European Economy: Summary

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Optimum Currency Area Theory

- Benefits
  1. Lower transaction costs
  2. Price transparency
  3. Uncertainty reduction
  4. Improvements in trade
  5. Quality of monetary policy
- Costs
  1. Link between shocks and exchange rate
  2. Asymmetric shocks
  3. Symmetric shocks with asymmetric effects

Criteria for a common currency area

NB - These criteria are endogenous

1. Labour mobility
2. Production diversification
3. Trade openness

4. Fiscal transfers
5. Homogeneous preferences
6. Solidarity

Is the EU and optimum currency area?

Criterion	Satisfied
Labour mobility	No
Trade openness	Yes
Product diversification	Yes
Fiscal transfers	No
Homogeneous preferences	Partially
Commonality of destiny	Hard to tell

Main principles of the Economic and Monetary Union (EMU)

1. Provide price stability
   - Keep inflation between 1.5-2% over the medium term
2. Central bank independence
   - European Central Bank's main aim is securing price stability
3. Fiscal discipline
   - Budget deficit below 3% of GDP
   - Public debt should not exceed 60% of GDP

Fiscal policy in the EU

- Fiscal policy set by member states, but subject to Maastricht Treaty
- Remaining macroeconomic instrument to deal with shocks
  - Slow to implement
  - Budget needs to be balanced
  - Fiscal policy is countercyclical
- Enforcement of debt/deficit limits through Stability and Growth Pact
- Fiscal compliance with Maastricht Treaty is poor
  - Except for most new member states
  - Even with compliance things can go wrong, e.g. Spain

The Eurocrisis

- Large macroeconomic shock with asymmetric effects
  1. Exposed euro design faults
  2. Underwhelming response EU
- Effects Great Recession amplified by
  1. High levels government debt
  2. Financial integration (debt exposure)
  3. Trade imbalances
- Illustrated competitiveness problem of EU countries

The Eurocrisis

- EU response complicated by politics
  - Little agreement on how to deal with issue
  - Ad hoc measures (financial bail-outs), combined with harsh austerity
  - No cyclical fiscal transfers
- ECB response very conservative
  - Discussion about mandate
  - More hands on since Draghi
- Recovery takes long time for certain countries
  - Economic divergence
  - Need to implement structural reforms

Economic growth in the EU

- Slow growth since 1990s
  - Growth mainly through capital deepening
  - Little improvement in total factor productivity
- Productivity slump potentially result of
  1. Taxation level
  2. Regulations
  3. Level of competition
- Main macroeconomic issues in EU
  1. Lack of competitiveness
  2. Low employment rates
  3. Gloomy demographic prospects
- Potential growth stimulants of EU membership
  1. Boost in trade and investment
  2. Lower consumer prices
  3. Improvement in fiscal and monetary policy
- New members could potentially benefit from joining the Euro