NYU 上海 SHANGHAI 纽约大学

International Political Economy (SOCS-SHU 222)

THE EUROPEAN MONETARY UNION

Instructor: JING QIAN

Intro to LaTeX with Overleaf

Date and Time

Tuesday, May 6 2025 at 5:15 PM CST to
Tuesday, May 6 2025 at 6:15 PM CST

Add To Google Calendar | iCal/Outlook

Location

W507, Active Learning Classroom
Library, West Building, NYU Shanghai
View Map

THE EUROPEAN MONETARY UNION

Kathleen R McNamara

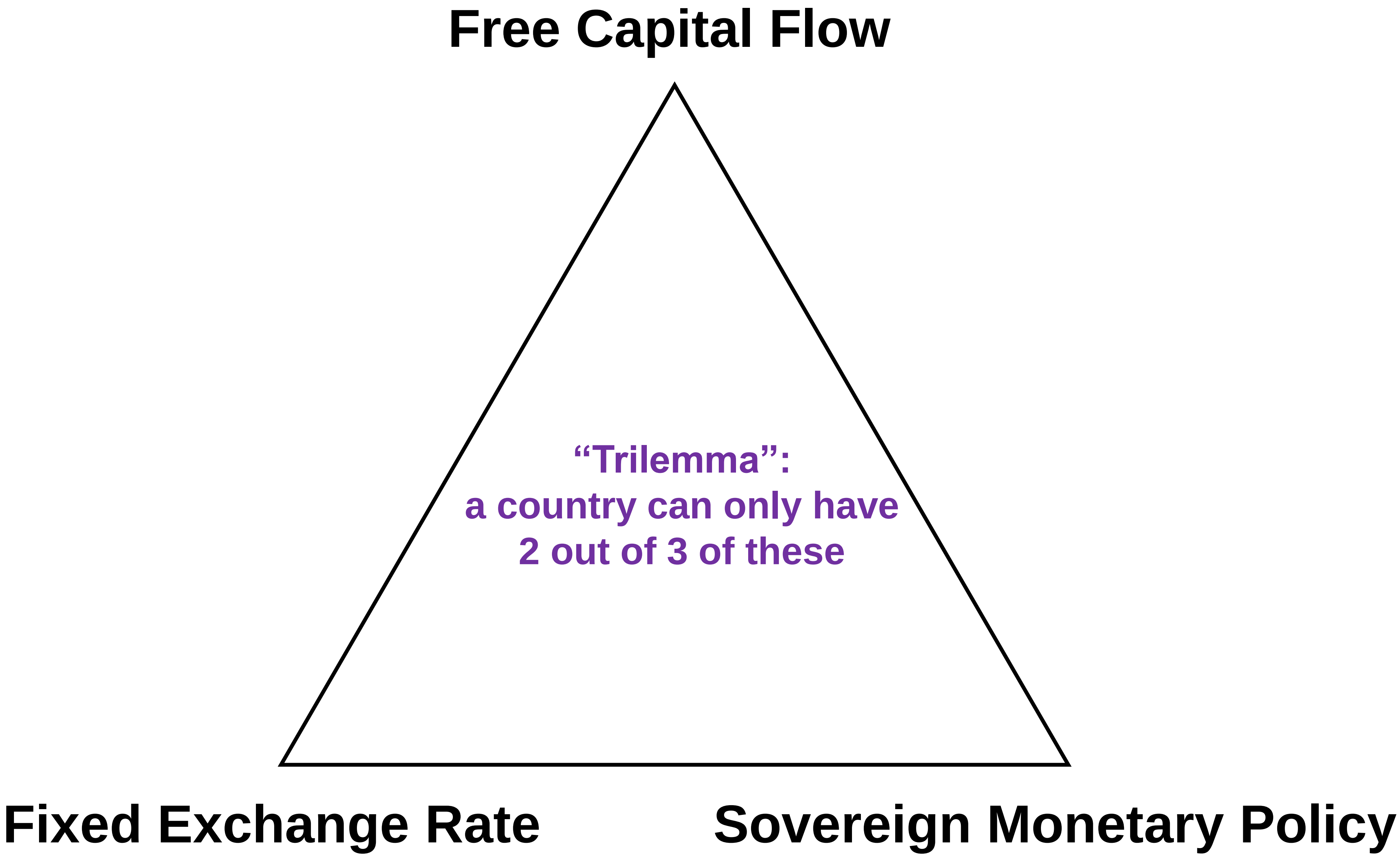
Professor

GEORGETOWN UNIVERSITY

READING ASSIGNMENT:

McNamara, Kathleen R. 2008. A rivalry in the making? The Euro and international monetary power. *The Review of International Political Economy* 15 (3):439-459.

NYU SHANGHAI 上海纽约大学


Free Capital Flow
“Trilemma”:
a country can only have
2 out of 3 of these
Fixed Exchange Rate
Sovereign Monetary Policy

Fixed Exchange Rates

- The problem: Cannot credibly commit to hold the fixed XR
  - East Asian financial crisis, Argentine pesos, etc.
- The **Euro** represents an ultimate* commitment
  - *unless they really figure out a way to kick out Greece & Cyprus
  - Survived the 2008 GFC

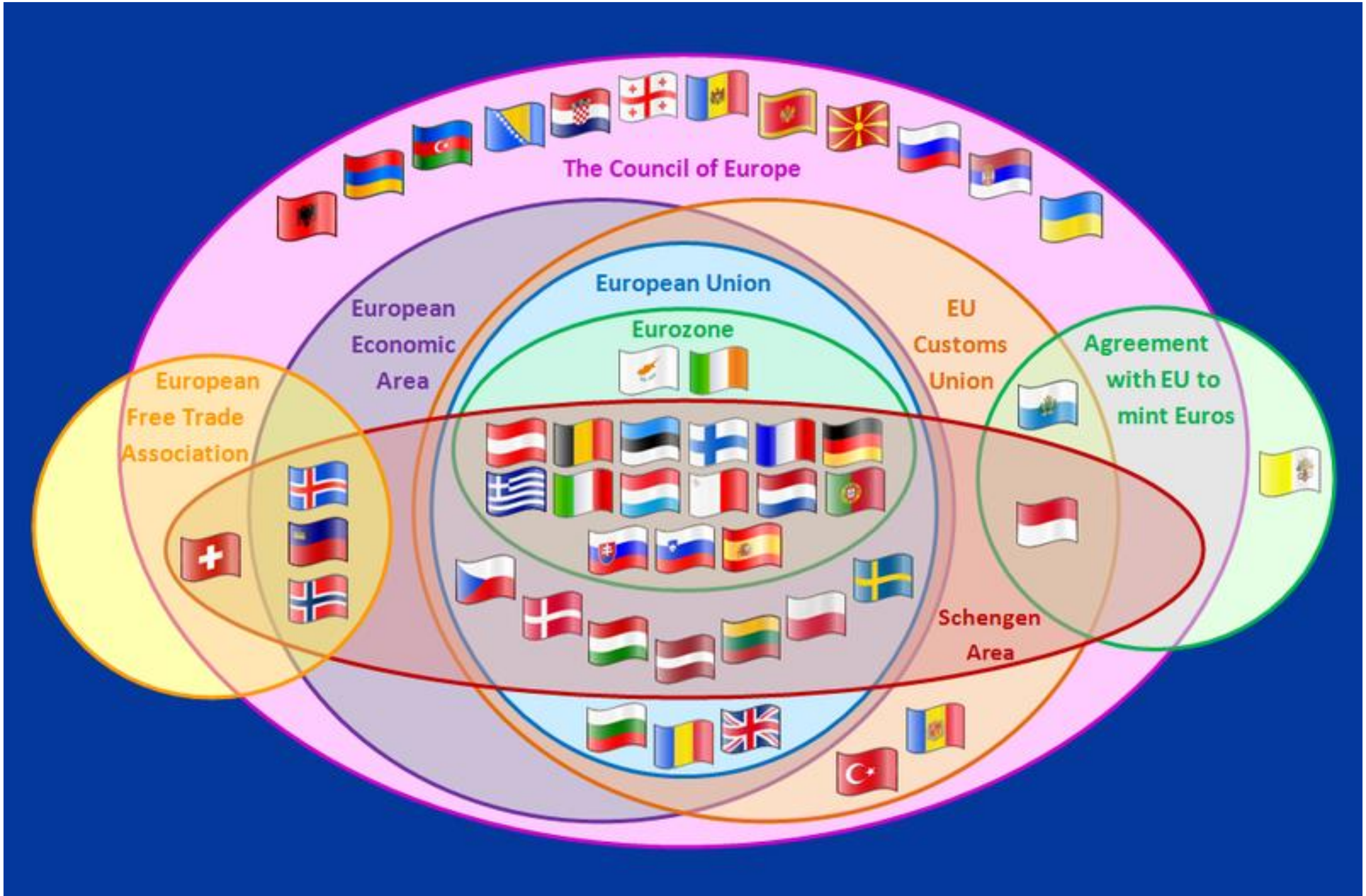
How did it all start?

- 1951: European Coal and Steel Community (ECSC)
- Six members
  - Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany

How did it all start?

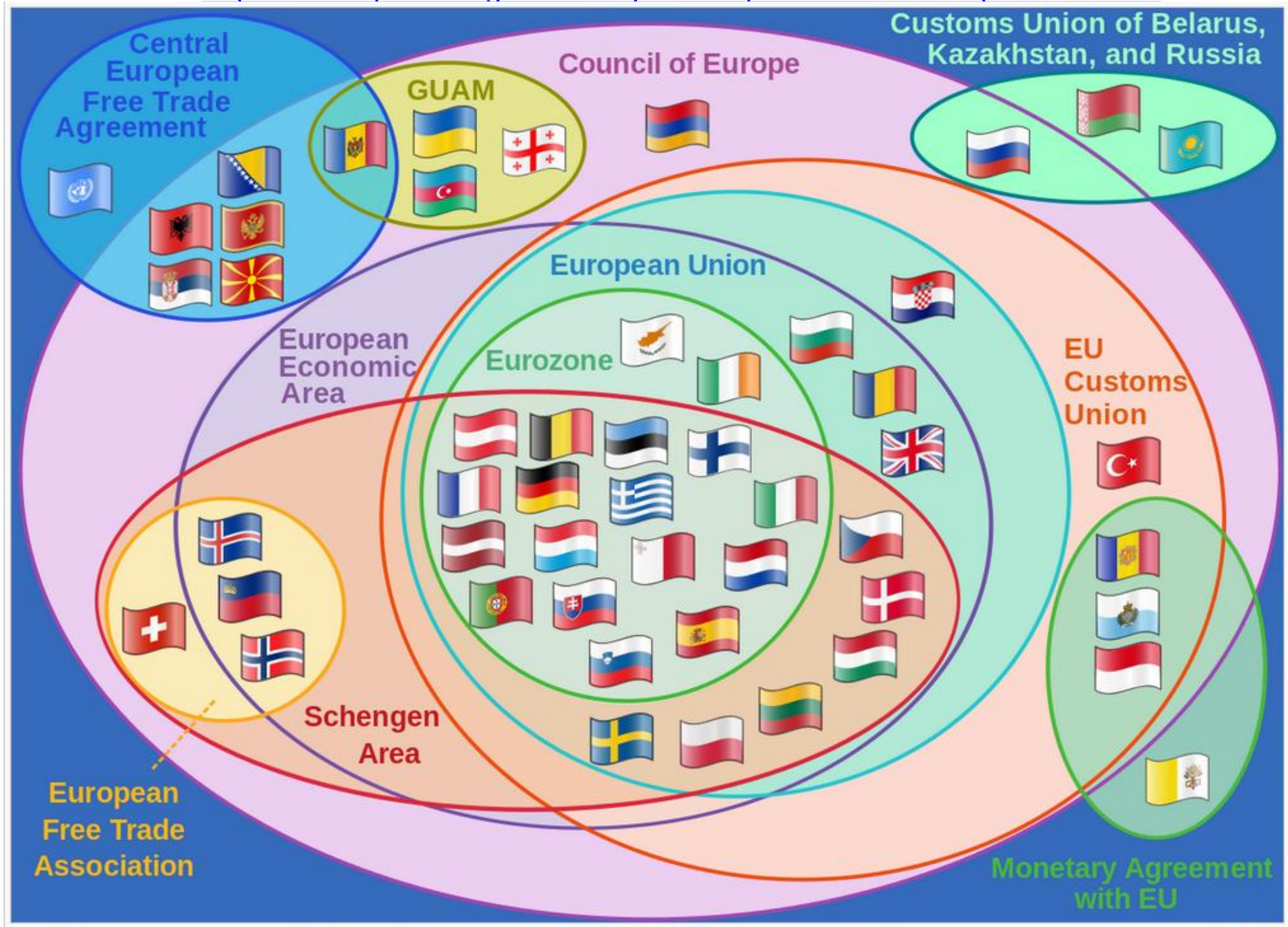
- 1979: The European Monetary System
- Fixed but adjustable
- How did it work?
  - Essentially, the Bundesbank (Germany) used monetary policy to keep inflation low, and the rest of EMS members fixed to the German mark

2010

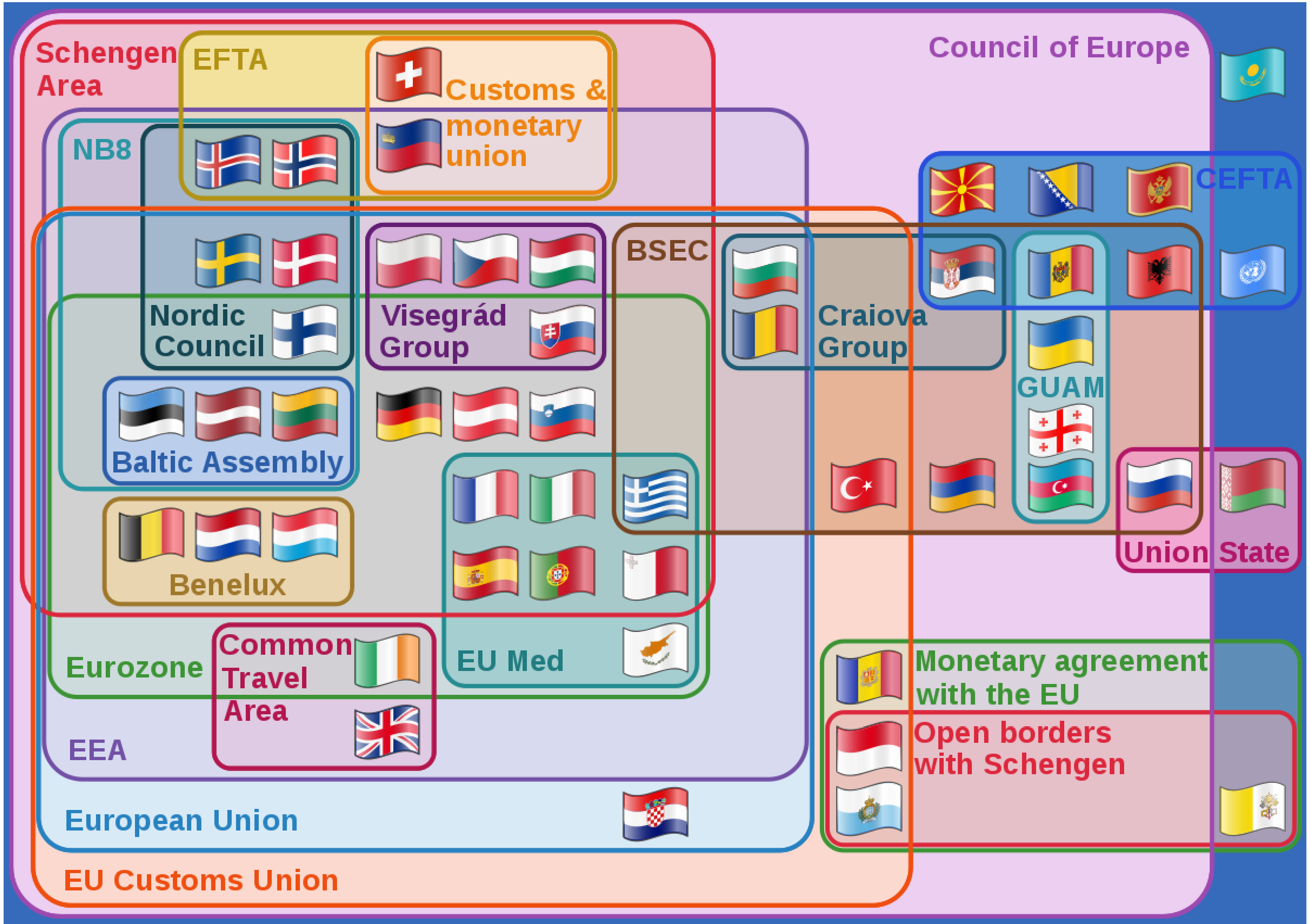

The Council of Europe
European Economic Area
European Union
Eurozone
EU Customs Union
Agreement with EU to mint Euros
European Free Trade Association
Schengen Area

2014

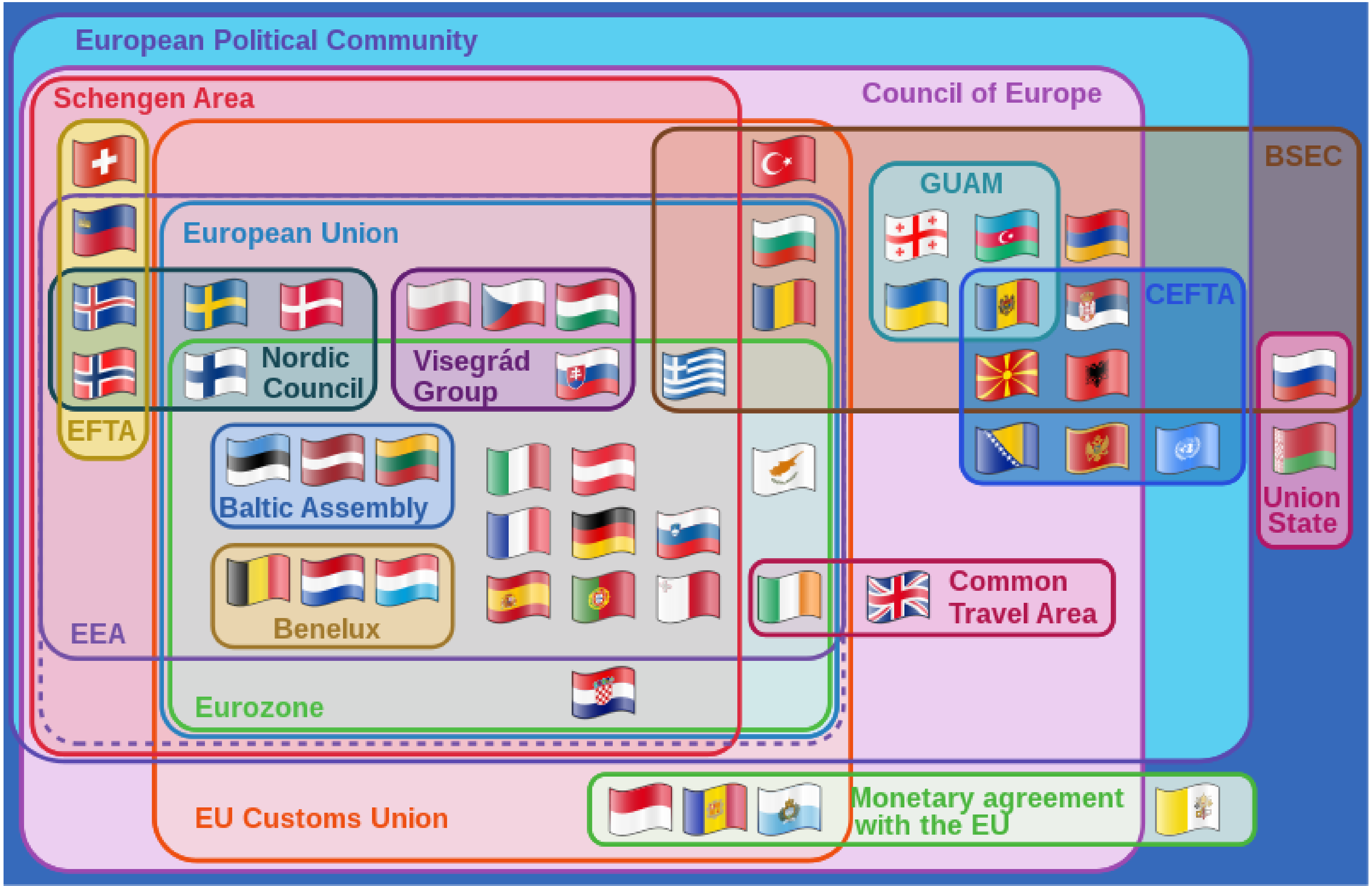
From http://en.wikipedia.org/wiki/Template:Supranational_European_Bodies



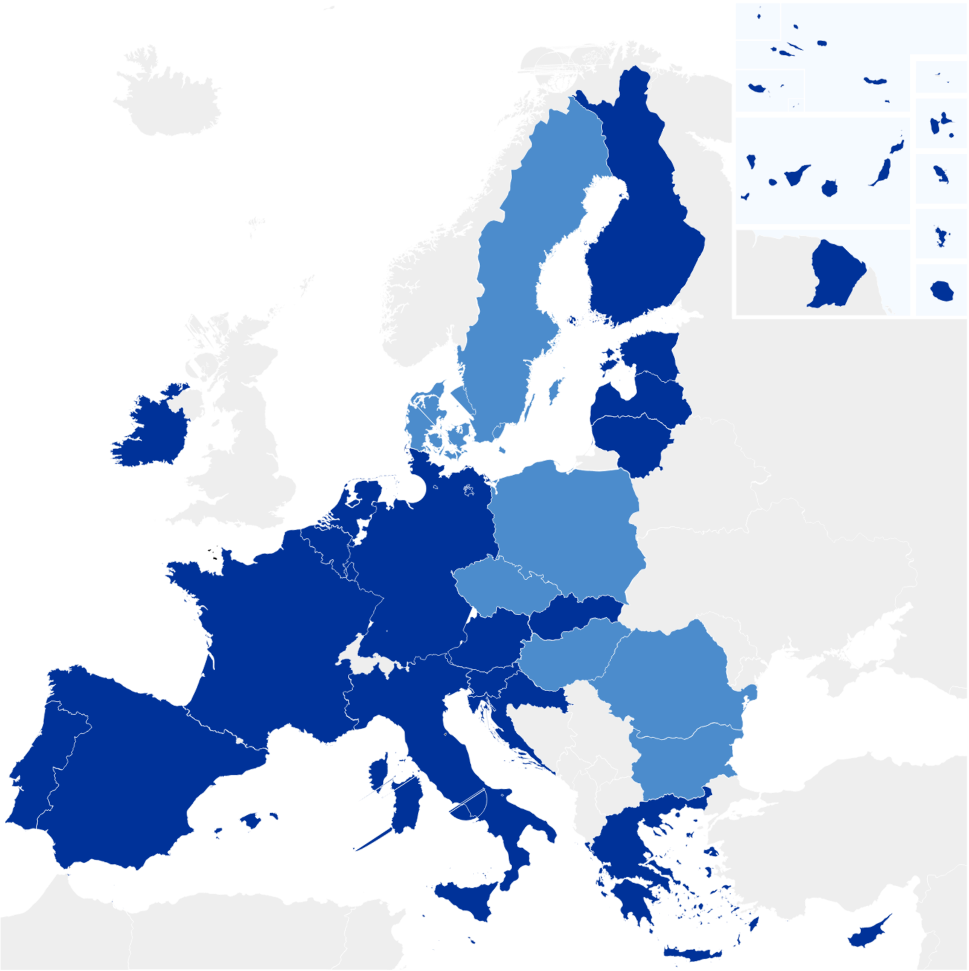
2017


Schengen Area
EFTA
Customs & monetary union
Council of Europe
NB8
CEFTA
Nordic Council
Visegrád Group
BSEC
Craiova Group
GUAM
Baltic Assembly
Union State
Benelux
Eurozone
Common Travel Area
EU Med
Monetary agreement with the EU
Open borders with Schengen
EEA
European Union
EU Customs Union

2023


European Political Community
Schengen Area
Council of Europe
BSEC
GUAM
European Union
CEFTA
Nordic Council
Visegrád Group
EFTA
Baltic Assembly
Union State
Common Travel Area
Benelux
EEA
Eurozone
EU Customs Union
Monetary agreement with the EU

The Euro Area



350 million

live in the euro area

That's **1** in **22**

people worldwide

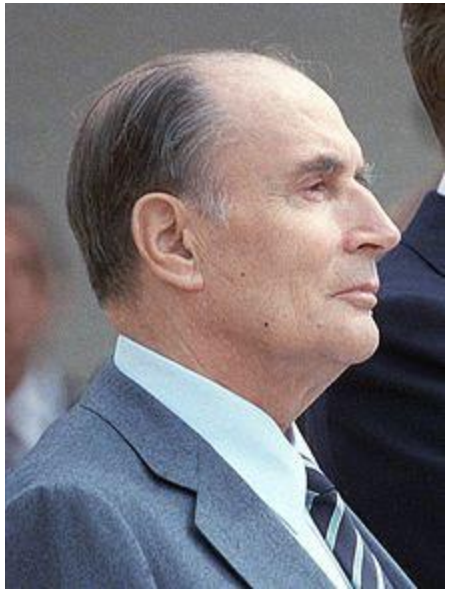
■ Euro area ■ EU members not using the euro

Membership

- Some countries, the “Eurozone” doesn’t want (yet/ever?)
  - Must do the 2 year European Exchange Rate Mechanism
- Some countries don’t want the Eurozone (yet/ever?)
  - Opt out – Denmark, UK
  - Sweden

- Why?
- It’s a real commitment
- A relatively recent test:
- The more historic test…

French-German Fight in 1981-3



French-German Fight in 1981-3

- Mitterrand – socialist president – believed German monetary policy was strangling
- Expansionist monetary policy (e.g., lowered interest rates)
- French inflation began to rise
- Called on Germany to lower their interest rates
- 18 month stand-off…
- the French backed down

1988-2002: Monetary Union

- 1988: Planning begins
- Gradually moved towards fixing their currency XR’s (1999 – “permanently” fixed)
- Jan 2002: ***The Euro!***
- Why union?
- High degree of economic openness across Europe ➔
- Sacrificed monetary autonomy for XR stability

Sacrifice

- In the pursuit of free-flowing goods & services, and capital across the borders of Europe…
- Eurozone countries have completely surrendered monetary policy
- Germany’s inflation concerns threatened by Portugal, Italy, Greece, & Spain
- Portugal, Italy, Greece, & Spain’s unemployment concerns threatened by Germany
- A genuine sacrifice of sovereignty has taken place

The Euro

- The ultimate commitment

- So, if it’s credible, will the euro overtake the dollar as the international reserve currency?

https://www.youtube.com/watch?v=36zdot18iBU

Good Will hunting

- (around min 21…)
- SKYLAR: Maybe we could go out for coffee sometime?
- WILL: Great, or maybe we could go somewhere and just eat a bunch of caramels.
- SKYLAR: What?
- WILL: When you think about it, it's just as arbitrary as drinking coffee.
- SKYLAR: (laughs) Okay, sounds good.
- http://www.imsdb.com/scripts/Good-Will-Hunting.html

Is the Euro an alternative?

- Coordination game
- Present distribution of reserve currencies:
  - Dollar: ~58%
  - Euro: ~20%
  - Pound: ~4%
  - Yen: ~6%
  - Swiss franc: ~0.1%
  - Other: 5%

Obstacles to the Euro

- A focal point: The more people who use an international currency, the more effective it is (increasing returns to scale)

- **No equivalent to the US treasury bill @ the EU level**

- Leadership – who bails you out?
    - US track record v. EU (…Greece?)

Be careful what you wish for…

- Benefits of international reserve currency
  - finance fiscal deficits
  - enhance international prestige
  - debt denoted in your own currency

- Costs of international reserve currency
  - Monetary policy autonomy is hindered - vast quantities of your currency held abroad
  - Overvaluation leads to uncompetitive export-oriented/import-competing sectors

Bretton Woods II

Bretton Woods II – The Shift After Crisis

- Asian governments: "Never Again" to IMF reliance post-1997 crisis
- Response: Build defenses to avoid future capital flow crises
- First line of defense: **Self-insurance**
  - Accumulation of large foreign exchange reserves
  - East Asia's reserves grew to over $4 trillion by 2009
  - China: $2.4 trillion; Japan: ~$1 trillion

Persistent Current Account Surpluses

- Strategy: Run current account surpluses to fund reserve accumulation
- Pegged currencies to the U.S. dollar at competitive (undervalued) rates
- Used capital inflows to finance exports, hold U.S. government debt
- Maintained sterilized interventions to keep domestic money supply stable

Modern Bretton Woods System

- East Asia finances U.S. deficits by recycling export earnings
    - Buys U.S. government bonds and securities
- Result: Mutual dependence
    - East Asia relies on export-driven growth
    - U.S. relies on foreign investment to fund deficits
- System stable as long as East Asia holds U.S. debt

Ching Mai Initiative & Global Impact

- **Second defense**: Regional cooperation via Chiang Mai Initiative (2000)
  - Regional swap arrangement among ASEAN+3 countries
  - Provide liquidity in crises without IMF
- Bretton Woods II's irony: Massive reserves helped fuel global imbalances
  - Contributed to 2008 crisis by lowering U.S. interest rates
  - Fed asset bubbles in the West while shielding Asia

Currency Wars and Taper Tantrums

Capital Flow Stability in the 2000s

- Early 2000s: Period of financial calm for developing countries
- Capital focused on U.S. property markets
- Low inflows to emerging markets → time to rebuild
- Many governments accumulated reserves
- By 2008: Lowest outstanding IMF credit in 30 years


financial crisis
Crash of 2008
SATURDAY, OCTOBER
Disbelief, and a punter
The plunging market yesterday dealt a
new blow to investors' confidence, as
the government decided to inject
million into counselling services
losers in the financial crisis
"Major
also started to cut
revised its economic
for this year down to
per cent. For next
to 2 per cent,
9.1 per cent in
"The slowdo
a normal fluctua
in a report yest
enough eviden
economic dow
Last night
Chao (李超),
spokesman,

U.S. Quantitative Easing (QE) and Spillovers

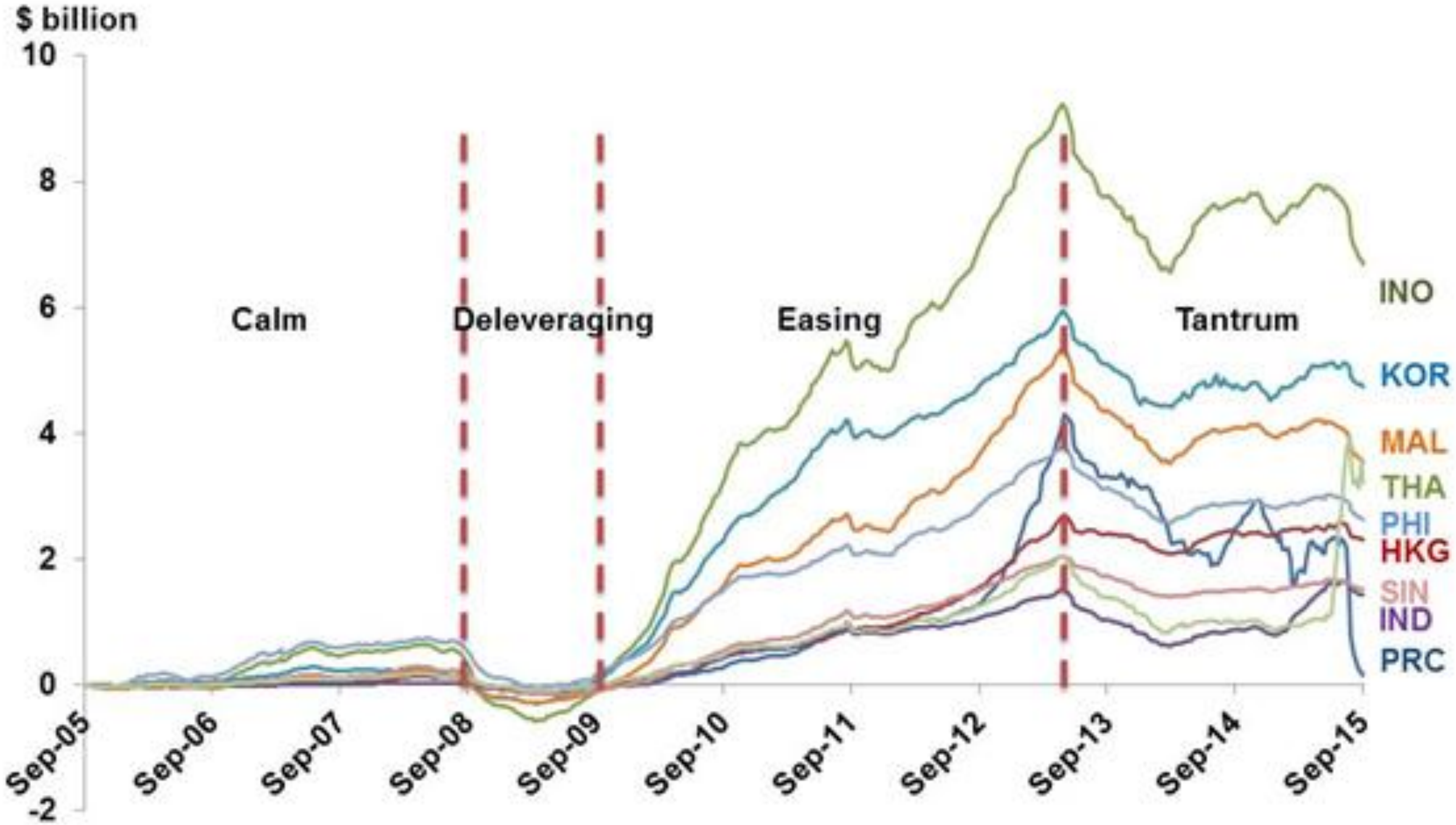
- QE1 (2008), QE2 (2010), QE3 (2012): Fed bought treasury bonds
- Lower interest rates in U.S. → Investors sought higher returns abroad
- Surge in capital inflows to emerging markets
- Consequences:
  - Rising asset prices (e.g., real estate)
  - Currency appreciation
  - Risk of asset bubbles

https://www.youtube.com/watch?v=7txAuJfDJD4&t=78s

Taper Tantrum and Reversal

- 2013: Fed signals end of QE ("tapering")
- Investors panic → withdraw capital from emerging markets
- Currency depreciation, stock market losses
- Governments raise interest rates to stabilize markets
- India, Brazil, South Africa, etc. affected

Cumulative net capital flows into local bond markets



What does a “run” look like?

https://www.youtube.com/watch?v=iPkJH6BT7dM

Global Capital Flow Cycle Revisited

- Recurring pattern: Boom in capital inflows followed by bust
- Triggered by changes in U.S. monetary/fiscal policy
- No systemic crises in 2010s→ Lesson from past reforms?
- Reducing volatility needs stronger macroeconomic coordination

Federal Funds Effective Rate (FEDFUNDS)

Observations
Mar 2025: **4.33**
Updated: Apr 1, 2025 3:17 PM CDT
Next Release Date: Apr 28, 2025

Units:
Percent,
Not Seasonally Adjusted

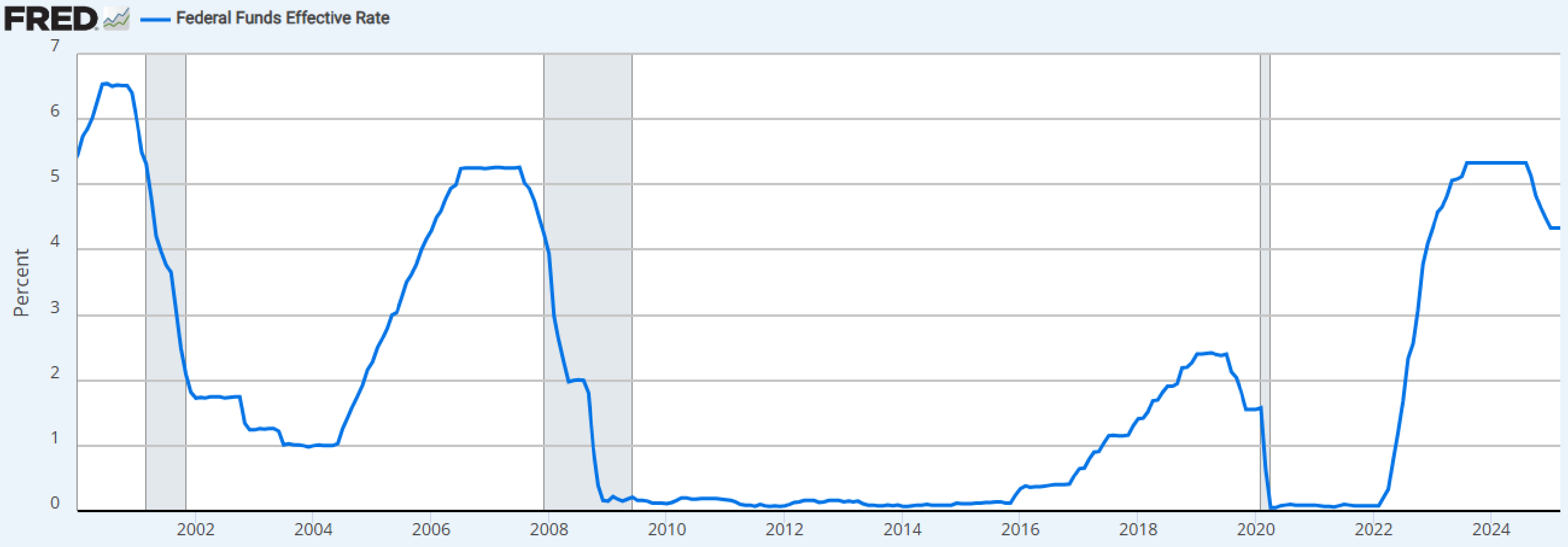
Frequency:
Monthly

1Y | 5Y | 10Y | Max

2000-01-01 to 2025-03-01

Edit Graph

Download



Source: Board of Governors of the Federal Reserve System (US) via FRED®
Shaded areas indicate U.S. recessions.

fred.stlouisfed.org

Fullscreen

Share Graph Account Tools

Thank You!

NYU 上海 SHANGHAI 纽约大学

Take-away

- Addresses the old problem that the IMF failed to solve
- Still limited as a currency
  - No EU-level bond
- Is it the next international reserve currency?
  - Not any time soon
  - Coordination game
  - The Dollar is still “noon, Grand Central information booth”