

SEMINAR IN EUROPEAN ECONOMICS

EUROPEAN INTEGRATION OPTIMAL CURRENCY AREAS

PRACTICAL CLASS 3

2024-25 S2

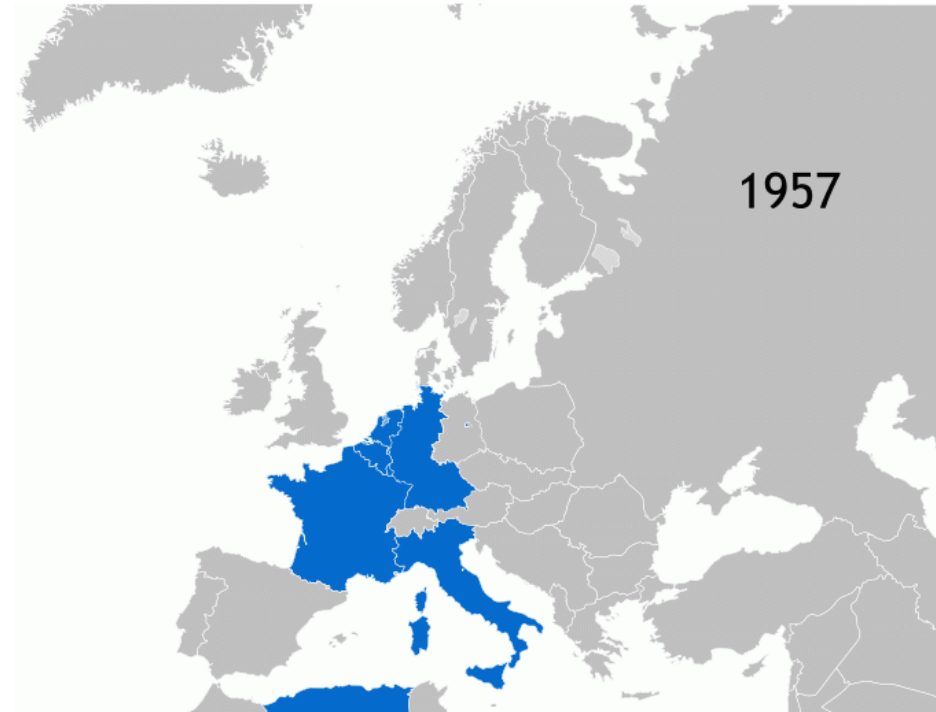
A PROJECT FOR PEACE AND DEVELOPMENT

Motivated by political factors but implemented through economic means



THE PROCESS OF EUROPEAN INTEGRATION

- **Motivated by political factors but implemented through economic means**
- **Gradualism**
 - Customs union (1958-1968)
Treaty of Rome, 1957
 - Single market (1986-92)
Single European Act, 1986
 - Monetary union, 1999
 - Treaty of Maastricht, 1992
 - Treaty of Amsterdam, 1997
 - Treaty of Nice, 2001
 - Treaty of Lisbon, 2007
- **Gravitational** effects of integration: enlargements
- **Balance between the federalist and inter-governmental positions**



TREATY OF ROME, 1957

Free trade in goods and services

- Removal of tariffs and quotas
- Removal of non-tariff barriers to trade

Harmonization of trade rules with rest of the world (customs union)

Free movement of labour and capital

Common Policies

- Competition Policy (Prohibition of government subsidies, non discrimination, legal and tax harmonization)
- Common agriculture Policy (CAP)
- Mechanism for the macroeconomic and exchange rate coordination

Supranational institutions: European Parliament Assembly, European Court of Justice, European Commission

TREATY OF ROME, 1957

Omitted areas of integration

- Social Policies
- Fiscal Policy

Different forms of trade integration

- OECD: non-discrimination
- EEC: discrimination and Common External Tariff
- EFTA: discrimination

Gravitational effects: enlargements

- 1º: UK, IR, DK (1973)
- 2º: GR (1981)
- 3º: PT, ES (1986)

ACHIEVEMENTS UNTIL 1985

Customs union, but not necessarily free trade

- non-tariff barriers to trade: different technical requirements and certification, industrial regulations, capital controls, preferential public procurement, subsidies, administrative formalities, etc)
- Non-tariff barriers even more relevant for services

Factor liberalization (labour and capital): not achieved

➤ Single European Act => reinforce the 4 fundamental freedoms of the TR

SINGLE EUROPEAN ACT, 1986

Programme for the Single European Market: 1986 -92

Trade liberalization

- Elimination of non-tariff barriers in goods and services

Elimination of administrative formalities, harmonization and mutual recognition of diplomas and technical requirements in production; tax harmonization, etc.

Factor liberalisation

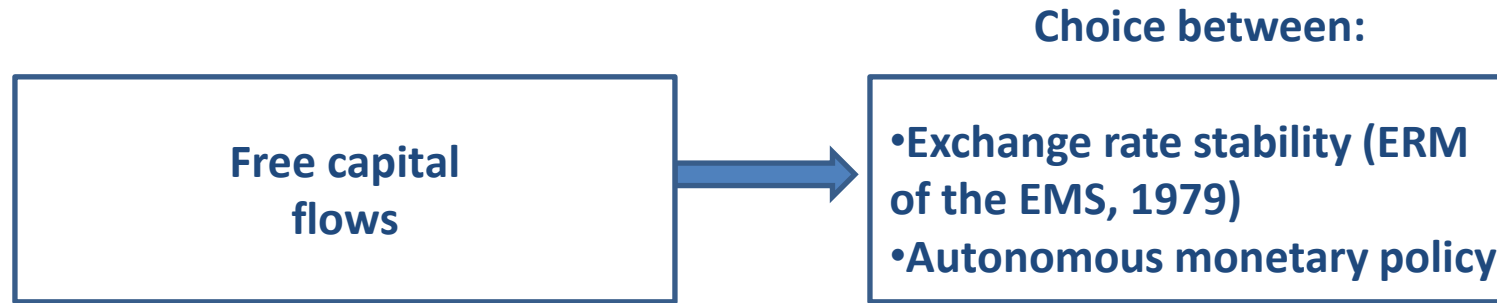
- Capital
- Labour

Strong emphasis on the elimination of capital controls and capital market integration

Liberalization of the right of establishment

Institutional changes: decision-making process: decisions concerning the single market adopted by majority instead of unanimity.

TOWARDS A SINGLE MARKET



Political factors:

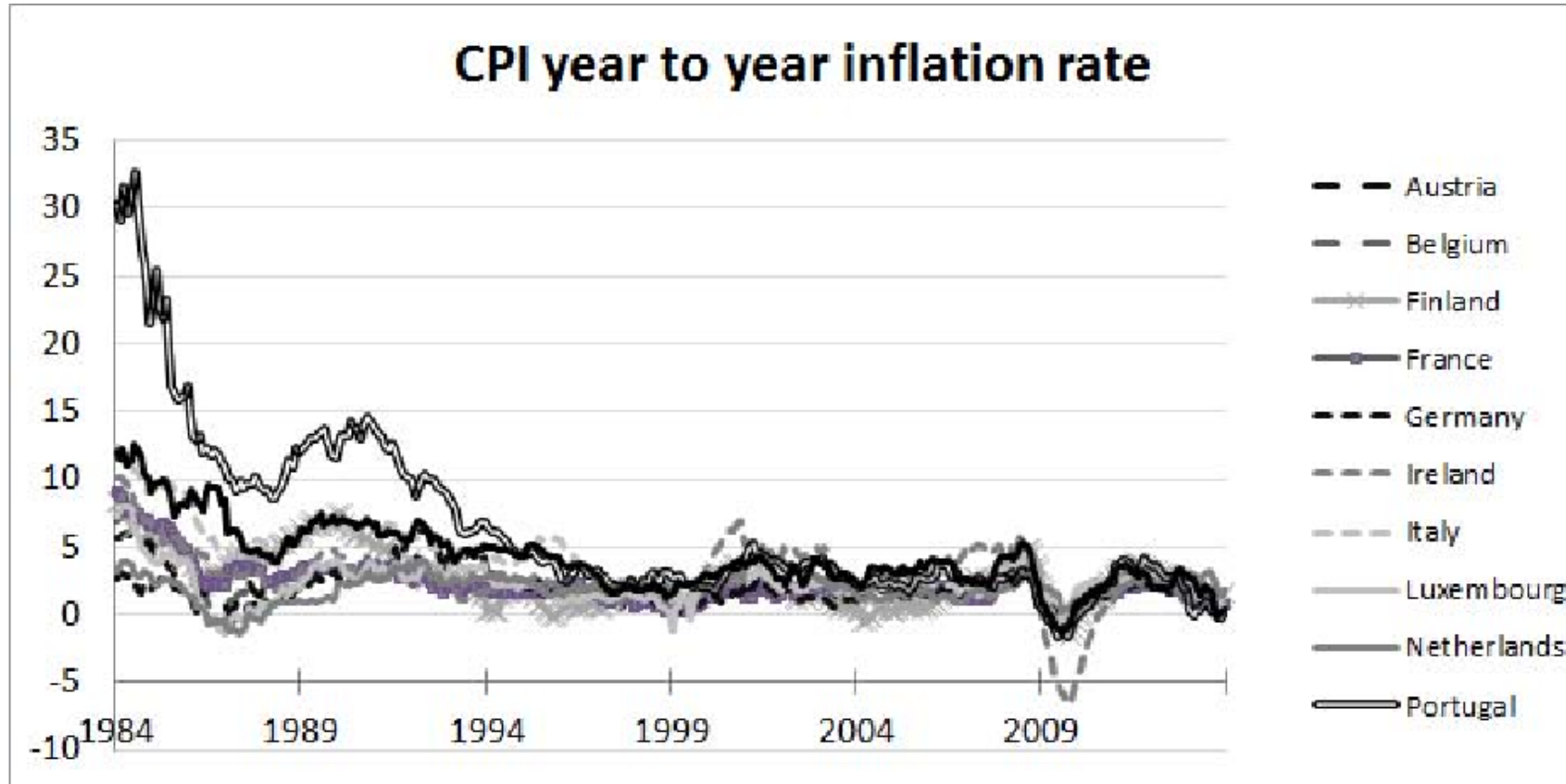
- Fall of the Berlin Wall and German Unification
- Greater integration: viewed as the best way to deal with unbalance of powers between European countries.

TREATY OF MAASTRICHT, 1992

Main Goal: to create a Monetary Union in 1999 and a single currency in 2002

- **Transfer of national sovereignty of monetary policy for a supranational institution (ECB). Abandonment of national currencies**
- **Convergence criteria: Maastricht criteria for MS to enter the EMU**
 - European citizenship
 - Free capital movements (already in TR)
 - Reinforced cooperation in non-economic areas (security, defence, justice, emigration policies)
 - Principle of subsidiarity
 - Reinforced the powers of the European Parliament
 - Introduced social policies (social protection, health)

Nominal Convergence



Council of the EU Council of Ministers	Decision-making body •representatives of MS (changes composition according to subject matter)	Supranational institutions Power to influence decisions on 1st Pillar Very limited powers concerning 2nd & 3rd pillars
European Council	Political power: provides guidelines and orientations •Rep of MS + Pres. EU Com.	
EU Commission	Executive body: Make proposals, implement policies, supervise application of EU law and Treaties	
European Parliament	Legislative body: Shares legislative powers with CM and Com. Supervision of EU institutions	
European Court of justice	Resolution of conflicts: Apply legislation and resolves conflicts (between MS; MS & EU; EU inst.; citizens and MS)	

THE TURN OF THE CENTURY

Enlargements and greater scope of EU Integration
created need for reforms in European Institutions

Relatively timid Steps:

Treaty of Amsterdam, 1997:

- Social policies, enhanced powers of European Parliament

Treaty of Nice, 2001:

- Goal: prepare institutions for new enlargements in 2004
- Reformed voting procedures

Bold but Failed step:

European Constitution, 2004: Not ratified

TREATY OF LISBON, 2007

Key points

- Amends the treaty of the European Union (TM) and the treaty establishing the European community (TR – renamed: Treaty on the functioning of EU)
- Includes most of the Provisions of the constitution, without ‘symbolic’, more controversial references
- Enhances co-decision procedure between the European Parliament and the Council of Ministers

Institutional Reforms

- ECB – status as an EU institution
- Council of Ministers: reformed voting procedures (from unanimity to qualified majority) and created ‘Triple Presidency’
- European Council: appointment of a president
- Appointment of a High Representative for Foreign Affairs and Security Policy: changes 3 pillar structure
- EU Commission: no longer 1 commissioner by Member State
- European Parliament: Enhanced powers given ‘co-decision procedures’

DISCUSSION QUESTIONS

Midterm 2017/2018 1st semester

In his latest speech relative to the State of the Union, Mr. Jean Claude Junker has mentioned that the presidency of the European Commission and the presidency of the European Council could merge into a single position in the EU institutional architecture.

a) *What are the main roles of the European Commission and the European Council?*

The European Commission is an institution of the European Union responsible for proposing legislation (legislative initiative), implementing decisions (executive body), upholding the EU treaties and managing the day-to-day business of the EU.

The European Council defines the EU's overall political direction and priorities. It sets the EU's policy agenda, which identifies issues of concern and actions to take. Its members are the heads of state or government of the EU member states, the European Council President and the President of the European Commission. However, neither the European Council President nor the Commission President vote in the European Council decisions.

The European Parliament (EP) is directly elected by EU citizens. Together with the Council of the European Union, it exercises the legislative function of the EU, including control over the EU budget. The EP also has the role of supervising EU institutions (can dismiss the commission by adopting a motion of censure). The Parliament also elects the President of the Commission.

The Council of the European Union is the main decision-making body of the EU. It adopts EU laws (together with the EP, based on proposals from the Commission); coordinates EU countries' policies; develops the EU's foreign and security policy, based on European Council guidelines; concludes agreements between the EU and other countries or international organisations; and adopts the annual EU budget - jointly with the European Parliament.

b) Is this a federalist or an intergovernmental oriented proposal? Justify.

Merging the two presidencies implies that political directions of the EU can be more directly translated into legislative proposals or policy implementation. It would allow the president of the commission (a supranational organization) to preside over the work of the European council and, thereby, influence political directions (even though he cannot vote). In this sense it can be considered a federalist movement.

Even though the opposite also occurs (i.e. the president of the European Council presiding over the Commission), it is less likely that this results into a more inter-governmental situation: even though members of the European Council represent their own countries, the President should be independent from national interests (he may not hold a national office).

c) What are the advantages and disadvantages of the referred proposal, also taking into account the role of the European Parliament?

Another possible advantage is the fact that it could facilitate decision-making. If Member-States represented in the European Council are more aligned with policies and laws proposed by the Commission, their representatives in the Council of the European Union (Council of Ministers) will also be more likely to pass the law.

A resulting disadvantage is the conflict of interest resultant from aligning the functions of proposing legislation and deciding about it.

These conflicts are, however, mitigated by the legislative powers of the European Parliament, which would remain unchanged.

The power of the European Parliament of electing the President of the Commission would be reinforced, as this role would now be more important.

Exam 2017/2018 1st semester

The latest economic and financial crisis triggered a strong debate about the need for institutional reform in the EU, which has led to several changes. These latest reforms accelerated a process that had started before the crisis.

a) Which have been the trends regarding the EU voting procedure and the democratic legitimacy of European institutions?

Reforms in the EU voting procedure started well before the crisis and have been materialized into a gradual reduction of the voting majority required to pass a decision in the Council (from unanimity to a smaller qualified majority). The aim is to prevent a minority of large countries to veto the decision-making process, thereby reducing differences in countries' relative power.

Furthermore, these reforms also consisted into enlarging the areas where the decision-making process follows the co-decision procedure (EU ordinary legislative procedure), implying greater decision-making power to the European Parliament, an institution with more democratic legitimacy, as its members are directly elected by the people.

Midterm 2018/2019 2nd semester

c) What are the advantages and disadvantages of the co-decision procedure?

Main advantages:

- **The fact that the approval of both the Council and the EP is needed for the legislation to be adopted ensures a consensus between federalist and intergovernmental views.**
- **In addition the EP participation confers democratic legitimacy to the proposal.**
- **The process involves significant efforts in order to ensure that a consensus is reached (several readings and interactions between institutions, possibility of amendments, redrafting of the proposal by the Commission in order to take into account amendments; the intervention of a Conciliatory Committee in order to search for a compromise).**

Main disadvantages:

- **The number of interactions described above can make the process very complex and lengthy, contributing to delay decisions.**
- **Even though recent reforms in the voting rules of the Council have reduced this likelihood, there is still the possibility of a relatively small number of countries to veto the decision.**

Midterm 2020/2021 1st semester

1 d) In the context of the current pandemic crisis, is it visible any significant institutional change? Please explain.

At the outburst of the pandemic, the ECB acted swiftly to keep the credit flowing in the economy. However, from the beginning the monetary policy makers warned for the limits of their role, given the previous environment of already low interest rates.

Governments have been asked to engage in expansionary fiscal policy to contain the economic consequences of the pandemic on economic activity and on employment. Since this shock – contrary to the previous financial crisis – is a more symmetric one, affecting all countries equally, there has been a push from the European institutions for a common fiscal approach. This led to a European plan composed both by grants and loans designed to provide financing channels to the economy and act in a counter-cyclical way. These new programs are to be financed, for the first-time, through mutualized EU debt, showing that countries are willing to share part of the risk for a common fiscal solution to the current pandemic

OPTIMAL CURRENCY AREAS (1/2)

Introduced by economist Robert Mundell in the 1960s, the concept of Optimal Currency Areas (OCA) has since become an important topic in the field of international economics. The theory suggests that a currency union can be optimal (i.e., making it beneficial) if the member countries have:

- **Flexible labor and capital markets:** Labor markets should be flexible, allowing workers to move easily across regions and sectors. This can help to reduce disparities in unemployment rates and wages. Capital markets also play an important by facilitating the allocation of resources across different regions or countries;
- **Business cycle synchronization:** Member countries should experience similar economic cycles, with similar patterns of inflation and unemployment. This is important because a common monetary policy will affect all member countries equally, and if their business cycles are divergent, macroeconomic imbalances may emerge;

OPTIMAL CURRENCY AREAS (2/2)

- **Fiscal transfers (e.g., operation of automatic stabilizers):** A mechanism for fiscal transfers should be in place. This helps to ensure that regional disparities are minimized and that all member countries benefit from the currency union;
- **High levels of economic integration (e.g., strong international trade flows):** Member countries should have strong economic ties in terms of trade, investment, and factor mobility. This will ensure that shocks affecting one country will not have disproportionate effects on the others;
- **Homogeneous preferences and solidarity across countries:** With homogeneous preferences, residents in different regions or countries are more likely to respond similarly to economic shocks. Solidarity across countries also plays an important role, as residents are more likely to accept fiscal transfers and other forms of economic support to help mitigate the effects of asymmetric shocks.

FOR DISCUSSION: IS THE EURO AREA AN OPTIMAL CURRENCY AREA?

Regular Exam 2020/2021 1st semester

1 a) What are the characteristics of an optimal currency area? To what extent does the euro area fulfill these criteria

An optimal currency area must follow criteria such as: 1) mobility of labour and capital as well as wages flexibility to allow for the smoothing of the cycle across different countries; 2) business cycle synchronization, through and homogenous production structure, thus minimizing the impact of idiosyncratic shocks, since monetary policies do not target any specific country; 3) fiscal federalism, allowing for the operation of automatic stabilizers across countries/regions; 4) strong international trade flows; 5) homogeneous preferences and solidarity across countries

The Euro area does not fulfill several of these criteria. Labour mobility is still constrained by language and cultural differences as well as different employment protection legislation across countries. Member countries still depict significant productivity differentials worsened by heterogeneous fiscal positions. This prompts macroeconomic imbalances to emerge, notably in terms of current account balances, which are hard to solve with a limited set of economic tools available.