Economic 461 | Maymester 2014
The crisis and European Economic and Monetary Integration | Prof. Bruno Dallago
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REQUIREMENTS

GOAL: Present and discuss the causes and main aspects of the present crisis in the European Union, with particular regard for the Eurozone and in the frame of the international crisis. The module pays particular attention to the problems deriving to the European integration from different factors: the unfavorable external economic environment, weak performance of various European economies, incomplete EU institutional architecture and policy instruments, common currency and monetary policy, national goals. Proposals for institutional and economic reform and alternative policies are presented and debated. Particular emphasis is placed on the countries that adopt the Euro as a common currency.

PREREQUISITES: ECON 101

LEVEL OF INSTRUCTION:

Students are expected to have a working knowledge of macroeconomic and microeconomic theory. The subject matter includes macro- and micro-policies and institutions. Graphical methods occasionally may be employed.

ORGANIZATION OF CLASS WORK:

The module uses an outcome-based approach focusing on what students need to know and the ability to focus on and solve problems. To this end, active learning is encouraged and use is made of short assignments with the instructor's regular feedback and support to students. Although grading is based on each student's individual result, cooperation and interaction among students and group work is encouraged.

Each class starts with the instructor introducing the topic, presenting the fundamental features, and proposing the most critical problems. Students are requested to study in advance the readings (one required reading for each day – further readings are also suggested during classes), search and propose additional sources, debate and solve the identified problems, raise questions, propose new problems, and participate actively in the presentation and discussion on the day issue.

REQUIREMENTS:

1. **The final exam** is obligatory. It counts 50% of the course grade.

2. **In-class activities** are part of the module. They count 50% of the course grade.

2. **Attendance:** Is compulsory and a record is kept. Students who miss more than 20 percent of the class days sampled without written permission will be penalized a half letter grade for the course. Those missing more than 30 percent will be penalized a full letter grade. Those missing more than 40 percent will **FAIL**.

3. **Tardiness:** Students who arrive after attendance is taken are responsible for notifying me at the end of the class. If they neglect to do so, tardiness is treated as an absence.

RULES: Exams

All exams are in essay format. You must comprehend and interpret the question properly, and be correct in the interpretation and the facts and data you use.

Use blue books. Do not sign your exams with your name. Pledge the honor code with your student ID#. Use a pen and write legibly. Illegible exams must be typed. Students who cannot write legibly for any reason may take exams at the learning center, but are responsible for making the necessary arrangements well in advance.

GRADING:

Grades depend primarily on your grasp of the topic you present in your assignments and the question in the final exam, analytic prowess, insightfulness and thoroughness of answers, not rote. An accurate fact profile is expected including strategic citations from appropriate sources. If facts are misstated or misconstrued, these errors will be penalized. Exams are read anonymously applying the standards set forth above.

Course grades depend solely on exams and on the participation to in-class activites. No other factor is considered. No credit is given for class presence (but excessive absences are penalized). Students are not permitted to retake exams unless they have valid written medical excuses or other equivalent authoritative justification.

GRADING SCALE:

A grade of C is assigned to exams that demonstrate a basic knowledge and understanding of the course material, allowance made for various minor errors of fact, and comprehension. A grade of B is assigned to exams that demonstrate a good knowledge and understanding of the course material allowance made for various minor errors of fact, and comprehension. A grade of A is assigned to exams that demonstrate a superior and complete knowledge and understanding of the course material, allowance made for various minor errors of fact, and comprehension. A grade of D is assigned to exams that fail to display a basic knowledge and understanding of the course material, allowance made for various minor errors of fact, and comprehension. A grade of F is assigned to exams that fail to display the minimal knowledge and understanding of the course material required for a grade of D, allowance made for various minor errors of fact, and comprehension.

REPORTING:

Course grades are electronically distributed to students soon after they are submitted. Please email me for an appointment only if you wish to see your exam. The rules stipulated above concerning your grasp of questions, analytic prowess, insightfulness and the thoroughness will govern appraisals.

SCHEDULE:

First Day of Class:	Tuesday, May 13th
Holiday:	Monday, May 26th
Last Day of Class:	Thursday, May 29th
Final Exam:	Friday, May 30th

OFFICE: Gardner XXX

OFFICE HOURS: M-F, 8-9AM

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COURSE OUTLINE

Contents

Background reading: Baldwin, Richard and Charles Wyplosz (2012), *The Economics of European Integration*, 4th ed., New York: McGraw Hill

The book provides students with an accessible presentation of the facts, theories and controversies driving rapid change in the heart of Europe. The authors combine essential elements of European history, institutions, law, politics and policies with clear and accessible explanations of the economic principles of European integration. The result is an expert analysis of the contemporary status of integration within the European Union.

Note: Background reading is a reference text for those who do not have a knowledge of the European integration. The background reading is not part of the exam. All other readings are required for the exam.

1. The long-run perspective and the context:

Presents the main components of the context within which the European integration and the crisis take place. The context has two fundamental components: the process of globalisation, which creates constraints and opportunities upon countries and the

Union, and national features and policies. The European Union has tried to pursue a synthesis of these two components in the form of the uneasy dialectic between the federalist and the inter-governmental principles in implementing European integration.

Required reading:

Faini Riccardo (2004), 'Europe: A Continent in decline?' (http://www.dagliano.unimi.it/media/98.pdf)

It was a common perception, on both sides of the Atlantic, during the 1990s that the European economy performed poorly when compared to that of the United States. While the latter's GDP grew at an average annual rate of 3.2 percent, the European Union's managed only an annual average increase of 2.1 percent. Moreover, the world's export share of the large Continental economies sharply declined, while the United States was able to achieve a slight increase in its share of total world trade. More importantly still, labor productivity growth in Europe remained higher than in the United States until the mid-1990s, after which time, however, productivity growth in the United States was more than twice as fast as that of the European Union. It is likely, therefore, that the 1990s witnessed a break in the long-established postwar trends that saw Western Europe and Japan catching up with the United States after losing ground for over a century prior to 1950.

2. Introduction to the European Union:

Sketches the main developments in Europe during the post-war period and the main features of the European Union in the frame of theories of economic integration. Particular attention is paid to the build-up of the European Union, the unfolding of the integration process, and policy making.

Required reading:

Sapir, André (2011), European Integration at the Crossroads: A Review Essay on the 50th Anniversary of Bela Balassa's Theory of Economic Integration, Journal of Economic Literature, Vol. 49, N° 4, pp. 1200–1229

The essay reviews developments in the economic literature and in the process of European integration since Bela Balassa's *Theory of Economic Integration* was published, showing that the book was incredibly prescient. It anticipated by more than twenty years the modern literature on economic integration that emphasizes scale economies, imperfect competition, and economic geography. It also predicted that monetary union cannot function properly without political unification, a condition well illustrated by the recent euro-debt crisis that is likely to be a watershed in the history of European integration.

3. The Eurozone economies and the early steps of the common currency:

Defines the Eurozone and its economic features and discusses the preconditions and the preparation for introducing the common currency. These include both technical aspects and steps and political ones, with important effects on the entire architecture and meaning of the European integration. It also presents the reasons for the apparently illogical process of introducing the common currency before the political unification is implemented and the problems that this achievement opens.

Required reading:

De Grauwe, Paul (2009), 'The Euro at ten: achievements and challenges', *Empirica*, Vol. 36, N° 1, pp. 5-20 (http://www.econ.kuleuven.be/ew/academic/intecon/Degrauwe/PDG-papers/Recently_published_articles/fulltext.pdf)

The article discusses the achievements and the challenges of the Eurozone. It first analyzes the record with respect to inflation. Second, it discusses the degree of price transparency in the Eurozone. Next it analyzes the extent to which monetary union has promoted faster economic growth. Fourth, it studies the challenges that arise from the increasing divergences of wages and prices within the Eurozone. It concludes with a discussion of the governance of the Eurozone and the political issues to which this leads.

4. The world economic crisis and its effects in the European Union:

Deals with the reasons for and the unfolding of the crisis by comparing the United States and the European Union. It considers the long-run and structural factors, the macroeconomic disequilibria in the economy, the state of the microeconomy. It also deals with the role that finances and pre-crisis policies had in causing and accompanying the development of the crisis.

Required reading:

Bussière, Matthieu, Jean Imbs, Robert Kollmann, and Romain Rancière (2013), The Financial Crisis: Lessons for International Macroeconomics, *American Economic Journal: Macroeconomics*, Vol. 5, N° 3, pp. 75–84 (http://pubs.aeaweb.org.ezp.biblio.unitn.it/doi/pdfplus/10.1257/mac.5.3.75) (http://www.aeaweb.org.ezp.biblio.unitn.it/articles.php?doi=10.1257/mac.5.3)

The article introduces a special section of the American Economic Journal: Macroeconomics, containing five papers presented during a conference in Paris in October 2011. The aim of the conference was to derive lessons from the financial crisis, for research on international macroeconomics and for policy. The article opens with a summary of the key mechanisms at play during the crisis. The question of the crisis transmission across borders is addressed, with a focus on international trade and financial institutions. Recent advances in the analysis of sovereign default risk are also discussed. The article concludes with a discussion of policy responses to the crisis.

5. **Financial causes and real origins of the European crisis***:*

Although the manifestation of the crisis in both the United States and in the European Union was primarily financial, its deep origins are real, as much as their most lasting consequences. A proper understanding of the crisis and of policies and reforms require a deep understanding of the real economy and its interaction with finances. This helps to explain the great resilience of the crisis to policies.

Required reading:

Dallago, Bruno (2013), 'Financial and real crisis in the Eurozone and vulnerable economies', *The European Journal of Comparative Economics*, Vol. 10, n. 3, pp. 195-215 (http://eaces.liuc.it/18242979201303/182429792013100301.pdf)

The paper looks at the deep and the direct causes of the crisis in the Eurozone and considers what changes are necessary. It shows that, together with financial aspects, the Eurozone crisis stems from the difficulties of the real economy and the incompleteness of European institutions. The former include divergent real performances, unsustainable development paths of the Member States, and growing distributive disparities. The consequences of misconceived stabilization policies magnified the effect of the above factors. The international crisis caused a shock that has had asymmetric effects within the Eurozone due to the divergent economic performances and the different institutions of the member countries. At the same time, European institutional incompleteness deprived member countries of effective policy-making and European policy management and support, thus converting the common currency into a problematic asset. Building on this framework, the paper critically analyses the institutional and economic reforms necessary to vitalize the process of European integration, and it stresses the urgent need to tackle the real and microeconomic causes of the crisis.

6. The sustainability of the economic and monetary union:

It has long been known that the Eurozone does not constitute a perfect optimal currency area. However, it was considered that consistent integration of markets and strong political will and commitment would either create or complement the missing factors. Up to the crisis, the external effects of an expanding international economy and careful policy management created incentives to economic activity and avoided asymmetric shocks. However, the international crisis changed the situation and put the euro at risk.

Required reading:

De Grauwe, Paul (2011), The Governance of a Fragile Eurozone, CEPS Working Document No. 346, May (http://astrid.eu/Riforma-de/Studi-e-ri/Archivio-27/CEPS_De-Grauwe-on-Eurozone-Governance_04_05_11.pdf http://astrid.eu/Riforma-de/Studi-e-ri/Archivio-27/CEPS_De-Grauwe-on-Eurozone-Governance_04_05_11.pdf)

When entering a monetary union, member countries change the nature of their sovereign debt in a fundamental way, i.e. they cease to have control over the currency in which their debt is issued. As a result, financial markets can force these countries' sovereigns into default. In this sense, member countries of a monetary union are downgraded to the status of emerging economies. This makes the monetary union fragile and vulnerable to changing market sentiments. It also makes it possible that self-fulfilling multiple equilibria arise. This paper analyzes the implications of this fragility for the governance of the eurozone. It concludes that the new governance structure – the European Stability Mechanism (ESM), which is intended to be successor starting in 2013 of the European Financial Stability Mechanism (EFSF), created in May 2010 – does not sufficiently recognize this fragility. Some of the features of the new financial assistance are likely to increase this fragility. In addition, it is also likely to present member countries from using the automatic stabilizers during a recession. This is surely a step backward in the long history of social progress in Europe. The author concludes by suggesting a different approach for dealing with these problems.

7. The asymmetric build-up of the Union and the incompleteness of the economic and monetary union:

The most immediate reason why the euro is put at risk and the European economic and monetary union is meddling through a difficult period is that the institutional build-up is incomplete and in many cases asymmetric. Institutional incompleteness is the main reason why external shocks – such as the US crisis – have important asymmetric consequences within the Eurozone. Institutional incompleteness includes two components: a) the incomplete development of European institutions that were supposed to replace national institutions and b) the strong limits to national policy-making following European agreements and the adoption of the euro. Policy making suffers as a consequence and becomes ineffective and inefficient.

Required reading:

Pisani-Ferry, Jean (2012), 'The Euro Crisis and the new Impossible Trinity', *Bruegel Policy Contribution*, N° 2012/01 (http://www.econstor.eu/bitstream/10419/72121/1/683140442.pdf)

The search for solutions to the euro crisis is based on a partial diagnosis that overemphasizes the lack of enforcement of existing fiscal rules. Europe's leaders should rather address the euro area's inherent weaknesses revealed by the crisis. At the core of euro-area vulnerability is an impossible trinity of strict no-monetary financing, bank-sovereign interdependence and no co-responsibility for public debt. The article assesses the corresponding three options for reform: a broader European Central Bank (ECB) mandate, the building of a banking federation, and fiscal union with common bonds. None will be easy. The least feasible option is a change to the ECB's mandate; changing market perceptions would require the ECB to credibly commit overwhelming forces, and the ECB is simply not in a position to make such a commitment. The building of a banking federation, meanwhile, involves reforms that are bound to be difficult. Incremental progress is likely, but a breakthrough less so. This leaves fiscal union. It faces major obstacles, but a decision to move in this direction would signal to the markets and ECB a commitment to stronger Economic and

Monetary Union. One possibility would be to introduce a limited, experimental scheme through which trust could be rebuilt.

8. Policies and their effects:

Policies within the Eurozone are incomplete and largely ineffective as a consequence of incomplete institutions. Moreover, rigid mandates strictly limit European institutions and policies. The policy spectrum is also largely incomplete, since the attention and policy making is concentrated on financial issues and in particular on public finances. These policies are having negative consequences for the real economy in weak countries and, through production and trade linkages, also in strong countries. The weak real economy is jeopardising the fixing of finances.

Required reading:

Acocella, Nicola (2013), *A Tale of two cities: Exit Policies in Washington and Frankfurt* (http://www.unitn.it/files/download/31972/acocella_a_tale_of_two_cities.pdf)

The paper discusses policy reactions to the crisis across the Atlantic, with specific emphasis on the European side. The paper aims at explaining the different attitude of European policymakers *vis-à-vis* their USA homologues and to this end it chooses the perspective of the historical roots of European monetary union institutions.

9. Mounting economic and financial problems and policy options:

Problems are mounting following the incomplete institutional architecture and the policy asymmetry and ineffectiveness. Most important among these, particularly in weaker Eurozone economies, are stagnation and shrinking domestic markets; growing public debts; inequalities and low mobility; unemployment and economic insecurity; and the risk of economic and industrial decline.

Required reading:

Nuti, D. Mario (2013), Perverse Fiscal Consolidation (http://www.unitn.it/files/download/31968/nuti_trento_perversefc.pdf)

The paper considers that fiscal consolidation works only in those countries that, having a sufficiently low public debt/GDP ratio, do not actually need a consolidation. In fact, since fiscal multipliers are much higher than previously considered fiscal consolidation is more expensive in terms of output loss than previously believed. Moreover, the higher are fiscal multipliers, the higher is the probability that fiscal consolidation will have the perverse effect of actually raising the public debt/GDP ratio.

10. Social and political questions:

The Eurozone difficulties have various negative social and political consequences, which include growing divergence among member countries, democratic deficit, political and social opposition, unpopularity of the common currency, poverty, youth unemployment, falling quality of life.

Required reading:

Darvas, Zsolt and Guntram B. Wolff (2014), Europe's social problem and its implications for economic growth, Bruegel Policy Brief, N° 2014/03

(http://www.bruegel.org/publications/publication-detail/publication/823-europes-social-problem-and-its-implications-for-economic-growth/)

The European Union faces major social problems. More than six million jobs were lost from 2008-13 and poverty has increased. Fiscal consolidation has generally attempted to spare social protection from spending cuts, but the distribution of adjustment costs between the young and old has been uneven; a growing generational divide is evident, disadvantaging the young. The efficiency of the social security systems of EU countries varies widely. Countries with greater inequality tended to have higher household borrowing prior to the crisis resulting in more subdued consumption growth during the crisis. The resulting high private debt, high unemployment, poverty and more limited access to education undermine long-term growth and social and political stability. Policymakers face three main challenges. First, addressing unemployment and poverty should remain a high priority not only for its own sake, but because these problems undermine public debt sustainability and growth. Second, bold policies in various areas are required. Most labor, social and fiscal policies are the responsibility of member states, requiring national reforms. But better coordination of demand management at European level is also necessary in order to create jobs. Third, tax/benefit systems should be reviewed for improved efficiency, inter-generational equity and fair burden sharing between the wealthy and poor.

11. The advantages from integration and national institutional and economic reform:

European integration creates advantages for its members. However, it also creates opportunities for free riding. Some countries like Germany implemented important reforms in the past decade that have been bearing important fruits in terms of good financial management and dynamic real economy. Others, such as Italy, have been postponing the issue for decades and are disadvantaged by ineffective and inefficient institutions. Due to the difficult economic and financial situation, reforms meet even greater obstacles than in the past. The support of Europe and the coordination of reforms at European level may make a difference in pushing reforms through in each country.

Required reading:

Boltho, Andrea and Barry Eichengreen (2008), 'The Economic Impact of European Integration', *Discussion Paper No. 6820*, Centre for Economic Policy Research (http://eml.berkeley.edu/~eichengr/econ_impact_euro_integ.pdf)

Economic integration, from the European Payments Union and the European Coal and Steel Community to the Common Market, the European Monetary System, the Single Market, and the euro, is one of the most visible, controversial and commented-upon aspects of Europe's development since the end of World War II. It is hard to imagine that Europe's economy would have developed the same way without it. Or is it? We see how far we can push the argument that European living standards, growth rates, and economic structure would have been little different in the absence of the institutions and processes that have culminated in today's European Union. We adopt the methodology applied by Fogel to the railroads: suspecting that the results are small, wherever possible we adopt assumptions that bias upward the estimated impact. We conclude that European incomes would have been roughly 5 per cent lower today in the absence of the EU.

12. Devolution and proposals for common institutional and economic reform:

Various proposals have been advanced for a devolution away from the euro. Others maintain that the only option for the European Union is to accelerate the process of integration, with particular concern for completing common institutions and making them more effective, and for better coordinating national policies.

Required reading:

Pisani-Ferry, Jean, André Sapir and Guntram B. Wolff (2012), The messy rebuilding of Europe, Bruegel Policy Brief (http://www.bruegel.org/publications/publication-detail/publication/719-the-messy-rebuilding-of-europe/)

The euro crisis and subsequent policy responses have challenged the assumptions underpinning the governance of the euro area, and the relationship between the European Union's euro- and non-euro countries. The euro policy regime has become increasingly complex and difficult to manage, raising the question of the accountability of decision making to citizens. Complexity also threatens to create frustration for euro area members, which fear that initiatives to strengthen the euro will be hindered, and for non-euro members, which fear that they will be de-facto deprived of their say in decisions of major relevance to them. It is too early to determine if and how policy integration within the euro area will develop beyond its current limited monetary and budgetary remit. Alternative scenarios can be envisaged, from the building of a coherent euro area within the EU, to a fragmentation of the financial market and a generalised 'variable geometry'. Policy action should be based on the need to: a) Make room for deeper integration within the euro area, beyond the limited remit envisaged in the Lisbon treaty. b) Preserve the integrity of the EU27 and its essential governance arrangements. c) Ensure equal treatment in the application of common rules. d) Ensure that candidates for euro-area membership have a voice in the definition of its rules. e) Balance the requirements of legal clarity, accountability and efficiency with the desirability of experimentation through variable geometry.

13. The challenges ahead:

The fundamental problem that the European Union in general, and the Eurozone in particular are affording concerns the necessity to pursue fiscal stabilisation, institutional reforms and economic growth and development at the same time. The inability of Europe to manage the crisis so far has been fundamentally due to the lack of the proper instruments (complete and effective institutions), of coordination and of trust among the member states. This is apparently causing lasting damages to the European economic potential and the life of European citizens. On the plus side, there is the pressure from and the increasing awareness of the fact that the future and perhaps the very existence of the Union and the common currency are at stake.

Required reading:

OECD (2014), *Economic challenges and policy recommendations for the euro area* (http://www.oecd.org/eu/Euro_Area_Brochure_EN.pdf)

The study presents a diagnosis of the pending structural reform agenda as well as of other policy actions that hold much potential for boosting growth and jobs in the euro area. The euro area is beginning to show the much-awaited signs of recovery. Area-wide efforts to strengthen the public finances and the institutional underpinnings of the monetary union are sowing the seeds of growth. But comprehensive structural reforms are needed to enhance productivity and restore competitiveness and to pave the way for enterprise development and job creation in the years to come. Much has been achieved by the southern countries that have been worst hit by the crisis over the last five years. Courageous steps have been taken to enhance competitiveness and tackle the build-up of debt and external imbalances that occurred in the run-up to the crisis. But challenges remain in those countries and elsewhere in the euro area to further narrow intra-area imbalances in a durable manner, and to strengthen the recovery throughout the region. In particular, there is much scope for further pro-competition reforms in some core euro area countries, where the impetus for reform has not been as strong as in the south after the crisis. Ambitious reforms to secure lasting structural adjustment in the euro area need to be supported by sound macroeconomic policies and financial sector repair. Fiscal consolidation must continue as planned, while allowing the multipliers to operate and preserving much needed public investment in education, infrastructure, innovation and other key growth-enhancing programs. It is also essential to strengthen the euro area banks and put in place a well-functioning banking union so that lending and effective financial intermediation can resume in support of the recovery.