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); Latvia (2014); Lithuania (2015)

• 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 EU 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 ofEMS, 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-cyclical 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
  – Revived at summit in December 2011
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)**
  - May 2010: 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 (“troika”) conditionality
  - Greece requested and received rescue package from EU/IMF (€110 bn), May 2010
  - Ireland and Portugal followed

- **European Stability Mechanism (ESM)**
  - Permanent bailout kitty aka “Firewall”
  - Increased in late March 2012 to €500bn, started 7/2012, fully ready by 2014 (!)
    - Probably still too small (German objections; France + others wanted €1 tn)
    - EFSF + ESM limit is €700 bn
    - Draghi, Sept 2012: ESM approval implies unlimited ECB support

- **European Monetary Fund (EMF) started July 2012**
- **European Banking Union (stress tests, Fall 2014)**
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?