

Economic and Monetary Union: aka European Monetary Union

Primer on EMU

Dates

- Formal Start: Jan 1999
- Currency Physically Introduced: Jan 2002
 - Countries Have Acceded since 2001

Members

- Original (11) members: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain
- Later entrants: Greece (2001); Slovenia (2007); Cyprus (2008); Malta (2008); Slovakia (2009); Estonia (2011)
- Accession countries *must* try for entry via ERM-2
 - Denmark and UK have formal “opt-outs”

European Central Bank (ECB)

- Frankfurt (close to Buba)
- Run by executive board of six (non-renewable terms of eight years)
- Supervised by Governing Council (Executive Board plus national central bank governors = “E System of CBs” or ESCB), ruling by simple majority
- Highly independent
- Objective of Price Stability (interpreted as inflation close to but less than 2%); subordinate “general economic policies”

EMU Benefits

- Convergence of all European inflation rates to German rates
- Impossibility of “Beggar Thy Neighbor” competitive devaluations
 - UK, Italy, and Sweden in 1992
- Reduction in exchange rate volatility (thus transactions costs)
 - How important for business? Easy to hedge most risk via derivatives

Costs of EMU

- Loss of exchange rate as macroeconomic tool
 - Only relevant if shocks differ by member state *and*
 - Nominal devaluations have real effects
 - Recall Mundell’s “Optimum Currency Area”
criteria

“Convergence Criteria” 1

- Required for entry into EMU
- To be applied by the Council of Ministers
- Mostly Economic, but Highly Politicized

Convergence Criteria, 2

1. Institutions
 - Central bank independence
2. Inflation
 - CPI inflation within 1.5% of target;
 - Target is average inflation of three countries with lowest inflation
3. Interest Rates
 - Average long-term interest rates within 2% of target;
 - Target is average long-term interest rate of the three low-inflation countries

Convergence Criteria, 3

4. Exchange Rates

- Exchange Rates within “normal (?) bounds” ERM of EMS, 15% (!)
- No realignment within last two years

5. Fiscal Positions: “Sustainable Government Financial Position”, defined as:

- a) Flow: Deficit/GDP ratio of less than 3%, *and*
 - b) Stock: Debt/GDP ratio of less than 60%
- “Escape clauses” exist for “temporary circumstances” or declining debt

Stability (and Growth) Pact

- “Ins” should maintain deficits of less than 3% GDP or face penalties
 - German origins
 - Implies pro-cyclic fiscal policy
- Widely flouted by large countries in practice
 - France ‘03-’07, Germany ‘03-’06, Italy ‘03-?’
 - Also breaches by Greece, Netherlands, Portugal
 - Reformed slightly in 2005

EMU and Fiscal Policy

- Article 103 Maastricht Treaty “No Bail-Out”
 - “... neither the Community nor any Member State is liable for or can assume the commitments of any other Member State”
- European Financial Stabilization Mechanism (EFSM)
 - EC funds (from EU budget) of €60 bn
- European Financial Stability Facility (EFSF)
 - Created May 2010 by EMU ins “to safeguard financial stability in Europe”
 - Can issue €440 bn of bonds, guaranteed by members, to lend to members “in difficulty” who request help, s.t. EC, ECB, IMF conditionality
 - Greece requested and received rescue package from EU/IMF (€110 bn), May 2010
 - Ireland followed (€85 bn), November 2010

Optimum Currency Areas

- Economists usually ask two questions on EMU
 - “Do European Countries look like an Optimum Currency Area?” and
 - “Are European Countries similar to American Regions?”

Issues of Relevance

- Assessing OCA criteria for EMU
 - What are the *benefits arising from increased international trade* between areas?
 - How *synchronized are the business cycles* across areas?
 - How relevant are *Price Rigidities* (only for business cycles)?
 - If asymmetric business cycles: adjustment mechanisms?
 - *Fiscal flows* between areas (or some other kind of *risk-sharing*)?
 - How mobile is *labor* between areas?
- How relevant are OCA criteria for EMU?