The European Monetary Union

Origins, problems and solutions

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Today's seminar

1. The origin of the European Monetary Union and a bit of economics
2. The causes (and consequences) of the Eurozone crisis
3. Varieties of capitalism and European monetary integration

I. The origin of the European Monetary Union and a bit of economics

Europe after World War II

- Shattered continent after the devastation of World War II
- Liberal democracies, more equitable economic growth and increasing standard of life.
- *Wirtschaftswunder* (DE), *Les Trente Glorieuses* (FR), *il miracolo economico* (IT)
- Increased economic interdependence leads to peace (Robert Schuman, Jean Monnet, Cordell Hull)
- Pooling production makes **“war not only unthinkable but also materially impossible”** (Robert Schuman)

European economic and monetary integration

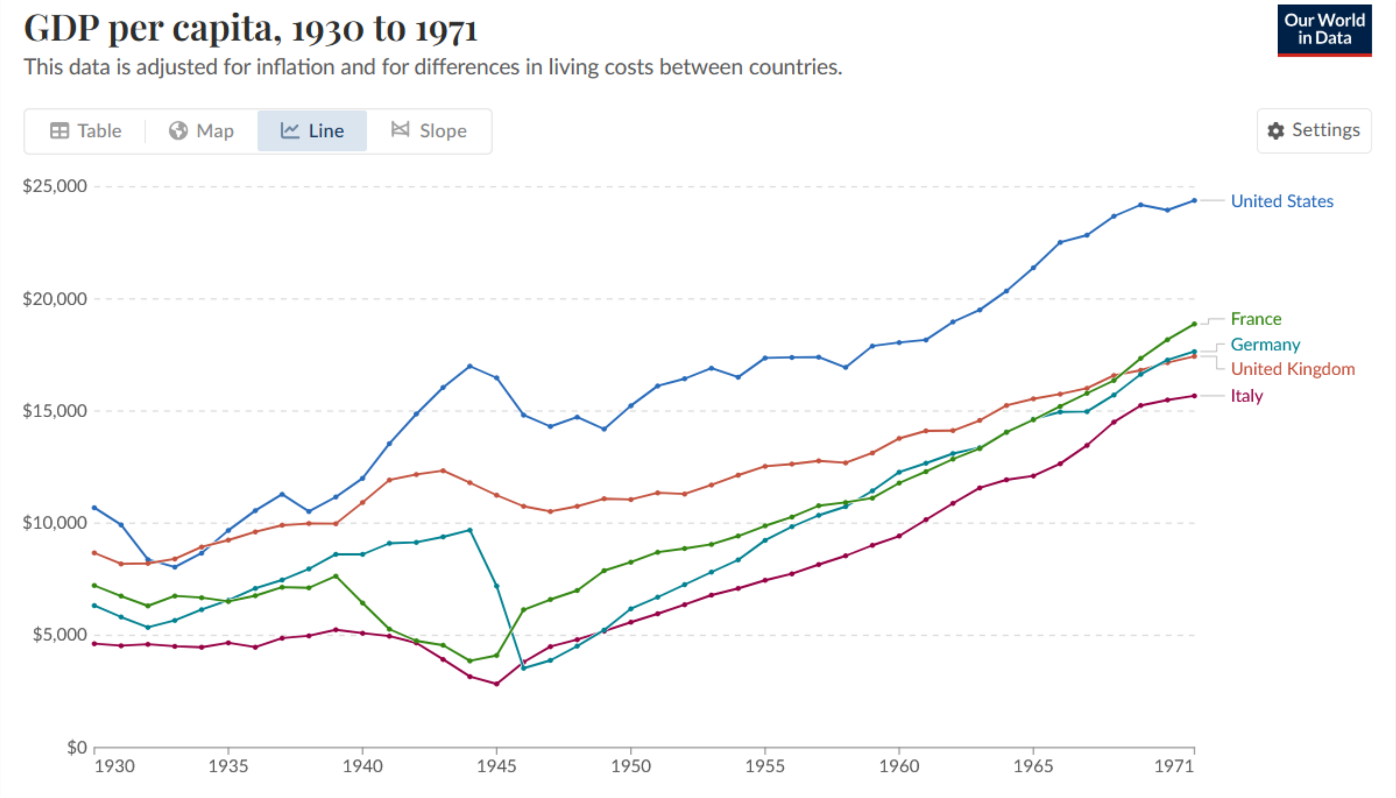
- European Coal and Steel Community (1951), Treaty of Rome and the start of the European Economic Community (1957)
- Customs union and elimination of tariffs between European countries
- Higher levels of intra-European trade
- Enlargement to more European countries
- Single market and the establishment of the **Four Freedoms of the EU**

Monetary integration

- A common currency eliminates exchange rate risks, enhances price transparency and reduces transaction costs for businesses and consumers
- No exchange fees
- It encourages cross-border trade, investment and economic integration

But first let us contextualize European monetary integration globally

- **Embedded Liberalism** (Ruggie, 1982)
  - A balance between free markets and state intervention.
  - Allowed European states to pursue economic growth & welfare policies while engaging in international trade.
  - Created stability for post-war European recovery.
- **Bretton Woods System (1944)**
  - Fixed exchange rates provided monetary stability, crucial for early European cooperation.
  - U.S. dollar pegged to gold; European currencies pegged to the dollar.
  - Collapse in 1971 forced Europe to seek new monetary arrangements (e.g., the Snake in the Tunnel, EMS).



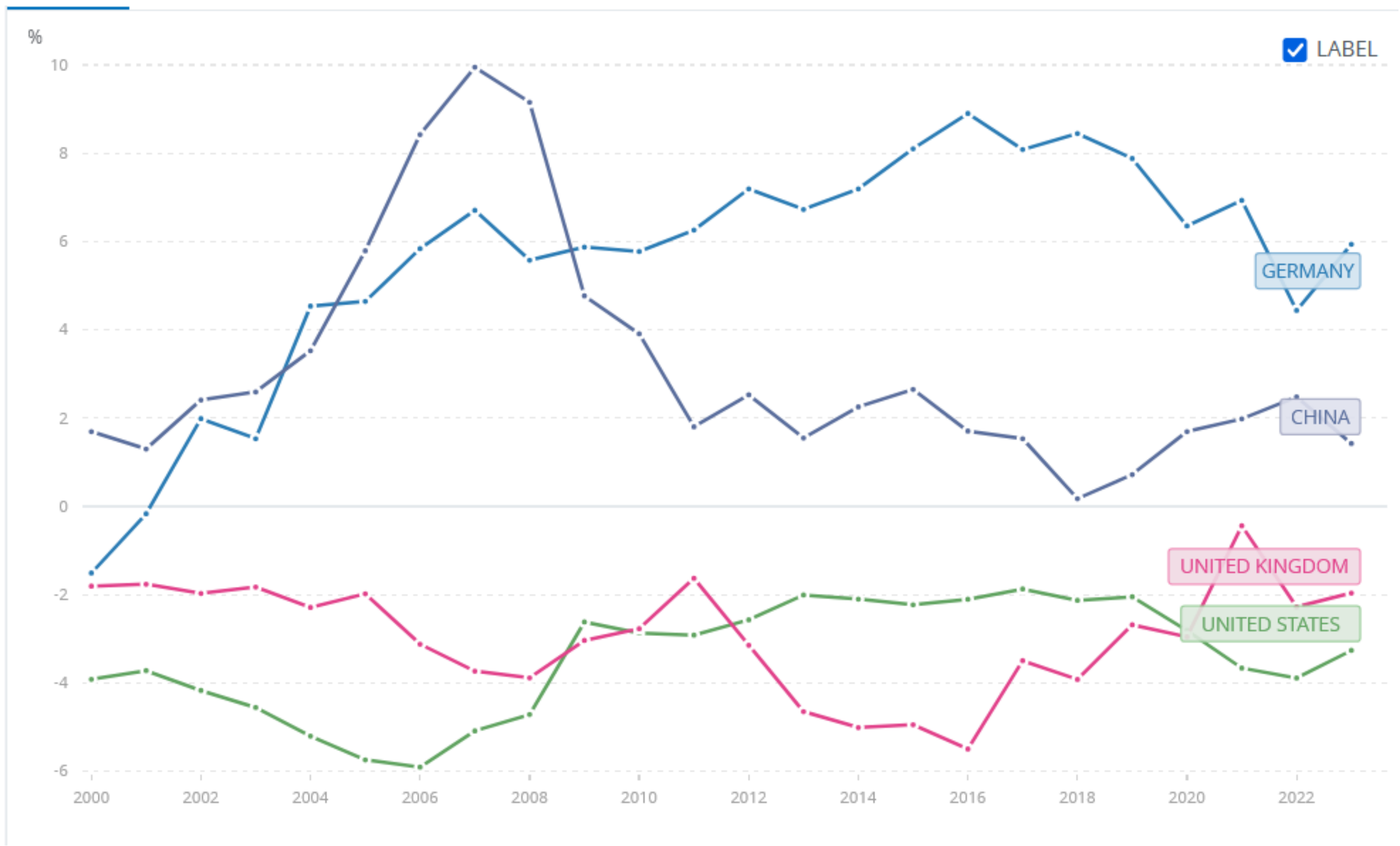
Some economics: The current & capital account

Current Account

- Tracks the flow of goods and services between countries
- **Surplus**: More exports than imports.
- **Deficit**: More imports than exports.

Capital Account

- Records cross-border investments and financial transactions (e.g., FDI, portfolio investments).
- **Inflows**: Foreign investments into the country.
- **Outflows**: Domestic investments abroad.



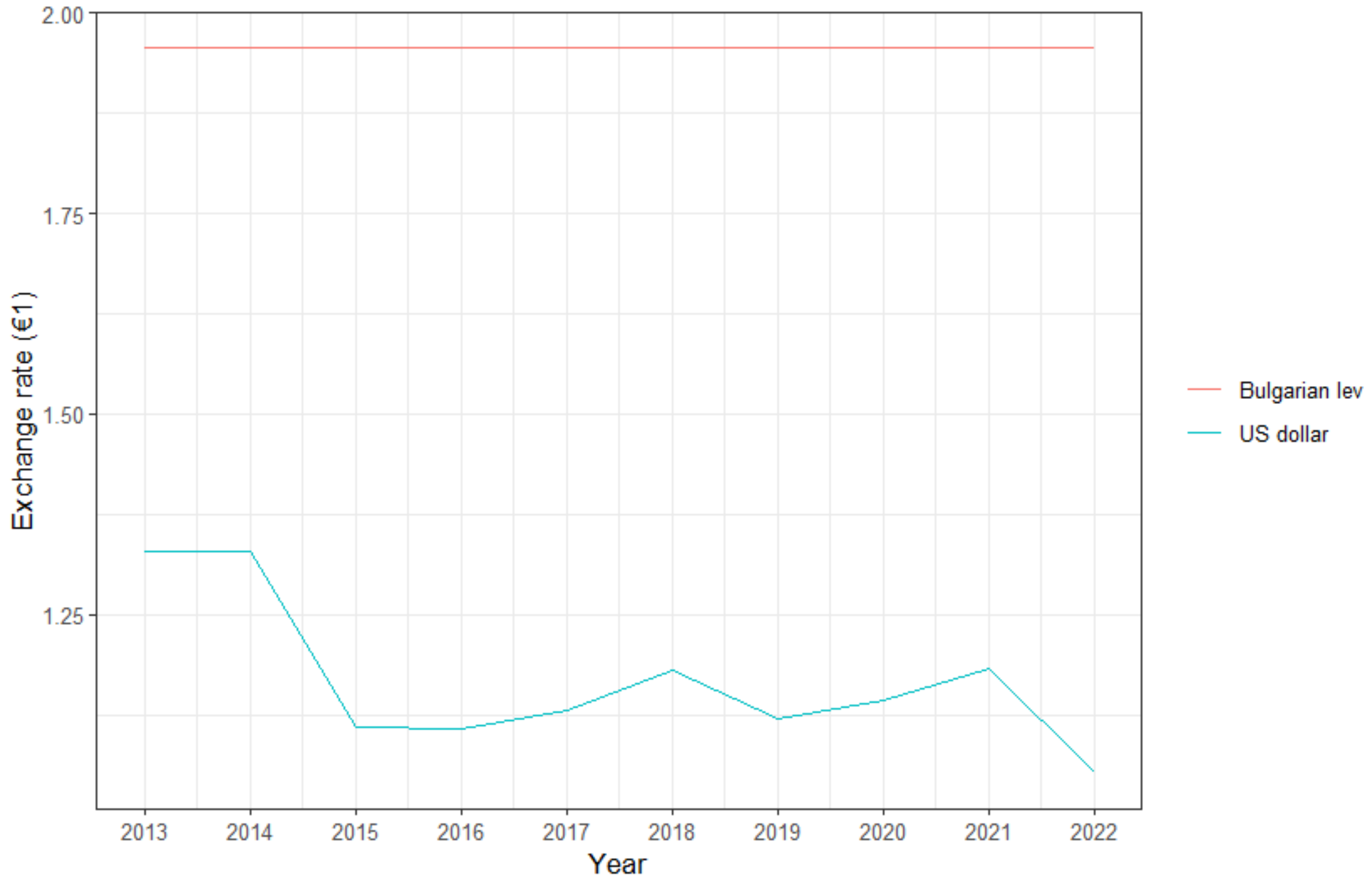
Some economics: Fixed vs. floating exchange rate

Floating exchange rate

- Determined by market forces (supply & demand).
- Currencies fluctuate daily based on trade, investment, and speculation.

Fixed Exchange Rate

- Government or central bank maintains a set value.
- Normally used by emerging markets, stability for international investors but lack of control over macroeconomic policy



Some economics: Currency appreciation & currency depreciation

Currency appreciation

- A currency increases in value relative to others.
- Example: If EUR 1 = USD 1.10, then later EUR 1 = USD 1.20 → The Euro has appreciated.

Consequences $\rightarrow$ Boost to imports, but weaker exports could lead to higher trade deficit

Currency depreciation

- A currency loses value relative to others.
- Example: If EUR 1 = USD 1.10, then later EUR 1 = USD 1.00 → The Euro has depreciated.

Consequences $\rightarrow$ Boost to exports, but more expensive imports could lead to higher trade surplus

Role of central banks/governments:

- Currency Depreciation $\rightarrow$ A market-driven decline in a currency's value due to supply and demand (e.g., lower interest rates, money supply).
- Currency Devaluation $\rightarrow$ A deliberate action by a government or central bank to lower its currency's value

Back to our story: The European monetary system, the Maastricht Treaty and the European Monetary Union

- Collapse of the Bretton Woods system, led to a new peg: The European Monetary System (EMS) and the European Currency Unit (ECU)
- Currency fluctuations within fixed margins (1979), within a speciifc range of +/- 2.25%

Delors Report

- Liberalization of capital movements
- Integration of financial markets
- Replacement of national currencies with European currency

Maastricht criteria (Euro covergence criteria)

- Low inflation
- Budget deficit (< 3% of GDP)
- ERM membership
- Government debt (< 60 % of GDP)
- 10-year government bond interest rate in line with other European economies

However fulfillment criteria were often ignored and the countries that wanted to join the Euro joined

Eurozone

Institutions

- European Central Bank: Issues the Euro, monetary policy and ensures price stability (inflation $< 2\%$)
- Eurogroup: Informal working group of Eurozone finance ministers, to coordinate and discuss
- European Commission: Monitors compliance
- Stability and Growth Pact: Sets fiscal rules (Budget deficit $< 3\%$ of GDP and Public Debt $< 60\%$ of GDP)

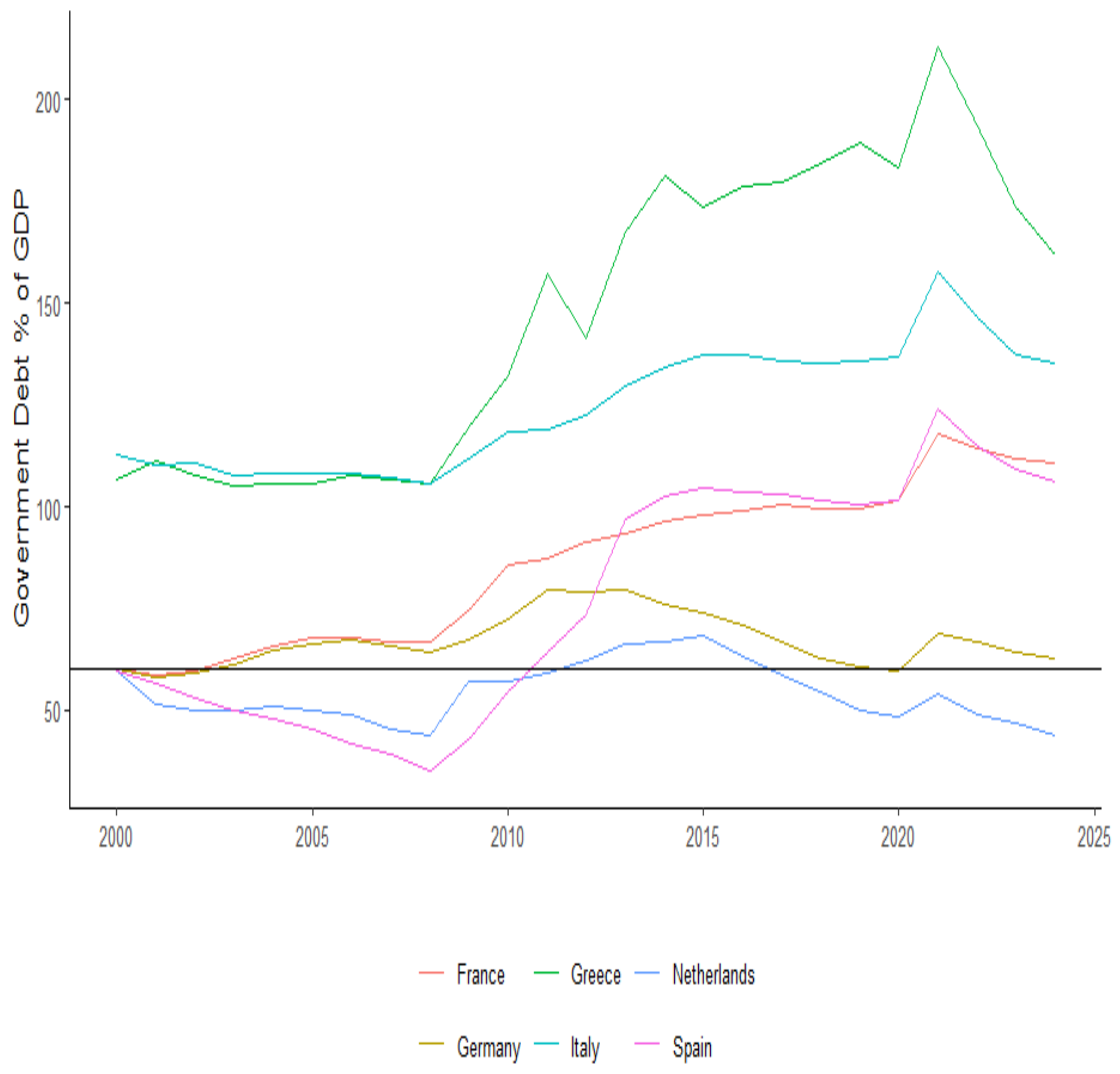
Pros of joining a single currency area

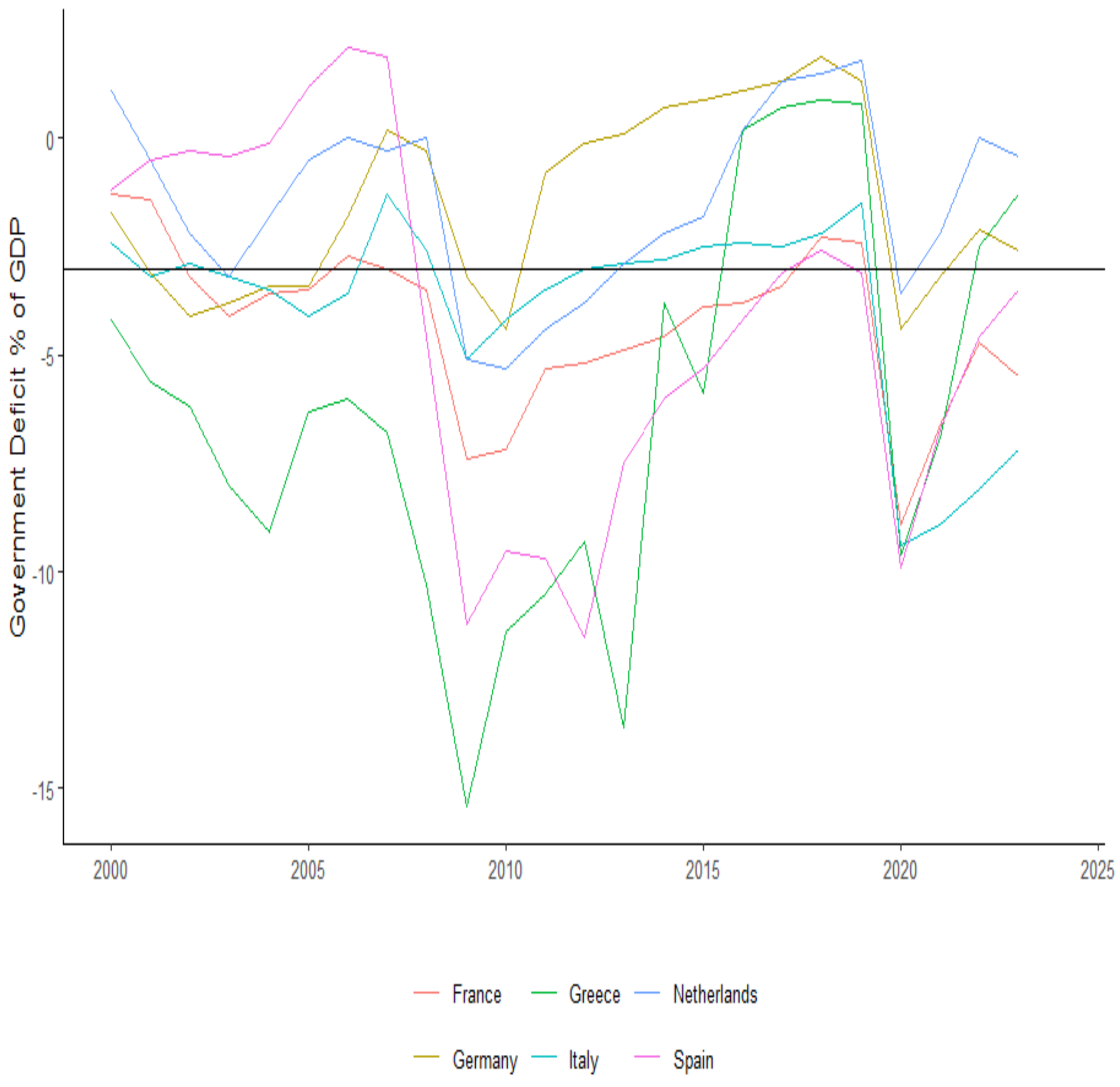
- Lower interest rates and cheaper borrowing, especially for Southern European economies
- Greater investment confidence as less currency risk (competitive devaluation)
- Global influence, world’s second most-used currency
- Boosts trade and investment, eliminates exchange rate risk

Cons of joining a single currency area

- Loss of monetary independence
- Heterogenous economic, one-size-fits-all approach?
- Strict fiscal rules

Government debt and government deficit

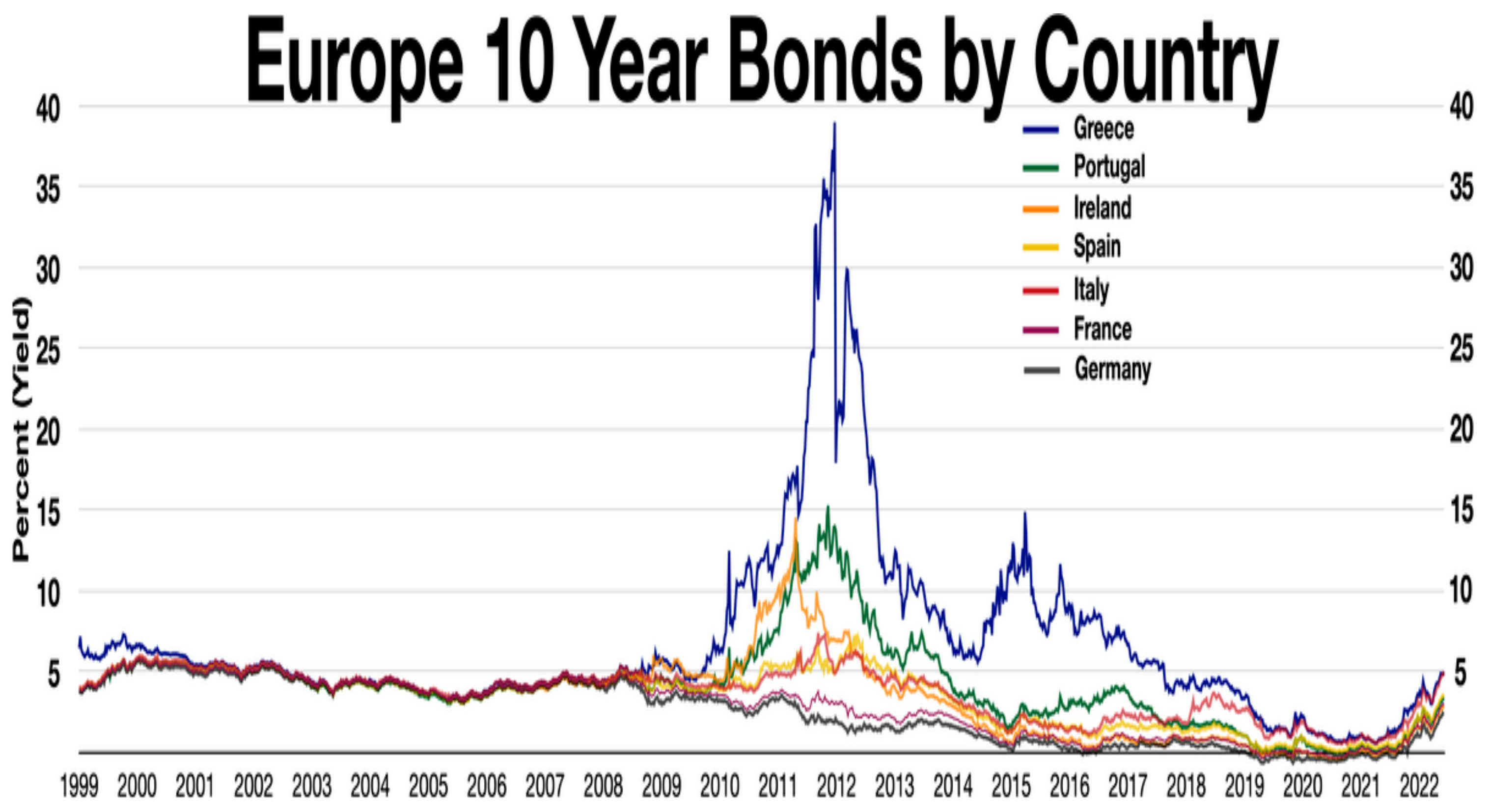




II. The Eurozone crisis

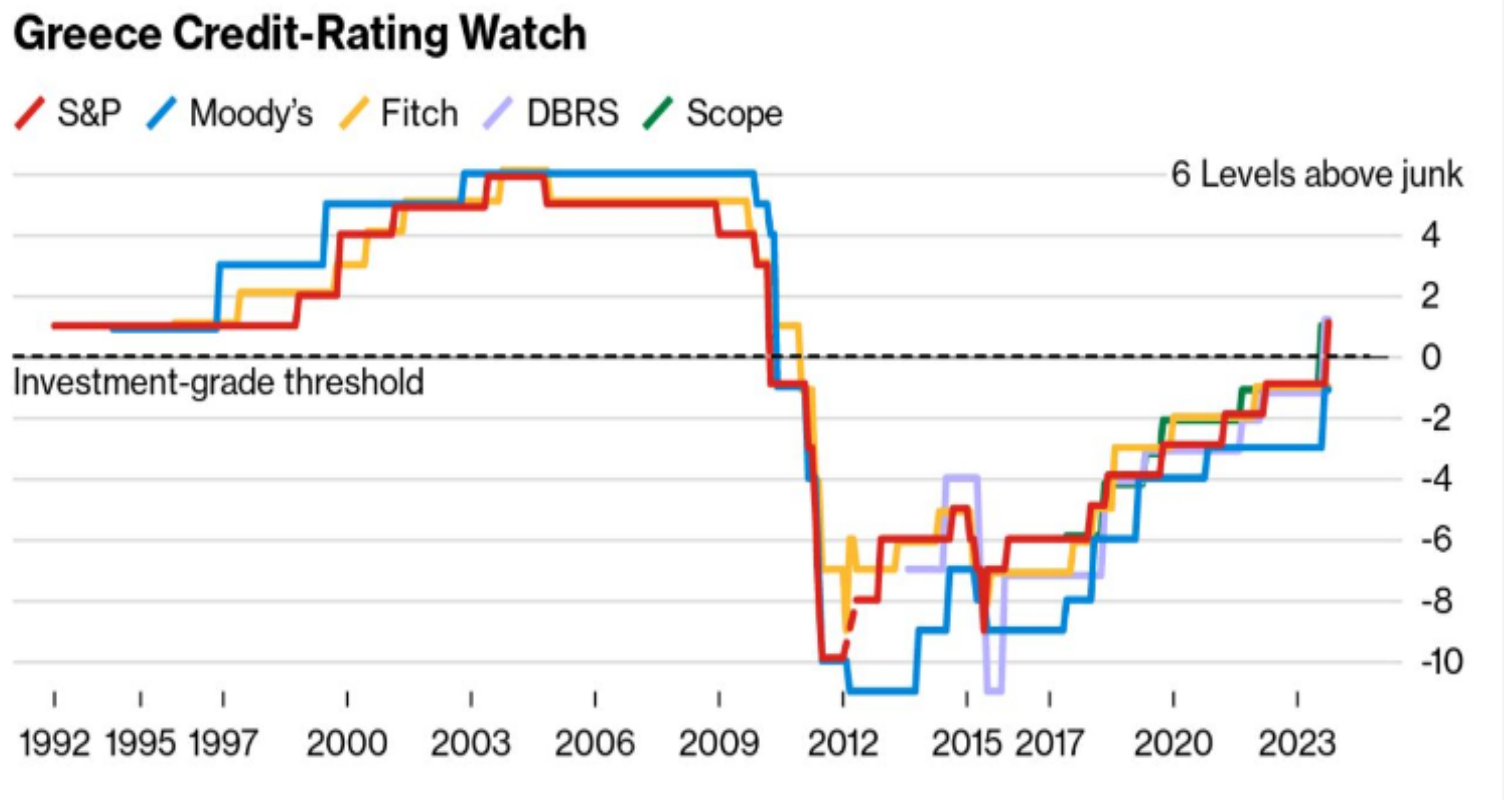
Causes of the Eurozone crisis

- The Euro allowed lower-income countries to **borrow at the same nominal interest rates** as high-income partners
- Consequences for both the public & private sectors
- Some peripheral countries experienced wage increases exceeding productivity growth, **eroding their competitiveness**
- This led to large current account deficits in the periphery and surpluses in the core
- **Capital** flowed within the Eurozone from high to low per capita income countries
- This could be interpreted positively (investment for growth) or negatively (financing distortions like asset bubbles and excessive deficits)
- Expectations of bailouts might have fueled excessive risk-taking by investors and borrowers



A brief chronology

- The crisis erupted in Greece in 2009-2010 with the revelation of understated public deficits
- Credit Rating Agencies downgraded Greek debt, triggering massive sales of sovereign securities
- This led to rapidly increasing interest rates, making borrowing prohibitively expensive
- Concerns about debt sustainability spread to other vulnerable countries like Portugal, Ireland, Italy, and Spain (2010-2012)
- Real estate bubbles in Spain and Ireland



Consequences of the Crisis

- **Austerity packages** aimed at internal adjustment (reducing deficits and improving competitiveness) often led to recessions and high unemployment
- **Troika** (ECB, IMF and the European Commission) mandate to manage bailouts in Cyprus, Greece, Ireland and Portugal
- These bailouts were often accompanied by strong conditionality, forcing crisis countries to implement harsh austerity measures and structural reforms
- The European Central Bank (ECB) was forced to engage in unconventional interventions to provide emergency liquidity (M. Draghi, ‘Whatever it takes’)
- This included **purchasing government bonds** of crisis countries to prevent sovereign spreads from exploding
- Trust in EU institutions and democracy fell significantly during the crisis, and euroskepticism rose

III. Varieties of capitalism and European monetary integration

Varieties of Capitalism

Foundational comparative political economy framework (Hall and Soskice, 2001)

Liberal Market Economies (LMEs)

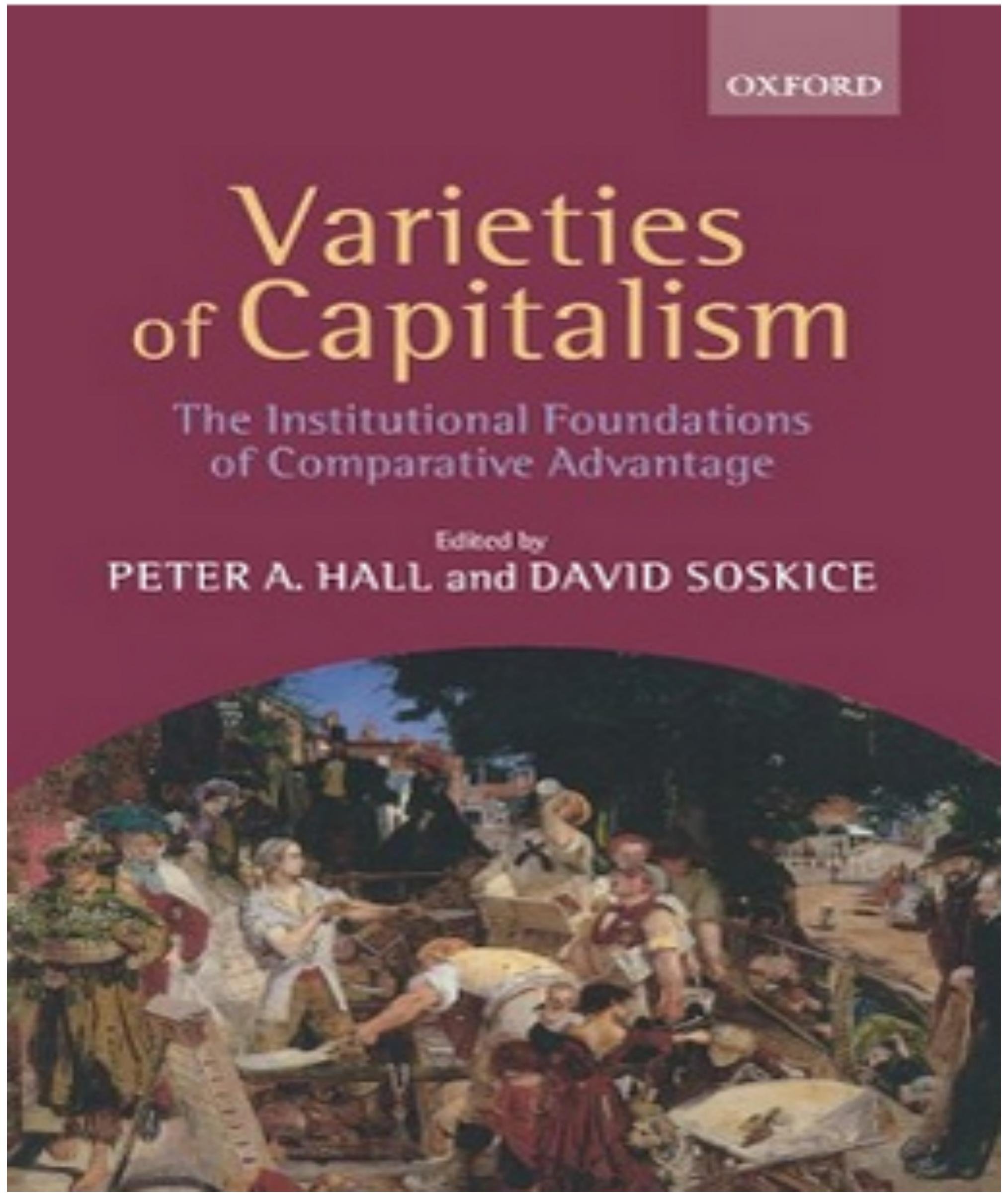
Example: USA, UK, Canada, Australia

- Market-driven competition.
- Flexible labor markets (easy hiring/firing).
- Short-term profit focus in firms.
- Weak labor unions, decentralized wage bargaining.

Coordinated Market Economies (CMEs)

Example: Germany, Sweden, Japan

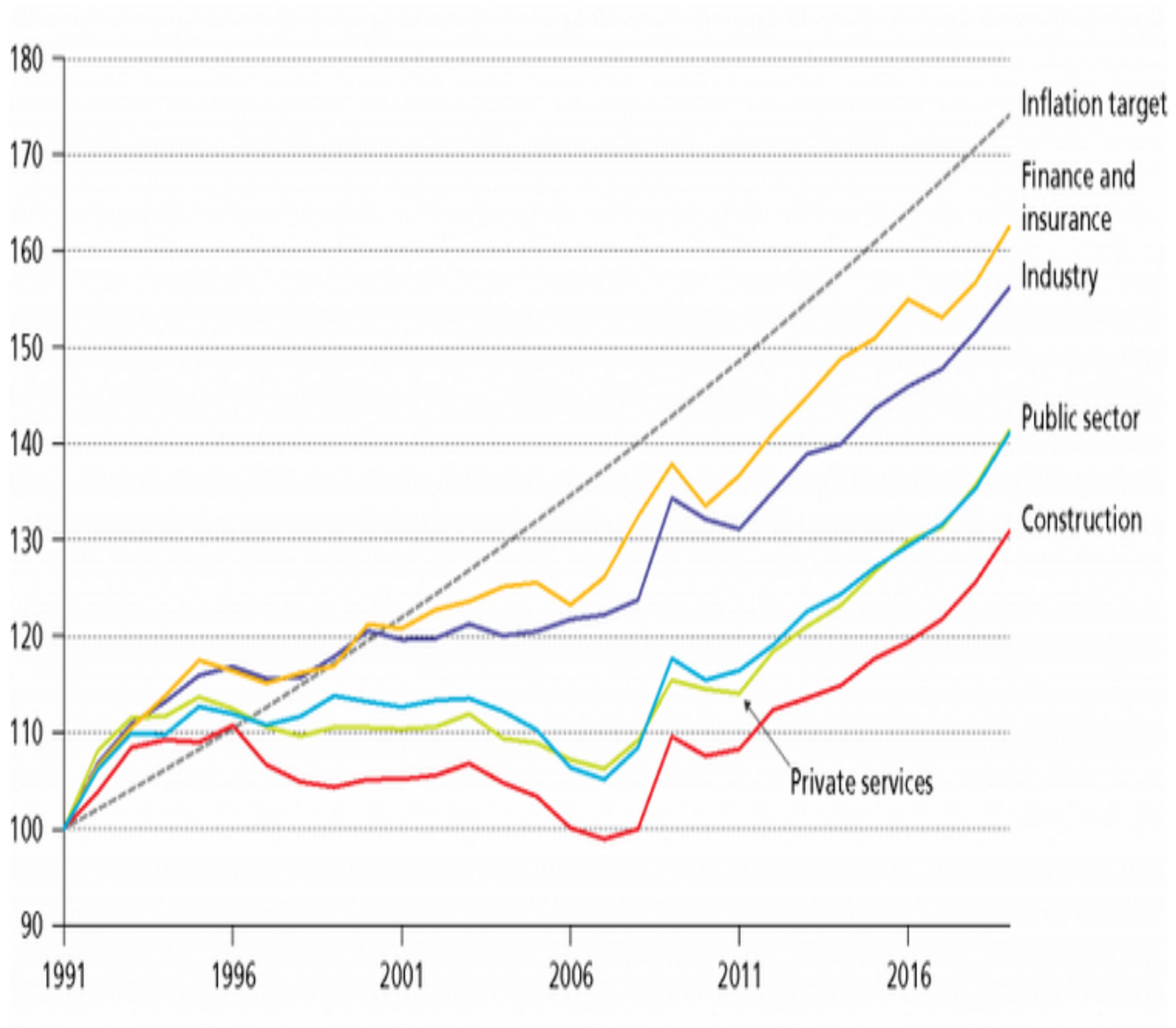
- Firms coordinate with stakeholders (banks, workers, suppliers).
- Stronger labor protections & vocational training systems.
- Long-term investment strategies (bank-based financing).
- Stronger labor unions, collective wage bargaining.



Why does this matter for this seminar?

- Export-led vs. Domestic demand-led growth models (Baccaro and Pontusson, 2016)
- Argument that the EMU favors export-led growth models, potentially disadvantaging those countries reliant on domestic consumption and debt (Johnston and Regan, 2018)
- What are the institutions needed for export-led growth when you cannot devalue your currency?
- Important to focus on the institutional diversity as well as the growth drivers.
- EU policies, including fiscal governance and the focus on cost competitiveness, may reinforce this bias.
- This can lead to imbalances and create winners and losers within the Eurozone.

Figure 1: Nominal unit labour cost increases in five German sectors (1991-2019)



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