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 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
  - 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?