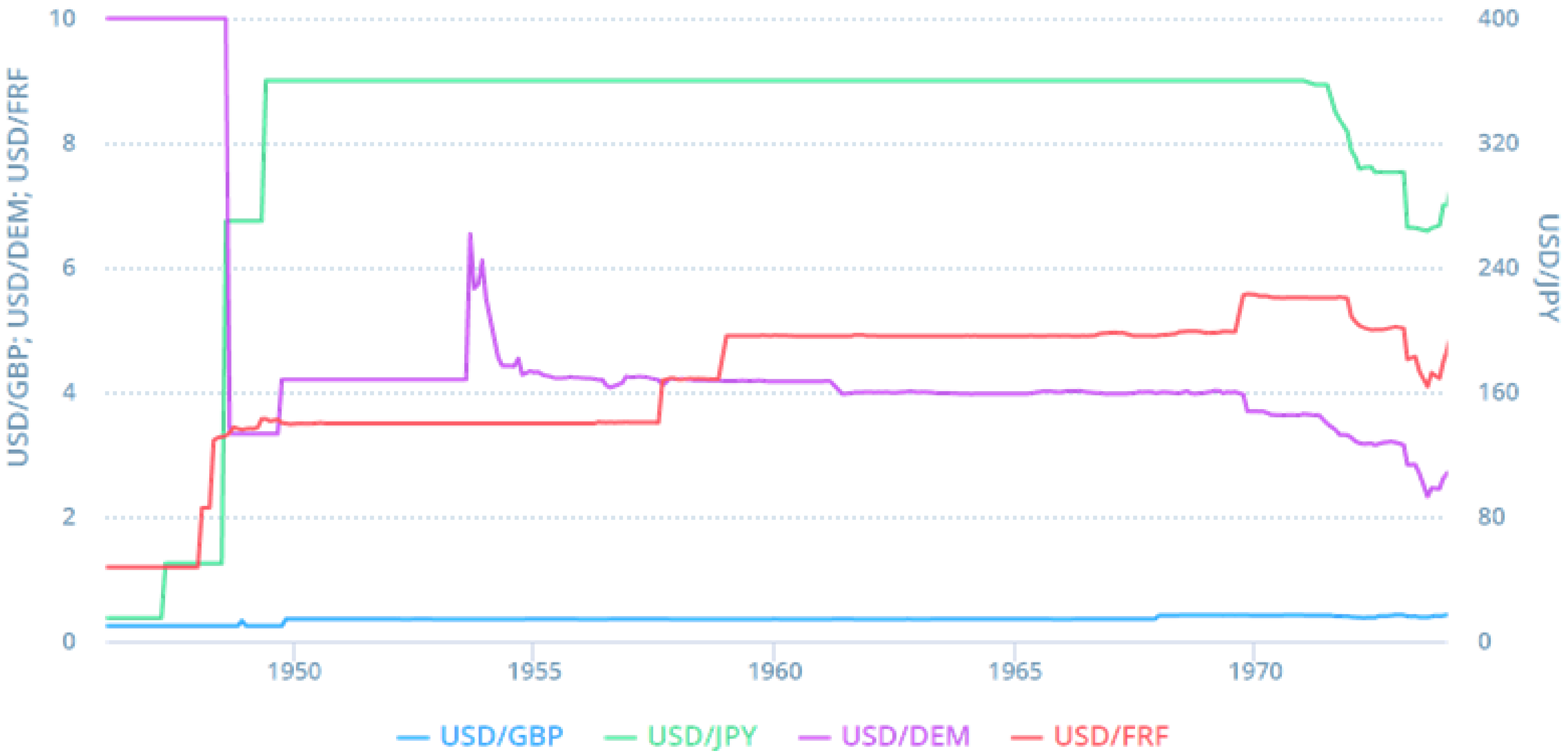
# Post WWII international trade

- **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** ≈
  - 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 Bretton Woods

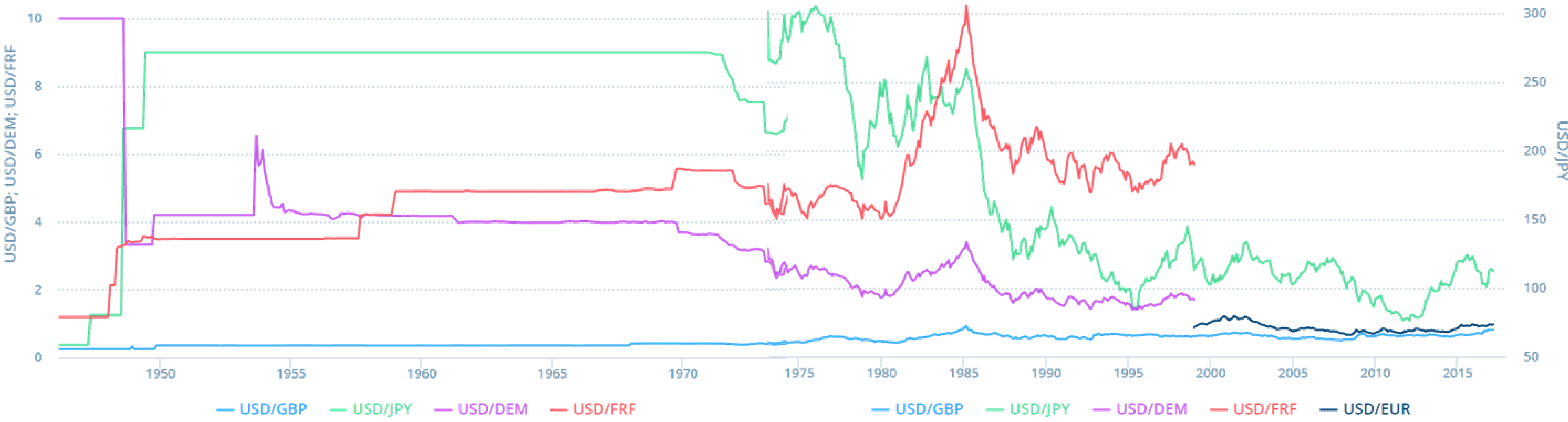



US $
= price stability

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

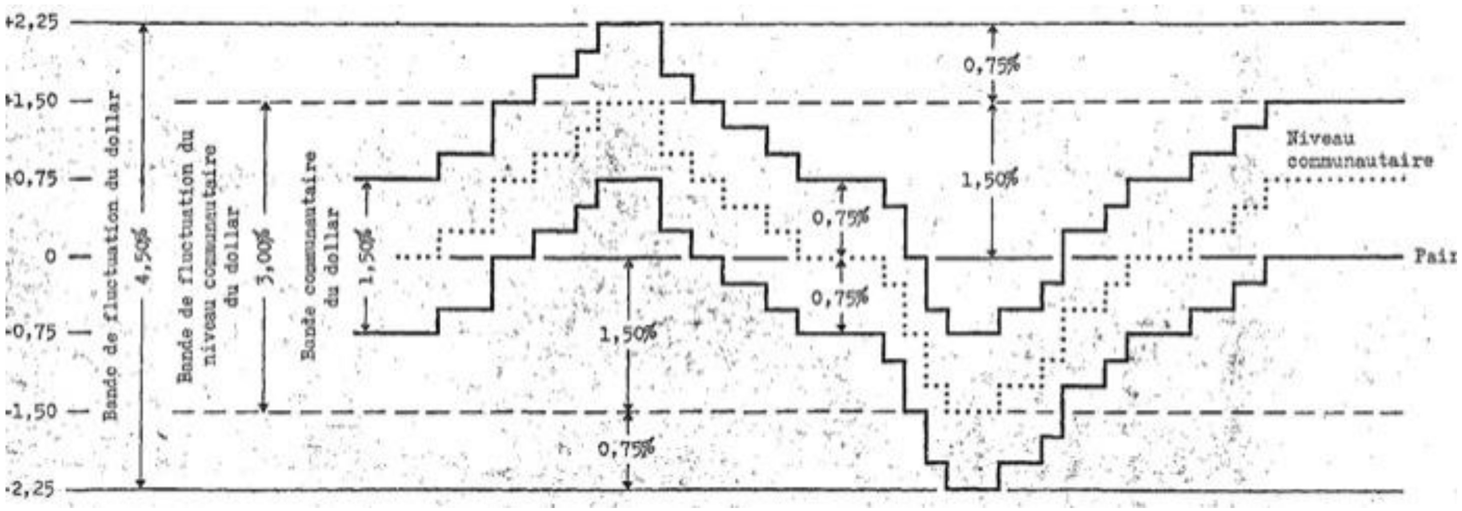
# End of Bretton Woods system 1971

-- > 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 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 ±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 Krones | 0.217 | 3.06 |
| FRF | French Francs | 1.15 | 19.83 |
| GBP | British Pounds | 0.0885 | 13.34 |
| IEP | Irish Punts | 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 <u>addressed by other means</u>:

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

# 1989 Delors' Report

- 4 elements of an economic union

1. Single market ✓
2. Competition policy ✓
3. Cohesion ✓
4. *Macro**economic** 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

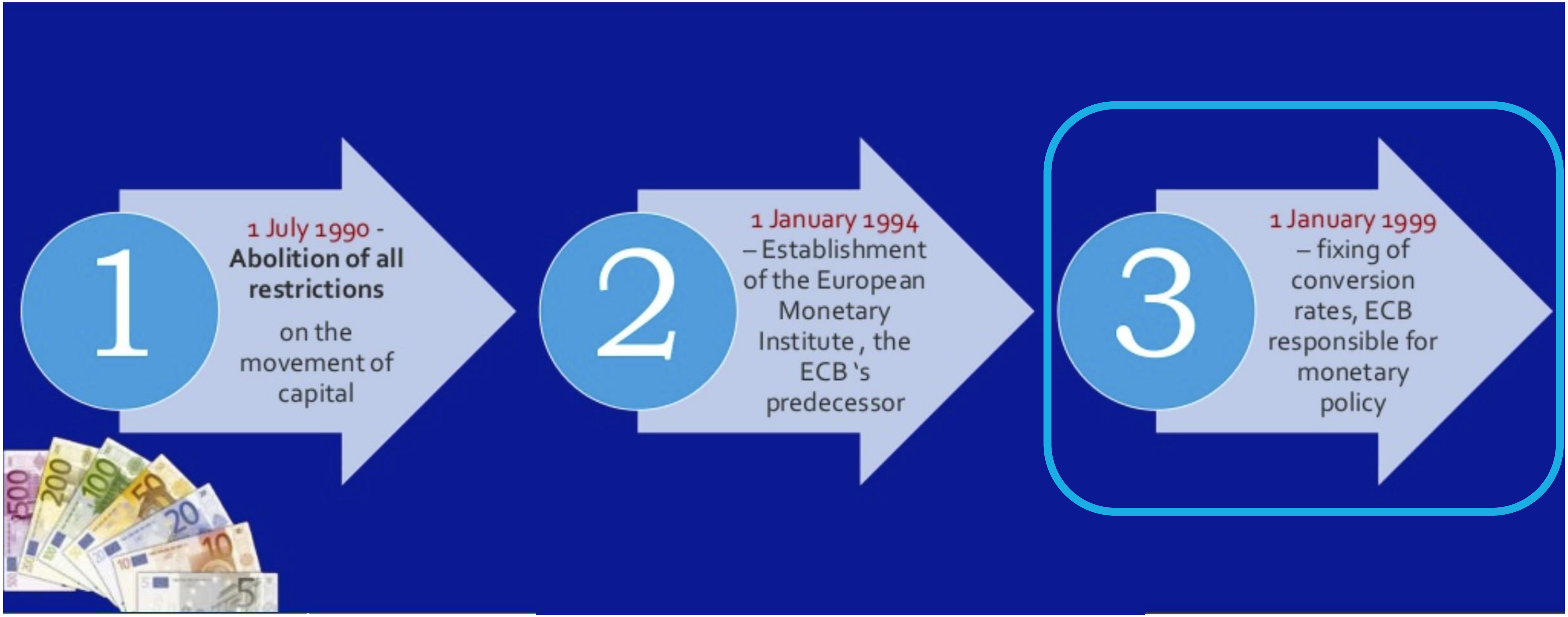
## fiscal policies coordination

### 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:** ration 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 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**

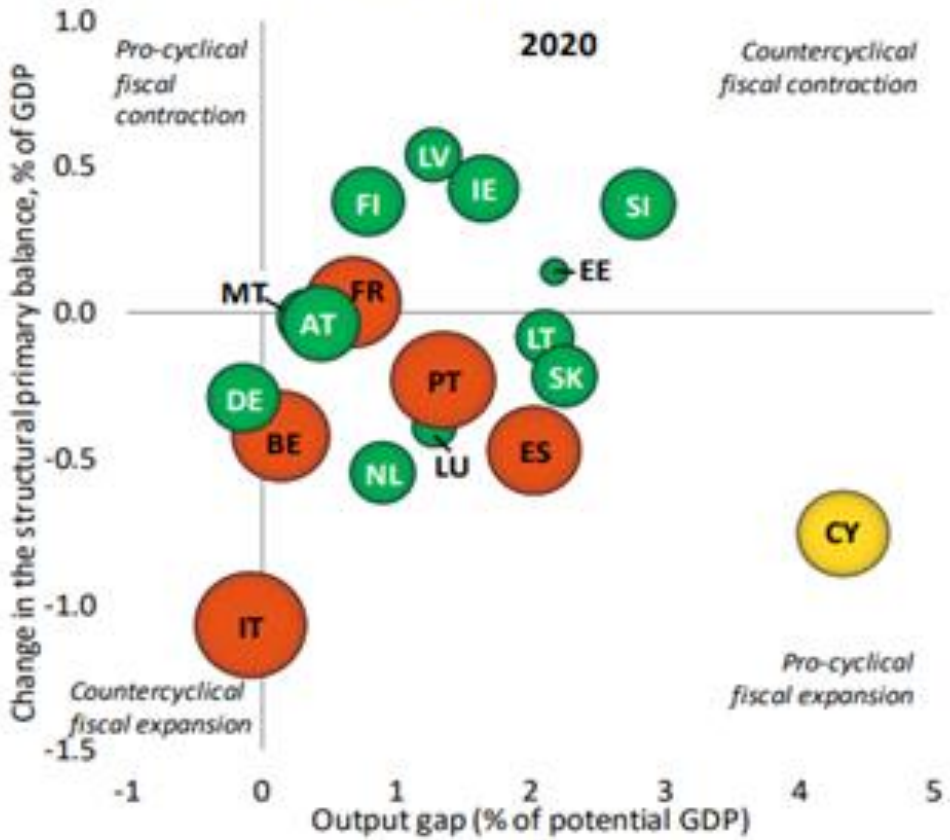
- <u>NOT responsibilities of ECB</u>

- **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

- **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



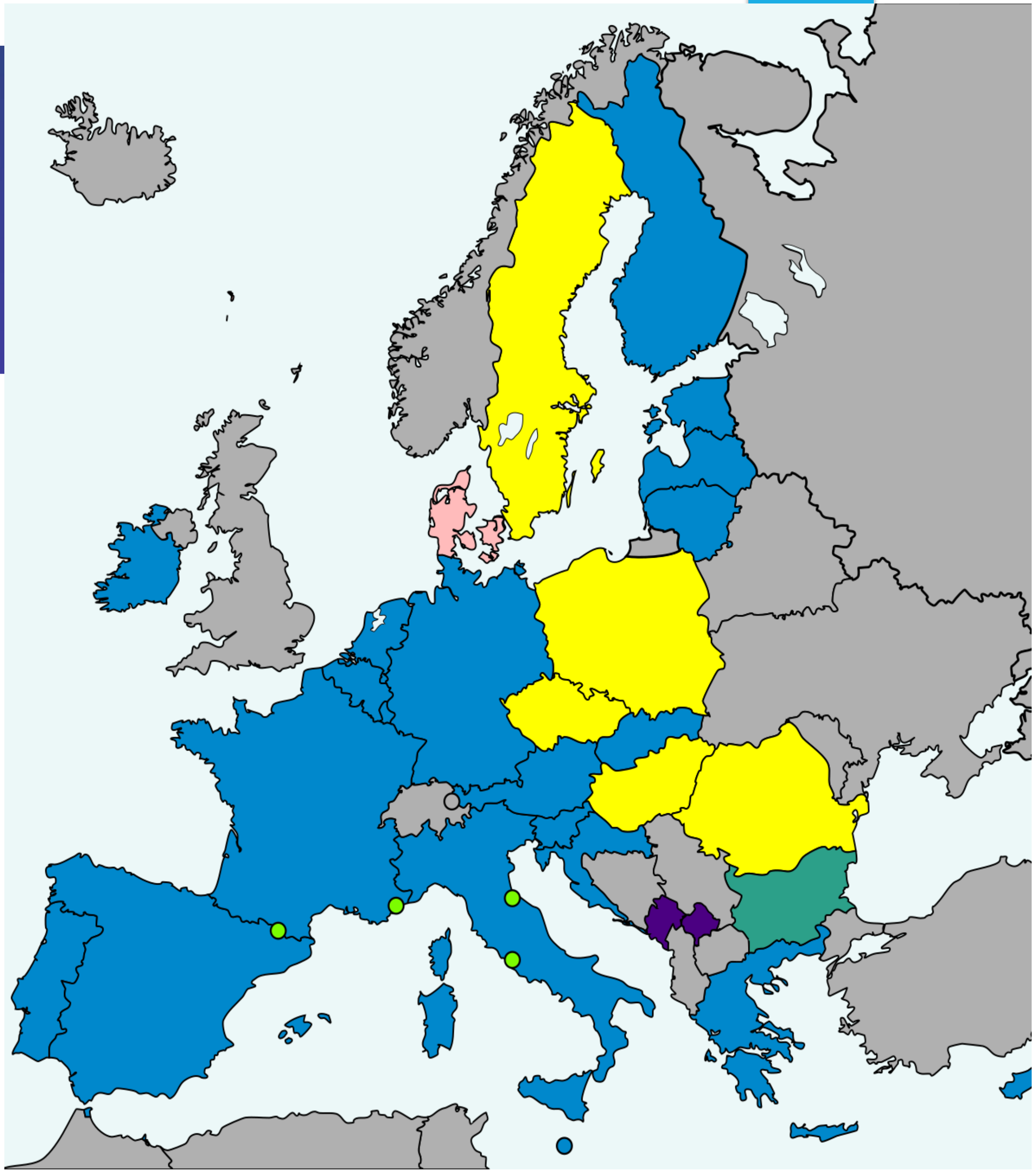
# 1999 Eurozone
(banknotes and coins since 2002)

- 11 countries in 1999
- **20 countries today**

- 20 Eurozone members
- 1 members in ERM II (Croatia joined in 2023)
- 1 member in ERM II (but with opt-out)
- 5 members not in ERM II (obliged to join)

-------------

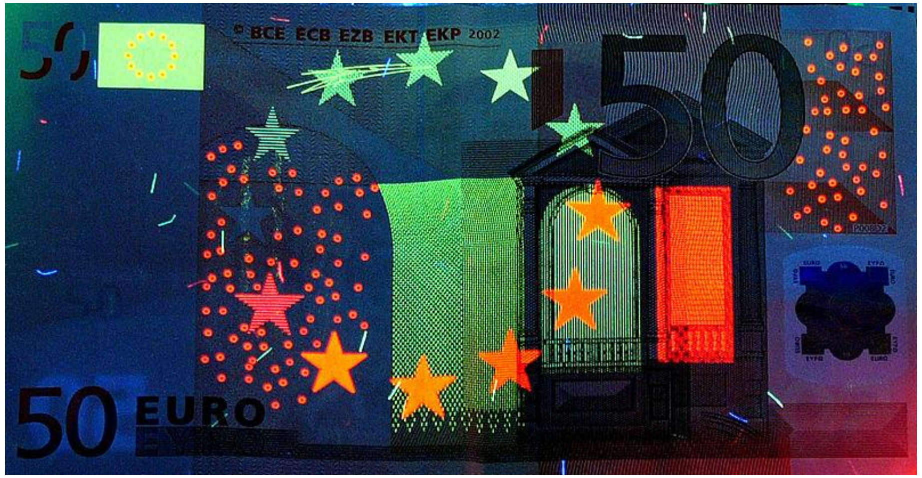
- 4 microstates
- 2 states unilaterally using the Euro




# 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 <u>not</u> 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

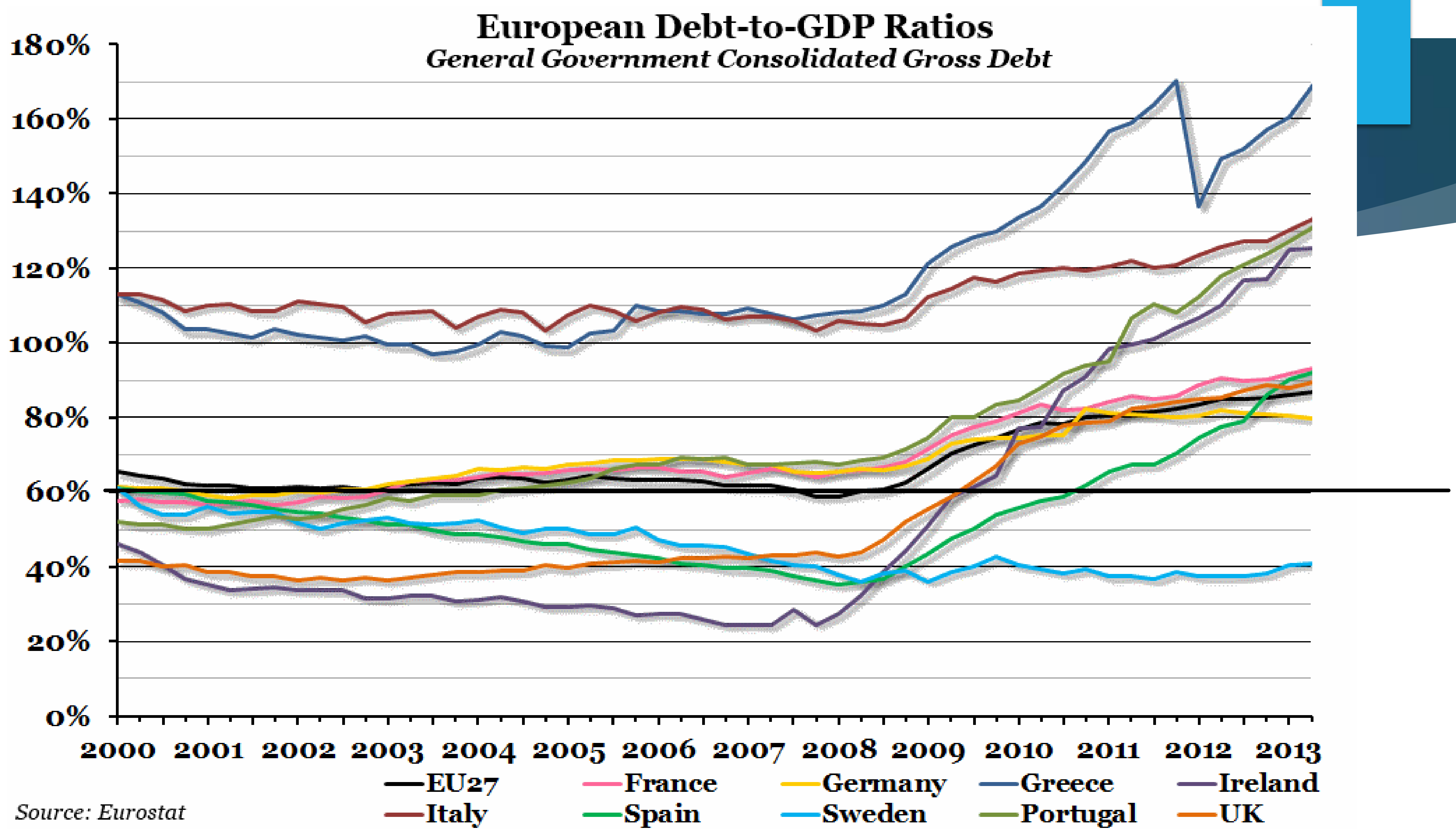
# Stability and Growth Pact (1997)
## ..in treaty of Amsterdam


- **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)**

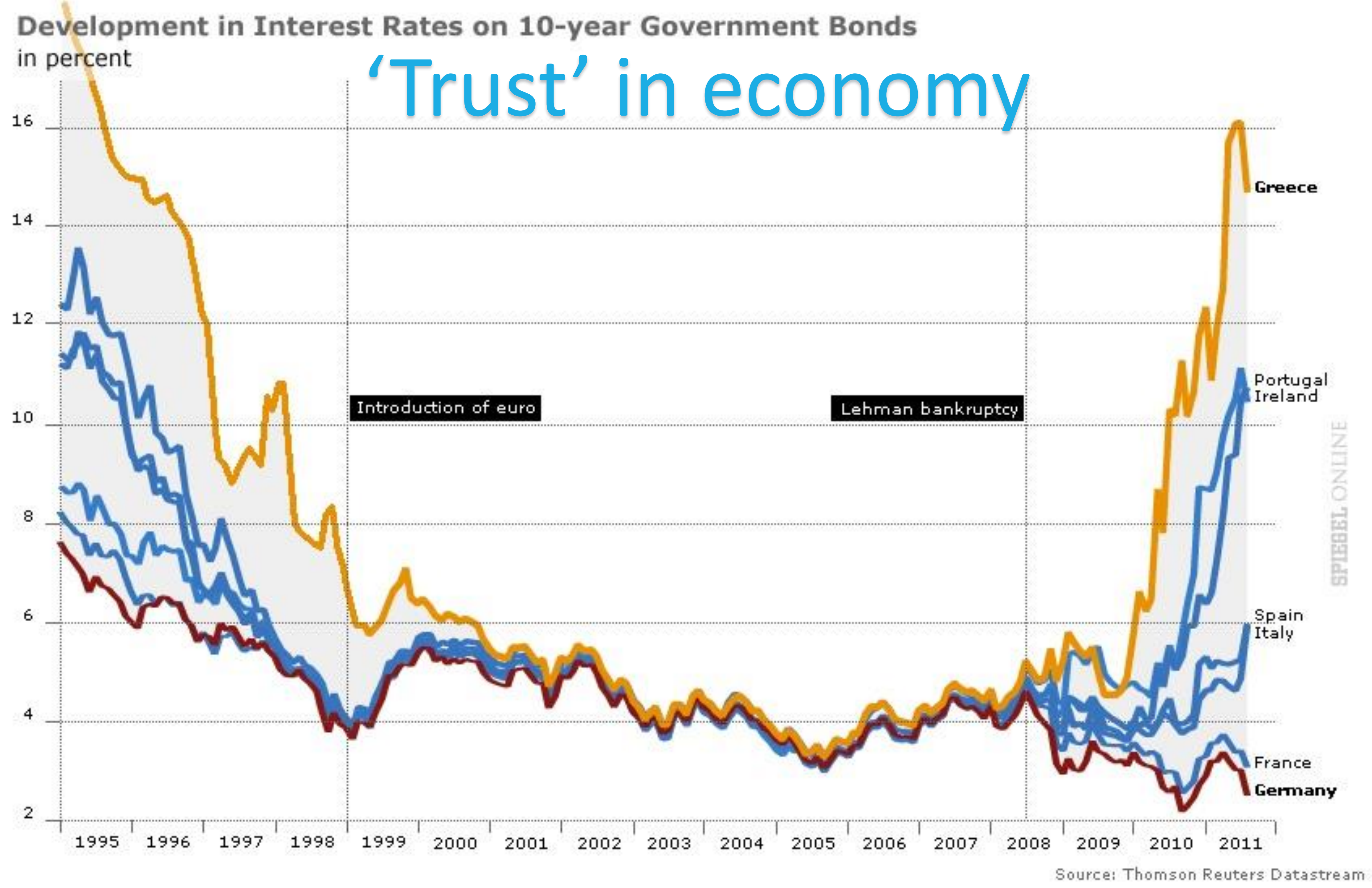
- Annual government deficit < 3% GDP, debt <60% GDP

- 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
180%
160%
140%
120%
100%
80%
60%
40%
20%
0%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
EU27
France
Germany
Greece
Ireland
Italy
Spain
Sweden
Portugal
UK
Source: Eurostat

# ‘Trust’ in economy



# 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…**

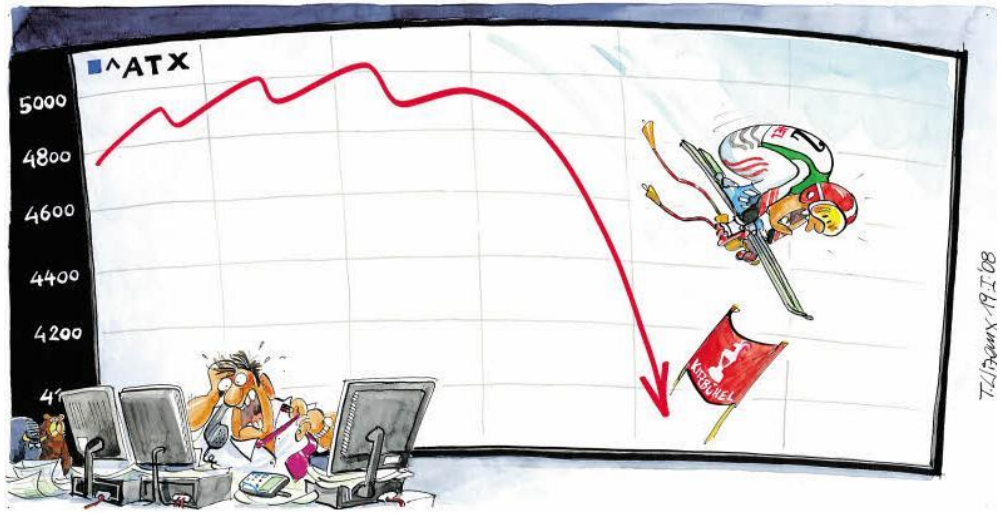
- 2004 – ECJ overturned the Council decision not to sanction but **damage was done**
- 2004 – it was revealed Greeks cheated in statistics to get into the Eurozone…


2008 financial crisis spills over from the US to EU

# The Crisis in EMU

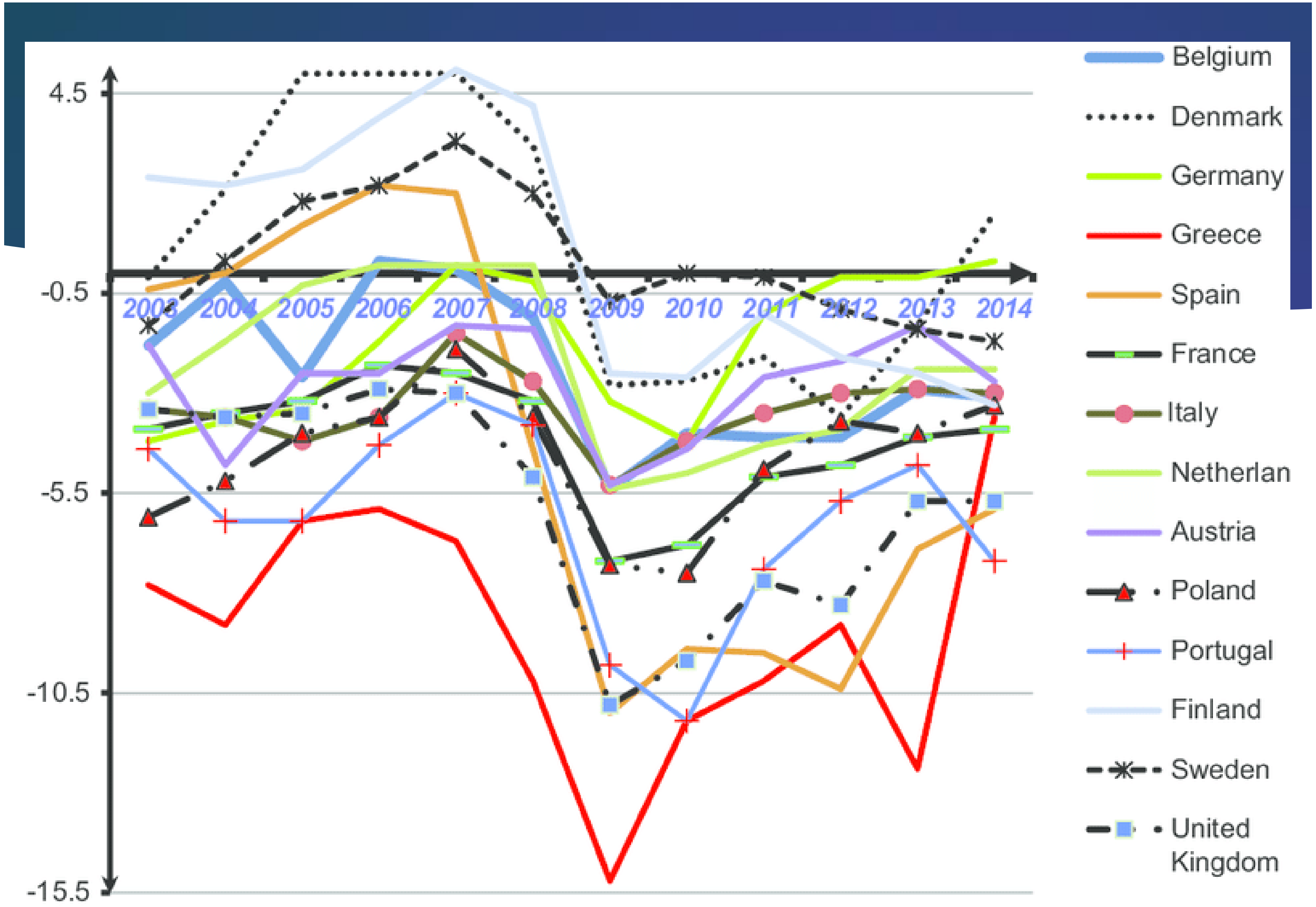
- Global recession triggered in the US when a housing bubble burst in 2008 causing ----> a global "credit crunch" (= shortage of credit/money supply)

- 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!**



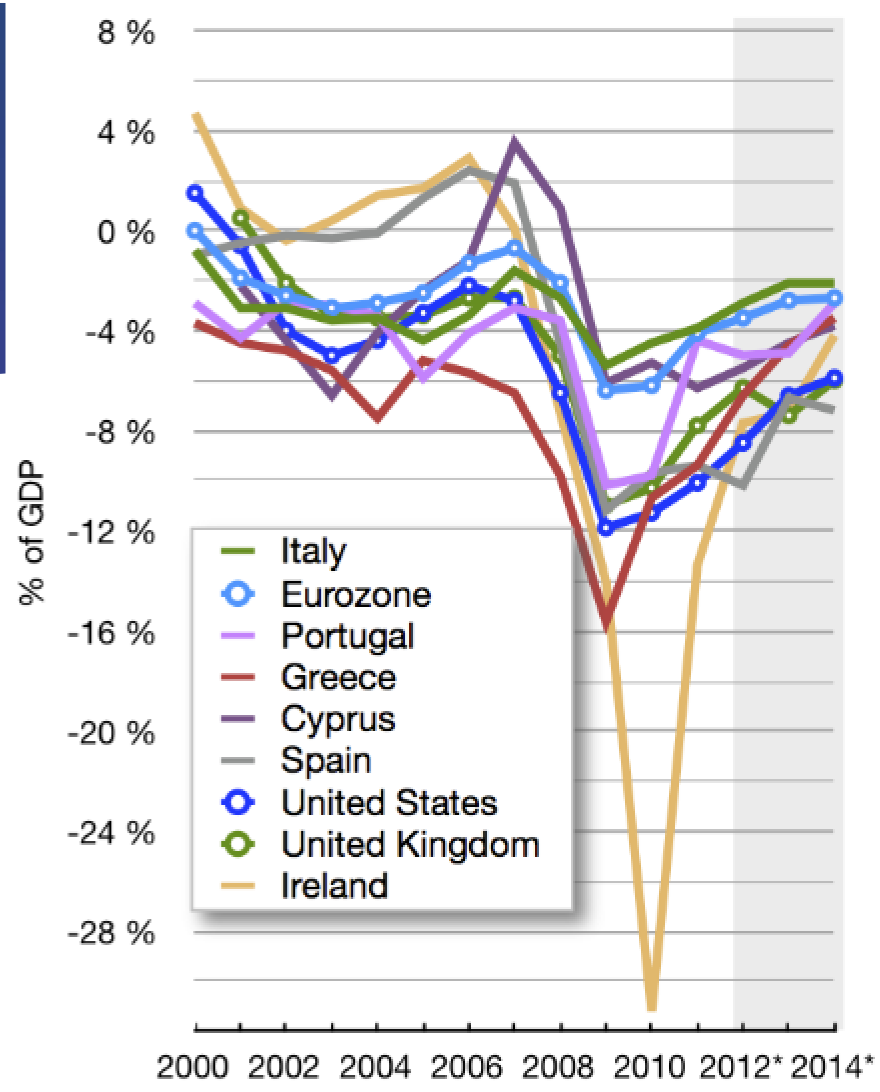
# Recession
# --> contracting economies

- 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**
- **Masking** of deficits! (i.e. Greece)
- Inability to pay back their **debts + interests**!!!!


General government deficit/surplus as a % of GDP

General government financial balances

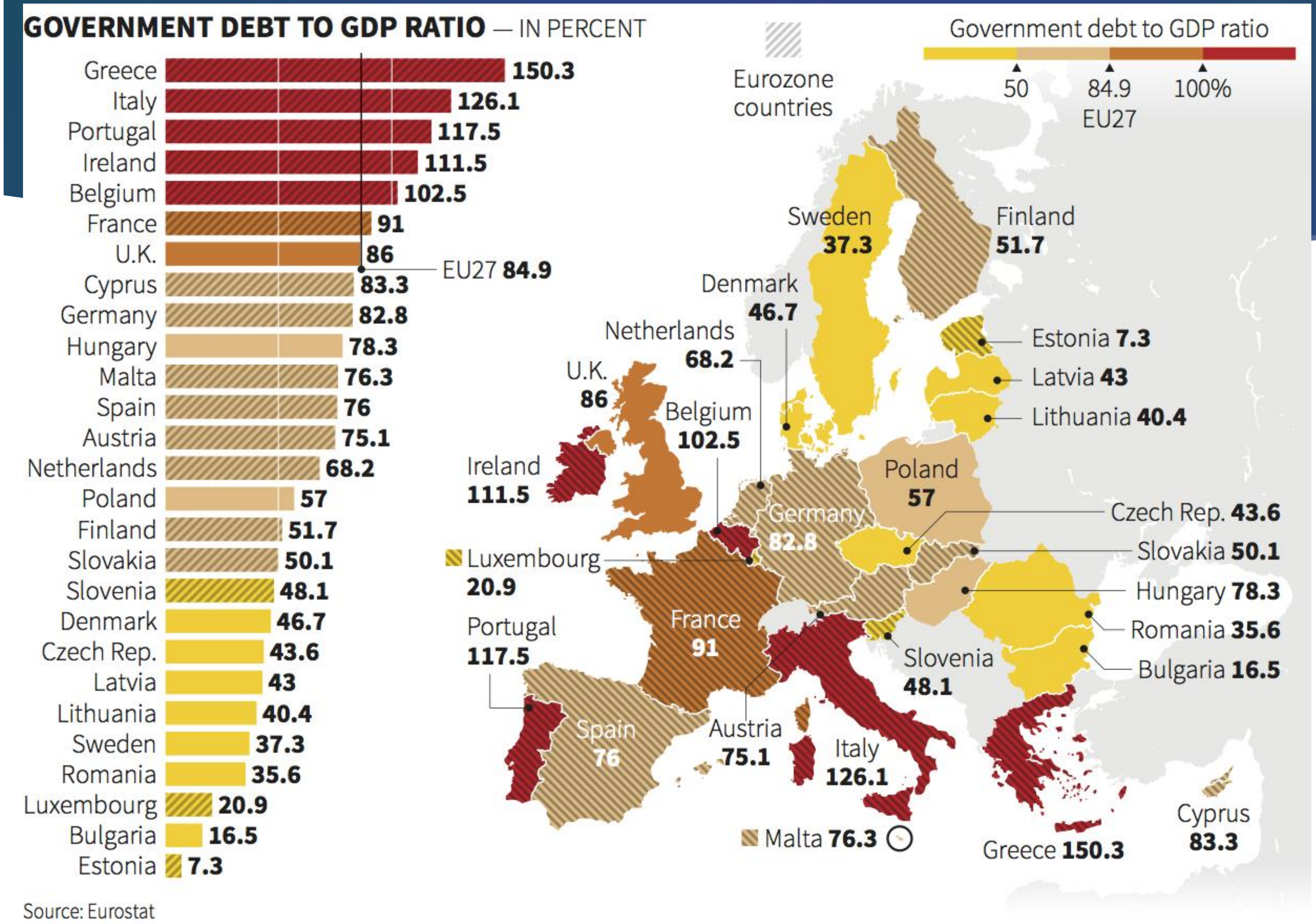



Source: Eurostat and OECD

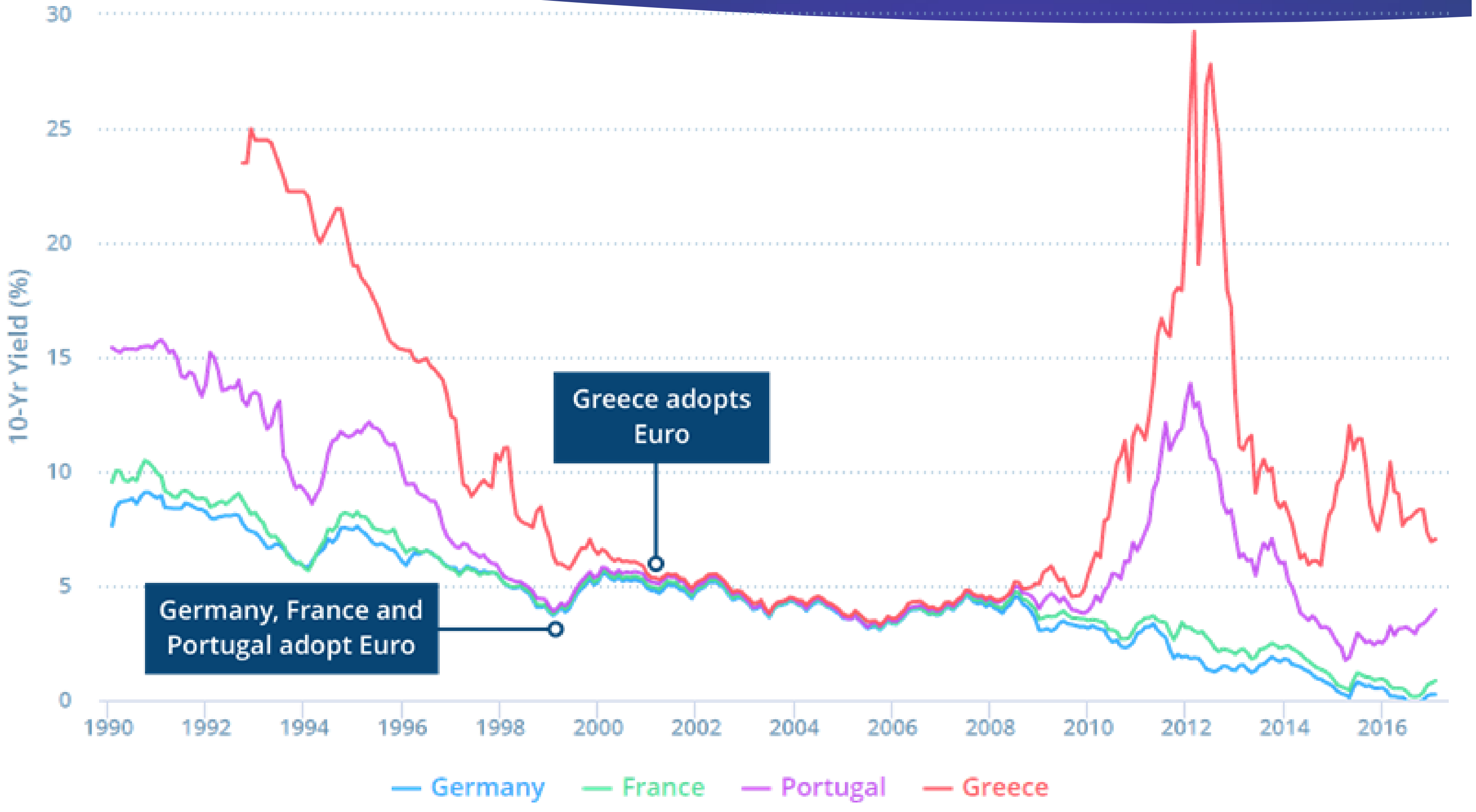
* 2012-2014 Eurostat estimates from January 2013

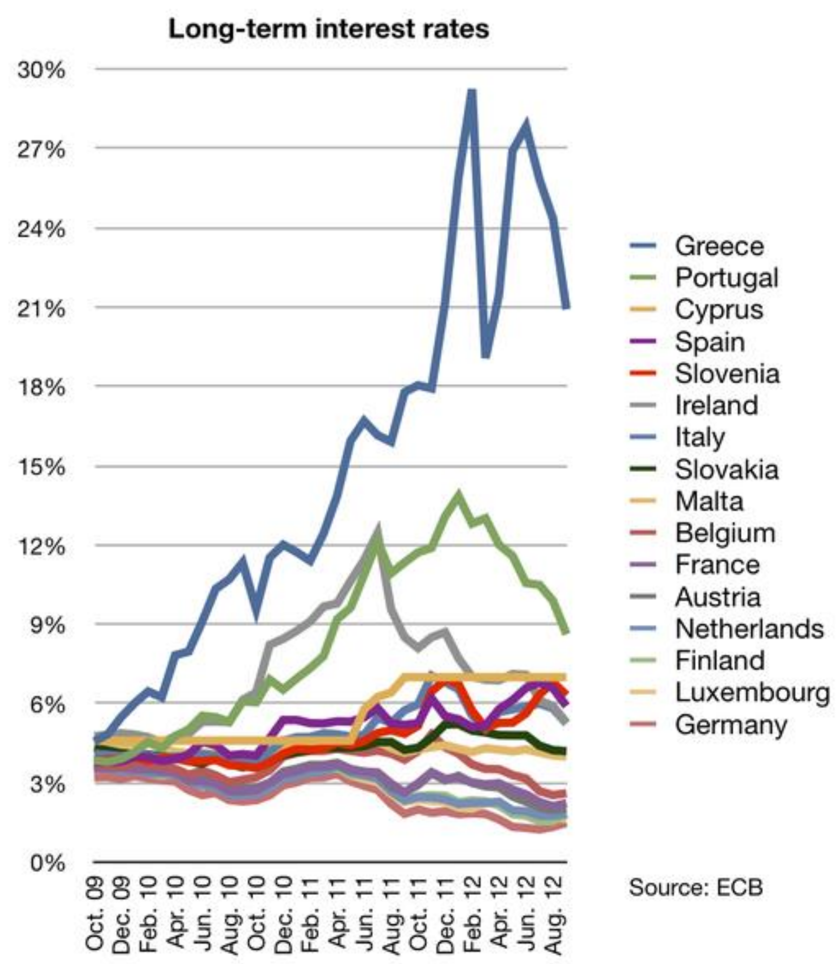
# Government debt as % of GDP 2012

Data 2016



# **Trust** in some countries disappeared like a …. in the wind



# 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

  not an export economy
- Borrowing cheaply, paying dearly
- Germany : “Greeks partied when they should have been saving”

# The Debt

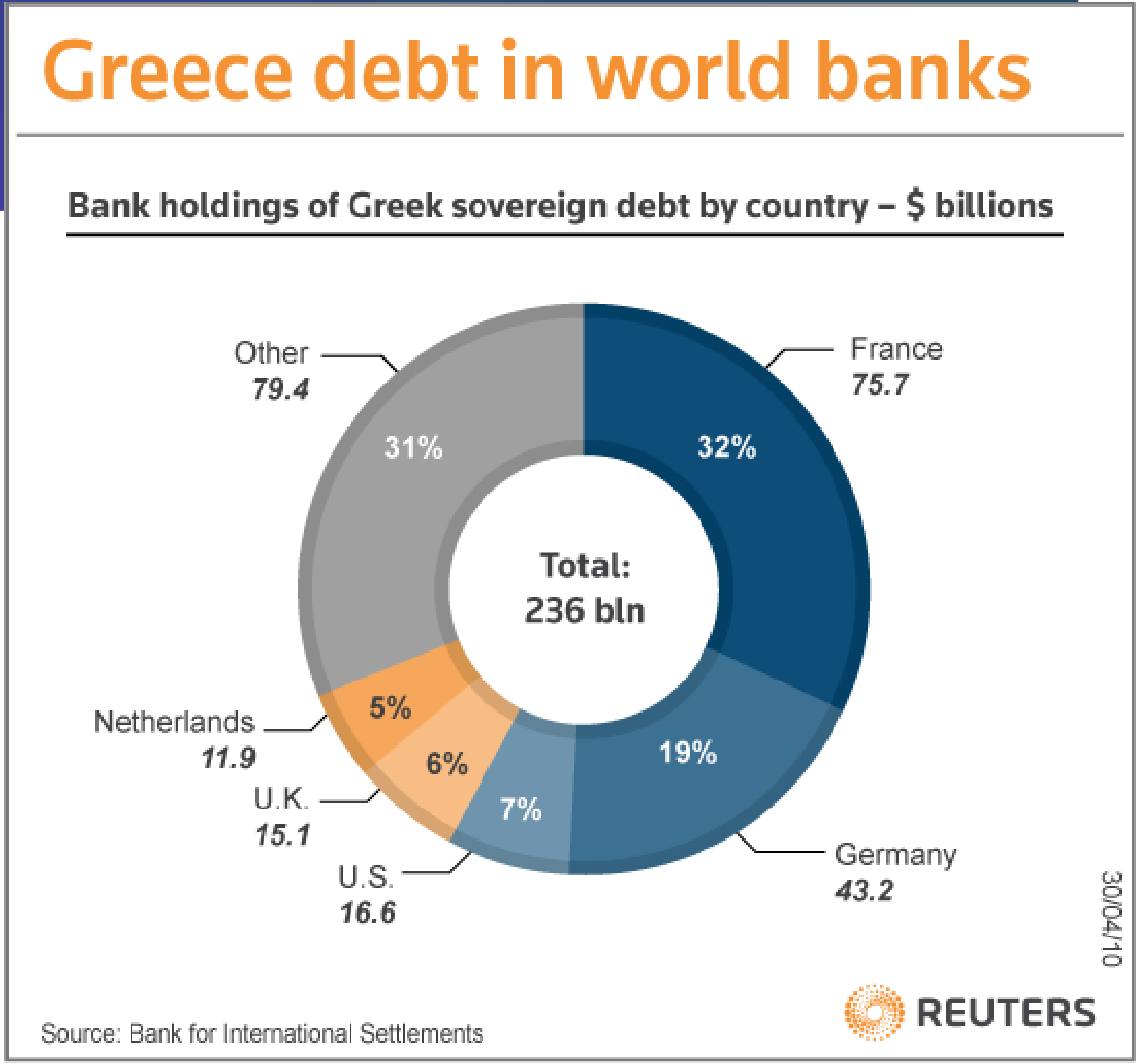
- PIIGS together owe – 3 trillion €

  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 ¯_(ツ)_/¯



Reuters graphic/Stephen Culp

# A bucket-load of problems

- **Integrated banking sector –> exposure** to dangerous 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 the first pebble that starts an avalanche ultimately leading to Eurozone disintegration

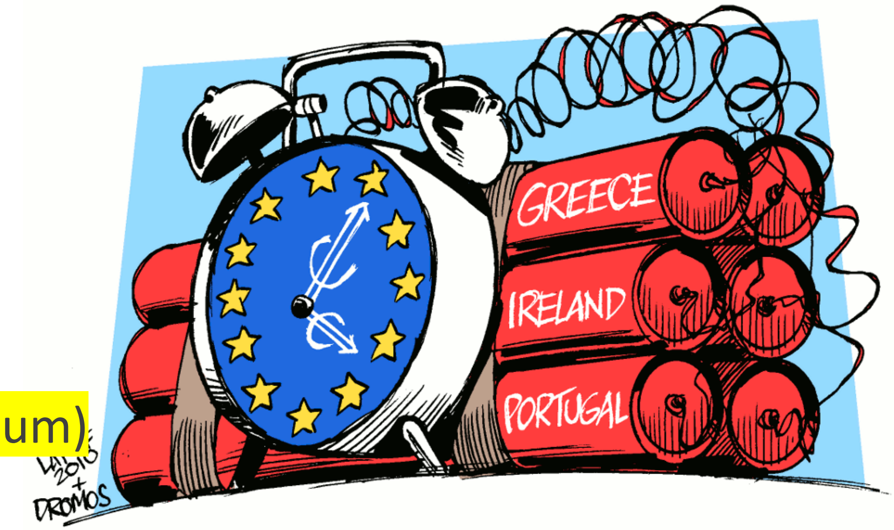
- **Regulation** of the global financial system?
- Curb the role of **rating agencies**…?
- **Crisis of capitalism as such**?

# **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 **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



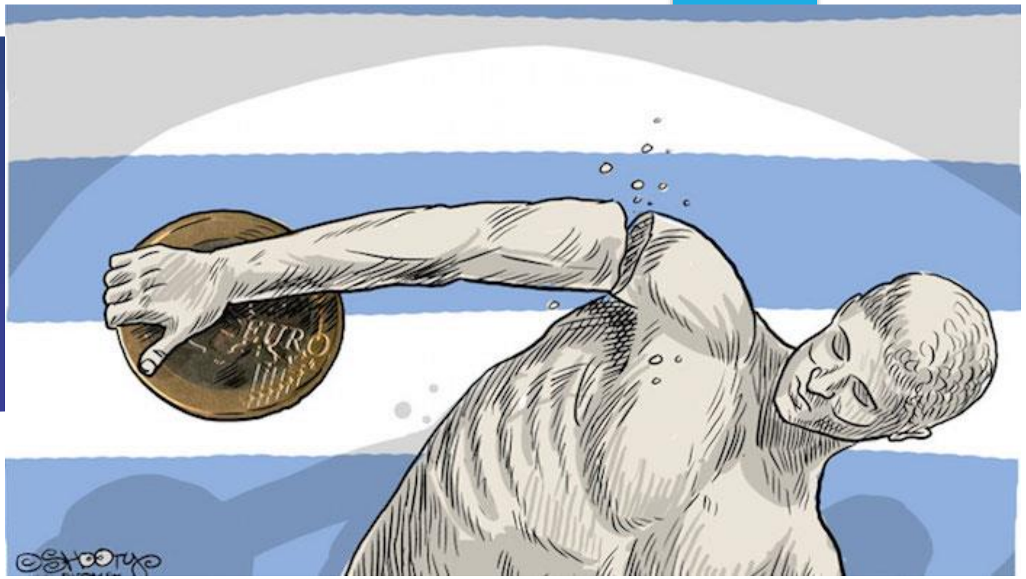
# Thomas Friedman:

*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…*

June 2012

# 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 brought the Greek debt down to 117% of GDP by 2020

 - June 2012 – **Spain I** (€100 billion) directly to Spanish banks not to increase 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%!!

# What has been done thus far?

## *European Stability Mechanism* 2012

- **a permanent** ‘bail-out’ **mechanism** to replace the *EFSF + 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

*“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**”*

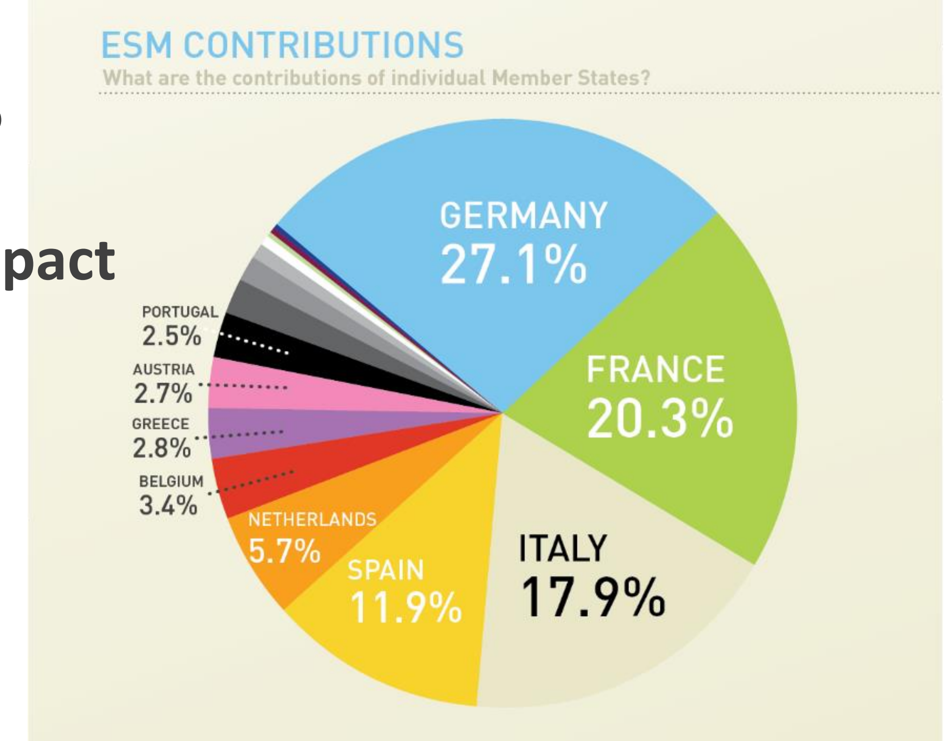
# *European Stability Mechanism*

→ 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**




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

# 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
- '**Two pack**' – extra layer of **budgetary coordination** for the Eurozone members

- Coordination of MS budgeting in a **'European Semester'**

# 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

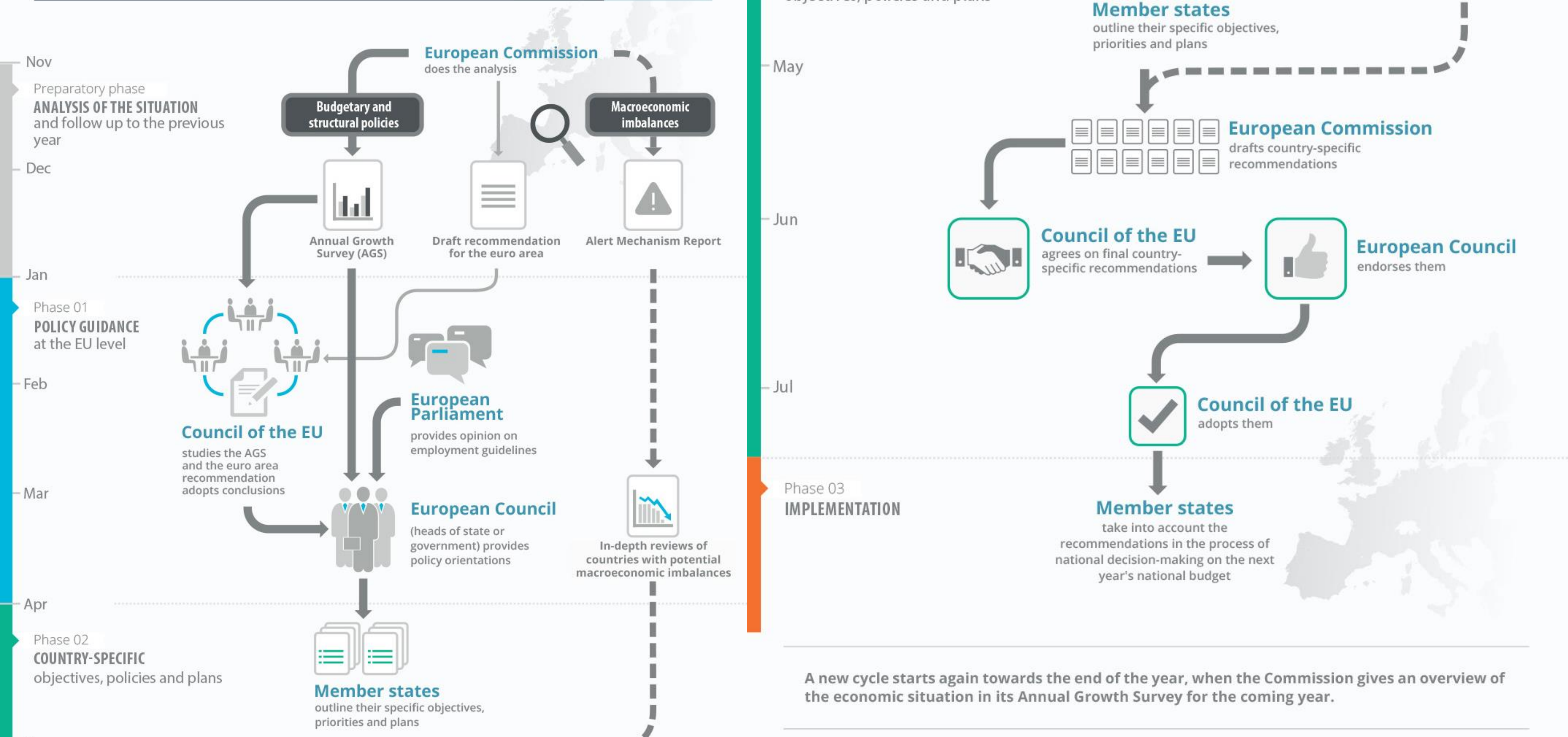
- Embryonic **fiscal union!! Eurozone’s economic governance**
- marginal role for the European Parliament, but European Commission’s oversight and advisory role
- European Court of Justice - arbiter

# Fiscal Compact

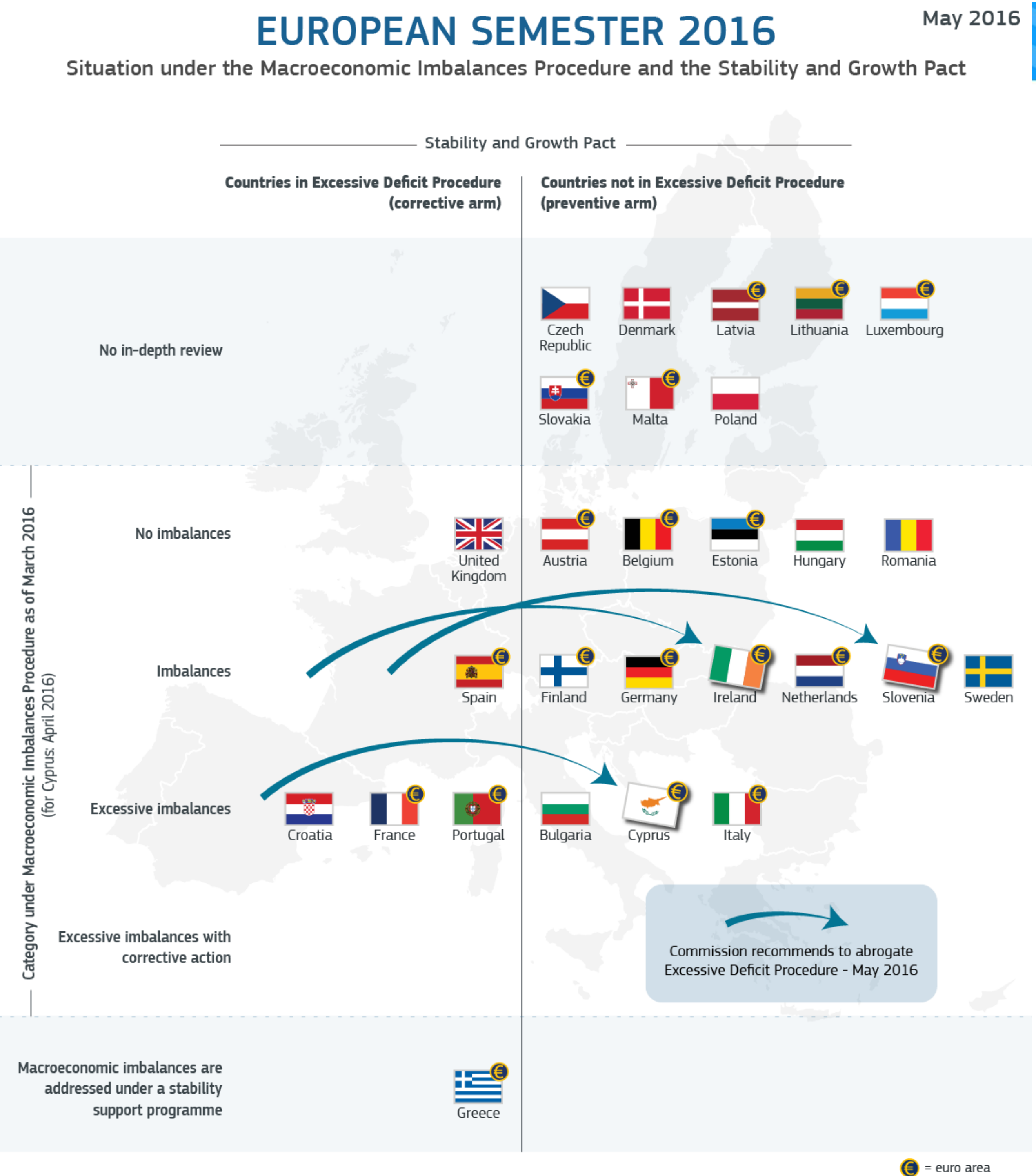

- ‘**Balanced budget rule**’, ‘**Debt brake rule**’, automatic correction mechanisms
- ‘**Balanced budget rule’** and **‘automatic correction mechanism’** be transposed into national legislation (preferably by a constitutional provision)
- Only countries with these rules are eligible for bail-outs!!!

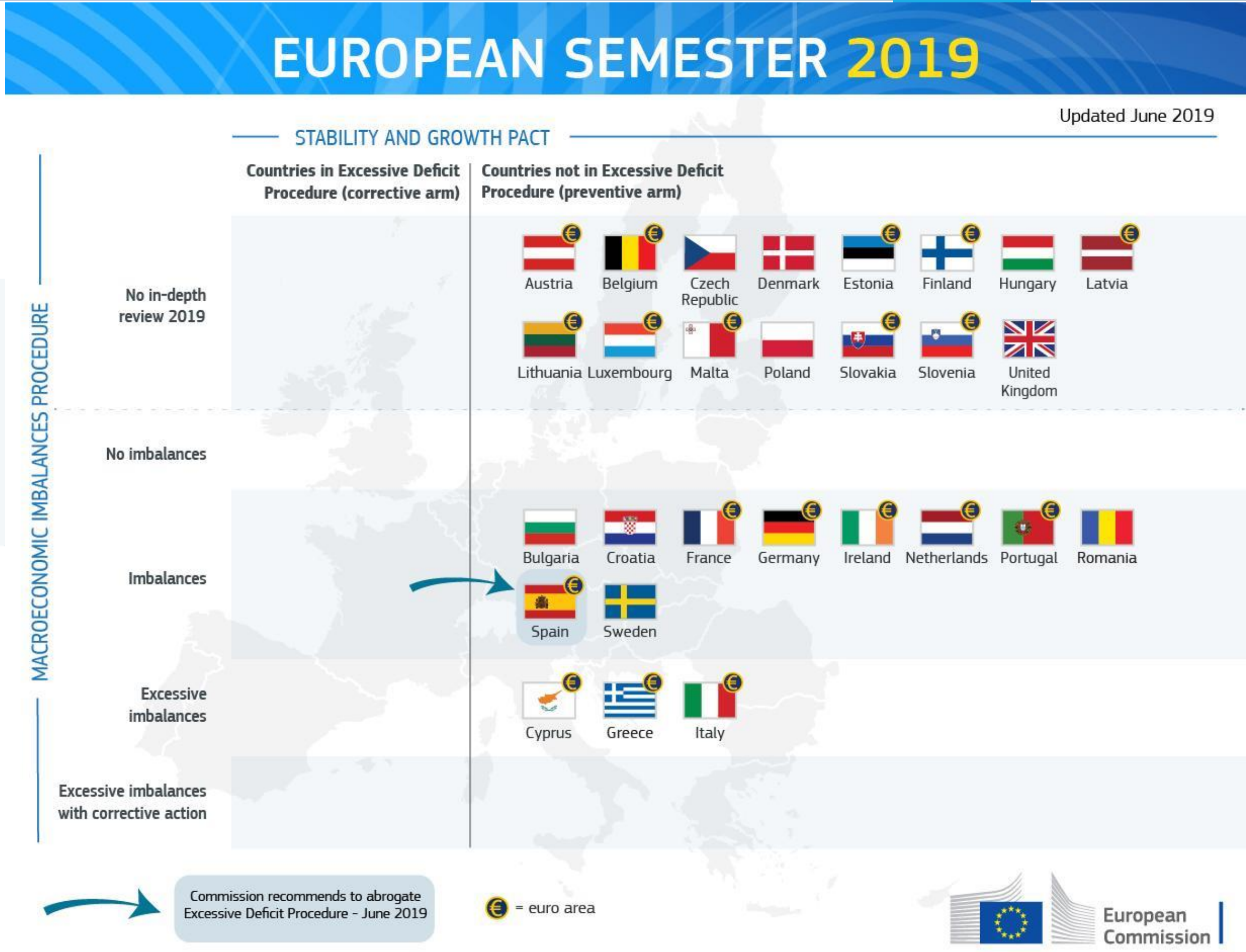
- ***Countries in excessive deficit* have to propose and implement structural reforms to ensure correction** – these measures **shall be submitted to the Council of the European Union and to the European Commission for endorsement (!) and monitoring**
- Ex-ante reports on public debt issuance – the **European 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

# Who does what in the European Semester?




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
Stability and Growth Pact
Countries in Excessive Deficit Procedure (corrective arm)
Countries not in Excessive Deficit Procedure (preventive arm)
Category under Macroeconomic Imbalances Procedure as of March 2016 (for Cyprus: April 2016)
No in-depth review
Czech Republic
Denmark
Latvia
Lithuania
Luxembourg
Slovakia
Malta
Poland
No imbalances
United Kingdom
Austria
Belgium
Estonia
Hungary
Romania
Imbalances
Spain
Finland
Germany
Ireland
Netherlands
Slovenia
Sweden
Excessive imbalances
Croatia
France
Portugal
Bulgaria
Cyprus
Italy
Excessive imbalances with corrective action
Commission recommends to abrogate Excessive Deficit Procedure - May 2016
Macroeconomic imbalances are addressed under a stability support programme
Greece
= euro area

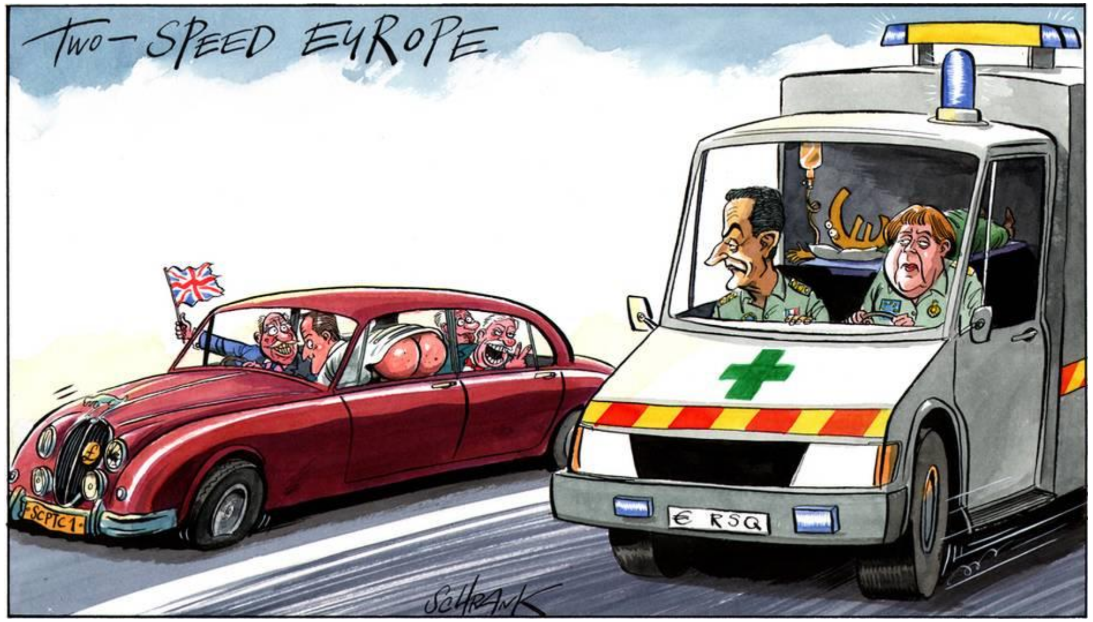

EUROPEAN SEMESTER 2019
Updated June 2019
STABILITY AND GROWTH PACT
Countries in Excessive Deficit Procedure (corrective arm)
Countries not in Excessive Deficit Procedure (preventive arm)
MACROECONOMIC IMBALANCES PROCEDURE
No in-depth review 2019
Austria
Belgium
Czech Republic
Denmark
Estonia
Finland
Hungary
Latvia
Lithuania
Luxembourg
Malta
Poland
Slovakia
Slovenia
United Kingdom
No imbalances
Imbalances
Bulgaria
Croatia
France
Germany
Ireland
Netherlands
Portugal
Romania
Spain
Sweden
Excessive imbalances
Cyprus
Greece
Italy
Excessive imbalances with corrective action
Commission recommends to abrogate Excessive Deficit Procedure - June 2019
= euro area
European Commission

# 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)