Centre for Economic Policy Research
POLICY INSIGHT No. 47
MAY 2010

Some observations on 'political' in EMU

Francesco Paolo Mongelli
ECB and The JW Goethe University

How did we get to a monetary union in Europe? And what does it entail to have a European Economic and Monetary Union (EMU) without a full political union? Even in the midst of a charged debate about crisis prevention and management it is important to recall the origins of EMU and ask what it can best achieve. As we will see, there are various political facets that matter for the success of EMU. In fact, short of political union, political commitment, will, and vision are of great significance - as is good political economy.

Monetary integration among a group of European countries has been part of a broader process of economic and financial integration that started over 50 years ago. Needless to say this is a political process. In fact, the importance of the political origins, motivations and consequences of European integration cannot be overemphasised. Yet to label European integration solely as the outcome of a political process is inaccurate.

To make our case we take two steps. In the first we look at the political commitment, will and vision that went into making European integration possible. Over the last 50 years economic, monetary and institutional integration interacted and strengthened each other, profoundly changing Europe. But the global economy has also changed presenting many new challenges, as well as opportunities. In the second step, we look at some implications of EMU's institutional framework in addressing various structural weaknesses.

Along the way we make some observations that are neither exhaustive nor comprehensive. We stress the role of macroeconomic shocks, such as the ongoing financial crisis, in moving the EU forward, and the importance of adaptability and learning.

1st Step: One institutional framework and one market, and then one currency

Let's recall an index of institutional integration first suggested by Balassa (1961). The index identifies five main stages of integration among a group of partner countries. Simply for convenience we illustrate the case of the six founding countries of the EU, in short the EU6, that shared the whole route to the euro:

- In the first stage of integration the EU6 formed a Free Trade Area. Thus tariffs and quotas were abolished for imports from area members; however national tariffs and quotas against non-member countries continued. The implementation of the Free Trade Area took some time as it started in 1957 and ended in 1968.

- In the second stage the EU6 formed a Customs Union in 1968. A free trade area setting up common tariffs and quotas (if any) for trade with non-members.

- In the third stage the EU6 formed a Common Market. Non-tariff barriers to trade were abolished thus promoting the integration of product and service markets. Restrictions on factor movement were also abolished promoting the integration of capital and labour markets. The European Single Market was formally launched in 1993, although the Common Market was already one of the objectives of the 1957 Treaty of Rome: i.e., to establish the 'four freedoms'.

- In the fourth stage the EU6 formed an Economic Union, thus a common market functioning with a significant degree of co-ordination of national economic policies and/or harmonisation of relevant domestic laws. The EU is currently an Economic Union. Eurozone countries go even a step further as they are bound by the Stability and Growth Pact, a set of rules and criteria guiding national fiscal policies with the aim of fostering fiscal discipline.

- In the fifth stage the EU6 pursued Total Economic Integration, i.e. an economic union with all relevant economic policies conducted at the supranational level, while complying with the principle of subsidiarity. An example of Total Economic Intergration is the Eurozone whose members share the euro and have a single monetary policy. Eurozone countries also share a tighter framework to review and coordinate national economic policies.

To illustrate the deepening of institutional integration we assign scores from 0 to 25 to mark the development of, respectively, a Free Trade Area/Customs Union (considered jointly), a Common Market, an Economic Union, and an area with Total Economic Integration. By summing up the scores achieved at each moment in time, an index of institutional regional integration is obtained. It can range between 0, no integration, and 100, full institutional integration (see Dorrucci et al (2004) for a detailed analysis). Forming a full political union, akin to a sovereign state, goes beyond these five stages. The figure below illustrates the evolution of the index, as well as, the main steps toward monetary and financial integration.

Trade openness- captured by the ratio of intra-regional trade in goods to regional GDP - for the founding Eurozone countries rose from about 12% of GDP in 1960 to over 26% in 2002

Where do we stand in terms of institutional integration?

The EU6, but more generally the Eurozone as a whole, can be classified as being somewhere between an economic union and being totally economically integrated. Some Balassa stages overlapped. Diverse supranational institutions were established already with the 1957 Treaty of Rome, before the completion of the common market, and were enhanced over the years. An example is the European Economic Community, created in 1958 to spur the common market and the implementation of the treaties. Another example is the European Parliament that was 'born' as Common Assembly of the European Coal and Steel Community of 1952.

Over the last 50 years institutional integration has gone through various phases. There was rapid early growth driven mostly by 'real' economic integration. This was followed by a period of modest increases over the 1970s and part of the 1980s, until a new period of surge in institutional integration driven by financial integration. The sub-index of monetary and financial integration grows very gradually until a more pronounced rise in the early 1990s driven by the steps toward the completion of EMU. As the figure below shows, plans had to be drawn, arrangements had to be made, and countries had to prepare and then qualify for the euro.

What else happened over the last 50 years?

Looking back, we have witnessed a profound beneficial transformation of all EU countries. There was a remarkable intensification of economic and financial integration. For example, trade openness- captured by the ratio of intra-regional trade in goods to regional GDP - for the founding Eurozone countries rose from about 12% of GDP in 1960 to over 26% in 2002. Trade in services appears to have even higher increases although statistics are scarce. Meanwhile, real dollar-denominated bilateral trade among Eurozone countries increased by about 1200%-1400% over this period. Real exchange rate variability has also declined over the decades, as has inflation differentials. Equity market return correlation in Europe has also risen as has GDP per capita and business cycle correlation (albeit with wide fluctuations).

Figure 1 Index of institutional integration for the EU6

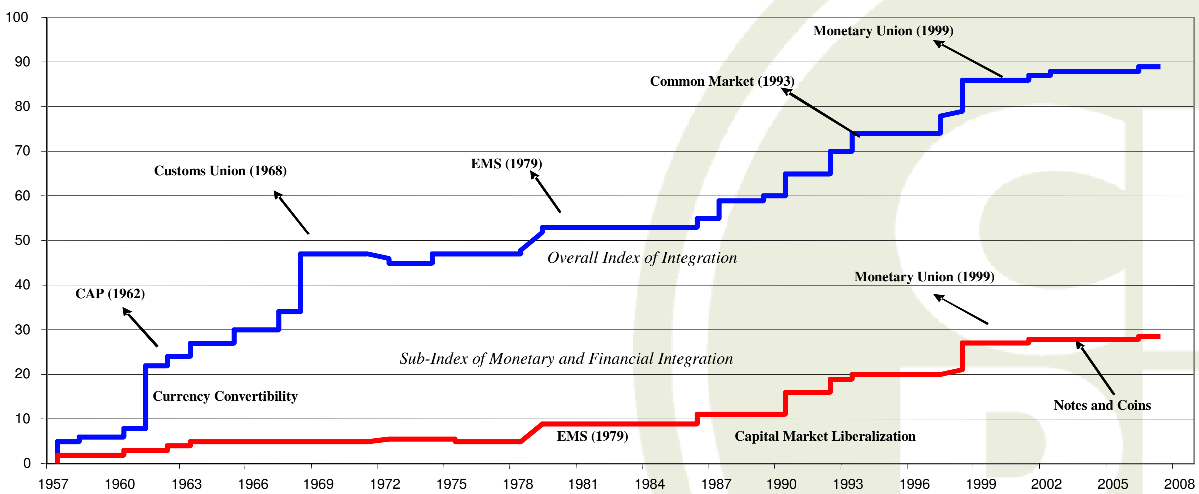
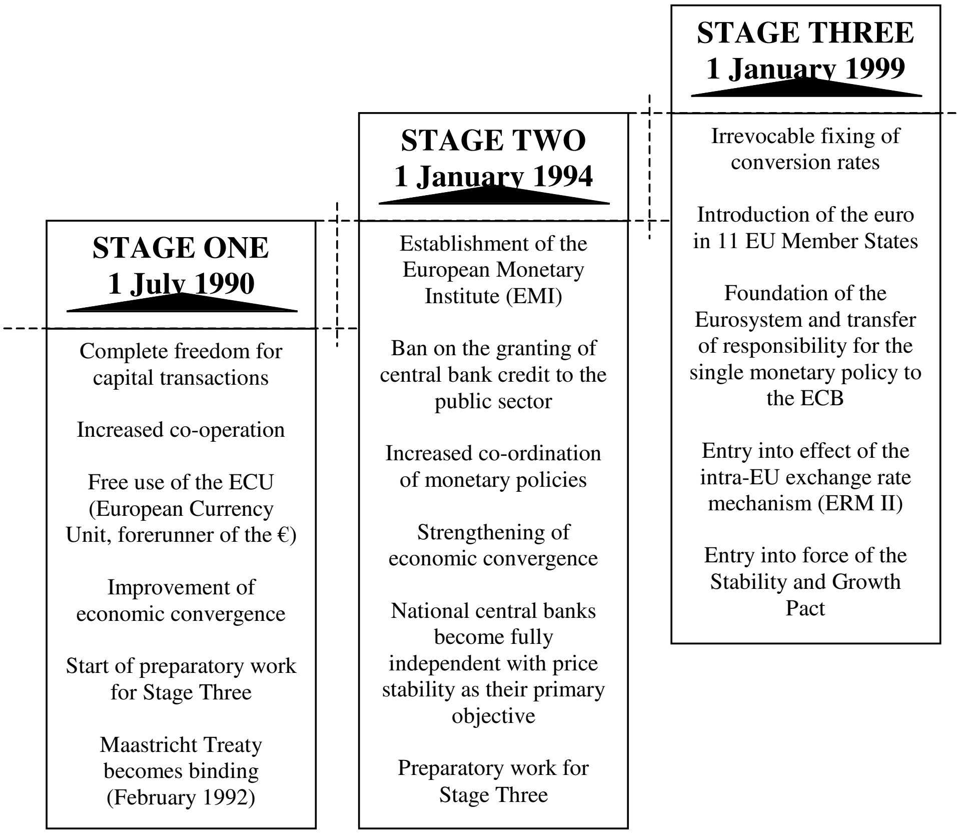


Figure 2 Three stages of Economic and Monetary Union (EMU)



Is there a two-way link between economic and institutional integration?

To answer we test for a systematic relationship between the index of institutional integration and economic integration proxied by trade openness. A simple Granger causality Test shows that in 56% of the cases institutional integration Granger causes trade deepening, whereas in 26% of the cases trade deepening Granger causes institutional integration. Hence, the link from institutional integration to trade deepening is very important. At the same time, the reverse link is also quite substantial, a finding also corroborated by using other measures of trade deepening and by applying a Vector Error Correction Model (see Mongelli et al 2007). The two-way link can also be generalised. In an earlier study we found a direct positive relationship between our index of institutional integration and an 'index of OCA' (Optimum Currency Area). This index is based on a 'cluster analysis' of a large group of economic and financial variables capturing increasing economic convergence, i.e. readiness to share a single currency (see Dorrucci et al (2004)). These findings justify our claim that to stamp everything as only having a 'political origin' is inaccurate. Let's now turn to the motivations.

Why did the two-way link advance for over 50 years?

In the early stages there were vast benefits from free trade (that are still being obtained). Then came the single market for goods, services and capital. Workers and companies are now allowed to move freely within the EU. Subsidies and regulations favouring domestic producers are prohibited (a few exceptions emerged during the ongoing financial crisis). The fundamental laws governing economic activity - whether banking, industrial production, or consumer protection - are also largely harmonised. Perhaps it is easy to no longer see what has been under our eyes for so long, forgetting this constant stream of benefits from the single market. Integration could only advance over many decades, also through successive enlargements, by proving beneficial for all participating countries .

A need to strengthen and defend these achievements

But some new challenges have arisen over time. The exchange rate mechanism currency crisis of 1992, and the subsequent devaluation of the Italian Lira and British Pound, is a case in point. This crisis entailed large swings in many exchange rate parities, strained financial systems, and disrupted trade flows. Important lessons were learned. Emphasis was then cast on completing nominal convergence and fulfilling the convergence criteria of the Maastricht Treaty and completing the above Stages of EMU. Thereafter the Stability and Growth Pact became the focus. We will be able to exploit integration to the fullest only by reducing impediments to the portability of pensions, and various social services and benefits.

Observation 1

Over more than 50 years, institutional integration has also worked toward ‘consolidating’, ‘defending’, and ‘promoting’ its two-way link with economic integration. For example, the euro supports the achievements of European integration but also fosters the completion of the single market and generated various benefits by itself.

Observation 2

Economic, monetary, and institutional integration, are deeply interwoven. All EU countries, and particularly Eurozone countries, are highly interconnected. We are now facing the worst financial crisis since the Great Depression, and the ‘Greek crisis’ is also unravelling. Calls to leave the EU, or the Eurozone, entirely miss the crucial point of European integration. There are enough incentives to prompt any country to get back on track and meet all requirements. Persistent irresponsibility would instead generate substantial negative externalities and could not be endured.

Observation 3

It has taken a great deal of political will, commitment and vision to reach the current status of European economic, monetary and institutional integration. This is remarkable and is widely acknowledged (see Buti et al 2010, ECB 2008, and ECFIN 2008). Does this mean that we have reached an endpoint? I argue that the answer is ‘no’.

Step 2. One money, one market, and then a new political economy

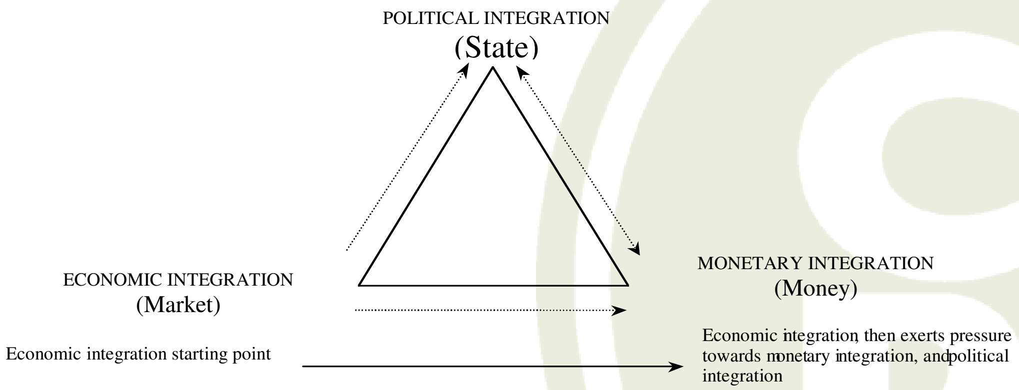
The euro is now shared by a group of sovereign countries that do not form a single state. Neither is the Eurozone likely to become a single state, in the traditional sense of this term, in the near future. There is no federal budget that could buffer asymmetric shocks (like among US states), it can be awkward to come to the rescue of a peer in need, and policymaking is significantly more complex than in a sovereign state. Yet, EU members already share some elements of a constitutional framework. Over the last 50 years bits of national sovereignty were gradually transferred to the supranational level. Various aspects need to be considered to grasp the ‘political’ in EMU:

a. Not long after the end of World War II it became clear that a full political union among European countries was not feasible. The choice was then made in the 1950s to pursue instead a Single Market. Therefore, the first aspect is that we have seen increasing *‘functional’ political integration* (see figure below). ‘Functional’ in the sense of aiming to pursue economic integration - in various steps and over time - and setting out the institutions, laws, and regulations to avoid the disastrous protectionist policies of the inter-war period. The EU Council, an inter-governmental body of the EU, and the European Parliament are the EU’s supranational legislators. They are also fostering the harmonisation of national laws in several areas. The European Commission contributes to initiating common policies and, inter alia, oversees the implementation of EU laws and regulations. The European Court of Justice gives unity to European laws. Functional political integration may further deepen as a result of the implementation of the Lisbon Treaty that has brought two new institutional figures, a fixed term EU President and an EU High Representative. The Lisbon Treaty has also increased the number of areas subject to majority voting, and as already said, the role of the EU Parliament is being strengthened.

Integration could only advance over many decades, also through successive enlargements, by proving beneficial for all participating countries.

b. The second aspect is that Eurozone countries have *delegated sovereignty over several economic policies to the supranational level.* Monetary policy, exchange-rate policy, and competition policy (for the EU) are now centralised (i.e., they moved us toward total economic integration in terms of the Balassa index above). Monetary policy has been transferred to the European

Figure 3 ‘Functional’ integration process (underlying the 1957 Treaty of Rome)



Central Bank (ECB) whose independence and price stability objective are enshrined in the Maastricht Treaty. Exchange-rate policy has been transferred to the ECB and the EU Council that jointly decide on the exchange rate framework in consultation also with the Eurogroup and the EU Commission. The ECB is solely responsible for managing foreign-exchange reserves and for conducting foreign-exchange operations. Competition policies and foreign trade policies are centralised by the EU Commission.

Calls to leave the EU, or the Eurozone, entirely miss the crucial point of European integration.

c. Growing economic integration generates more interdependence among EU countries. Each Eurozone country is more affected by developments in the partner countries (due to trade and financial linkages), and there are also increasing spillover from national policies. Hence, the third aspect is the *need for better working coordination in several policy areas*. There are various degrees of coordination. Close coordination is more encompassing and is based on rules and peer review which may lead to joint decisions. Fiscal policy is subject to close formal coordination. All Eurozone countries still set their national fiscal policies, but must do so within the rules and criteria set by the Stability and Growth Pact. An Excessive Deficit Procedure is started if the fiscal rules are breached. Policies that are subject to Single Market legislation are also subject to close coordination.

d. Weak coordination, on the other hand, may include the exchange of views and information, a common dialogue, and may lead to commonly agreed objectives (sometime in a not binding manner). Weak coordination is prominent in the area of monitoring labour market developments and policies, product and capital market policies, and external representation. These are politically sensitive areas and in which national governments may often have different preferences, special interests and background conditions.

Procedures and common standards support policy discussion and coordination.

A few years ago the European Council streamlined the open method of coordination and launched an EU Annual Progress Report with a set of Integrated Guidelines, a package including the Employment Guidelines that are added to the Broad Economic Policy Guidelines. Such Broad Economic Policy Guidelines are endorsed annually by the EU Council; they group together various macroeconomic and structural recommendation. In reality member countries do not often follow these guidelines or bend them. Moreover, member states prepare National Reform Programmes that have a three-year span but are updated annually. There is also a 'Partnership for Growth and Jobs', whose progress is monitored through the National Reform Programmes. The still ongoing financial crisis is now leading to a redesign of the European regulatory and supervisory system with the establishment, amongst others, of a European Systemic Risk Board and a European System of Financial Supervisors.

Observation 4

Eurozone countries are finding that their room for manoeuvre to conduct truly autonomous national economic policies is narrower than before EMU. On the other hand, each Eurozone country gains a better view, and might have a bigger say, on the policies undertaken by its partners. In fact, the more each country is a stakeholder in the policy of others, the deeper integration becomes. A case in point is the Eurogroup, a forum bringing together the Ministers of Finance of the Eurozone. Since the launch of the euro the Eurogroup has evolved from a small-scale informal body addressing mainly fiscal and exchange rate issues, into a relatively formalised body under a permanent President. It addresses a broad set of Eurozone policy issues with institutionalised monitoring procedures and follow-up requirements. It constitutes an important change in Eurozone governance (toward an economic union in terms of the Balassa index above), and each country has a voice in the discussion.

It has taken a great deal of political will, commitment and vision to reach the current status of European economic, monetary and institutional integration.

Over the last 15-20 years we have seen that the Achille's heel of various Eurozone countries has been a hapless economic performance driven by a combination of factors including: low innovation and productivity growth, an erosion in competitive advantages, and low or stagnant potential growth (sometimes referred to as the 'eurosclerosis' although it has nothing to do with the euro), lack of fiscal discipline and lack of reforms. In some countries these factors were initially masked by a boost in aggregate demand upon entry in a low inflation and interest rate environment. These factors that preceded the adoption of the euro are well known, they cannot go unabated and require some stark choices to spur structural reforms. In fact, there have been various structural initiatives promoting forms of EU-wide benchmarking. The Lisbon strategy for broad economic and social reforms was put forward in 2000 and revised in 2005, but did not deliver as expected. The new Europe 2020 agenda for structural reforms recently put forward by the EU Commission to foster smart, sustainable, and inclusive growth is a narrower and sharper exercise that deserves the utmost consideration and support.

Observation 5

If we look at the political economy of EMU, the areas characterised by single policy have delivered as expected. The single monetary policy and the new monetary policy framework have been successful. We had price stability and very low interest rates at all maturities. The exchange-rate policy has worked faultlessly. The single competition policy has also made strides in the last decades. The areas characterised by close coordination such as fiscal policies and structural policies have instead shown more uneven results. The areas characterised by weak forms of coordination are the ones exhibiting the most pronounced unevenness. Thus lower potential growth and persistent intra-Eurozone imbalances must still be tackled.

We had price stability and very low interest rates at all maturities. The exchange-rate policy has worked faultlessly.

What else do Eurozone countries share? By varying degrees, they all share numerous challenges, and opportunities. There are domestic (i.e., Eurozone) challenges such as the need for structural reforms to spur innovation and productivity (and thereby enhance growth potential). There is also a need to re-establish fiscal consolidation and coordinate national exit policies. All Eurozone countries face a rapidly ageing population which strains national pensions systems, health provisions, and long-term care plans. There is also the need for joint financial reforms and tackling of issues such as the 'too big to fail'.

There are also various common external challenges. Various forces are rapidly redefining world economic and financial balances and interdependence including the rapid decline in the cost of transporting goods and travelling, the increasing role of knowledge and innovation, and the speed of communication and information technologies. These forces are giving rise to a phenomenon labelled 'globalisation'. There is also the need to address climate changes. Moreover, reforms of the global financial system, and also the global financial architecture, are well underway.

Observation 6

Eurozone countries are exposed to relatively similar challenges and systemic risks. So maybe there is a reasonable expectation that some dysfunctional diversity will also slowly fade (Wyplosz 2010).

Some functions of government are still primarily under national control including the allocation role, the redistribution of income, the stabilisation of economic activity, and the promotion of domestic growth and employment. This is understandable due to the subsidiarity principle, but also for accountability reasons, as well as, heterogeneous national preferences, historic reasons, and so forth.

Observation 7

As integration further deepens and the domestic and external challenges mount, some economies of scale could well be realised. An example would be a common foreign representation, or closer security policies, and the provision of foreign aid. Interestingly, the highest tiers of the European defence and aerospace industry are already largely consolidated. Other industries are following suit.

Concluding observations

Over the last two and a half years the world has been struck by a full-blown systemic financial crisis, unprecedented in size, if measured by financial losses and fiscal costs, unprecedented in extent, if measured by its geographical reach, and unprecedented in speed and synchronisation, if measured by the precipitous fall in worldwide economic output. Looking back, all major central banks in the world have provided unprecedented and exceptional policy responses. The ECB and the Eurosystem were the first to act. The impact of the crisis would have been far worse without such responses. Yet, the aftershocks of this financial earthquake are proving quite severe in the Eurozone. One reason is that European economies are all extremely open and world trade has significantly declined. But there are also other reasons.

For a young endeavour such as EMU a learning process is understandable. The crisis has taught us about the links between monetary stability, financial stability, fiscal sustainability, and sound economic growth.

Three fault lines were gradually exposed by the ongoing financial crisis. The first is an inability by some countries to keep public finances durably under control. The second fault line reflects a gradual but persistent erosion of competitiveness in some countries. The third fault line is the low productivity growth. Countries at the intersection of these fault lines may be at greater risk of derailment. What type of remedies and prevention are at hand? What can the institutional framework of EMU best help achieve?

Observation 8

The institutional framework of EMU was deliberately designed without any provision for mutual financial insurance scheme - i.e., what the mooted European Monetary Fund may presumably deliver. This was not an involuntary omission. In fact such a scheme exists for non-Eurozone EU countries, and is being used by several. The intent was to underpin the no-bailout rule and strengthen national incentives toward fiscal discipline. In other words the presumption is that every member keeps the own house in order. More or less, amidst some short-lived episodes of excessive deficits over the last decade, this has been the case in most Eurozone countries. The fiscal story of EMU might have been very different without the Stability and Growth Pact. Obviously the incentives were not enough for all countries, and member's disclosures have been somewhat uneven particularly at the frontiers of financial innovation. We are now facing a sovereign crisis. Yet, Heads of States have the means and powers to remedy this if they choose to do so.

Observation 9

For a young endeavour such as EMU a learning process is understandable. The crisis has taught us about the links between monetary stability, financial stability, fiscal sustainability, and sound economic growth . In particular, three 'lessons' must be rapidly turned into action (but there are others).

The first is that the preventive arm of the Stability and Growth Pact needs improvement to secure stress-testing and early detection of any possible fiscal troubles (see Jonung et al 2008). Yet we know that there can be no lasting fiscal consolidation if confidence and growth do not rapidly return.

The second lesson is therefore that agendas for structural reforms should be given more teeth and become binding for those Eurozone countries in need of such reforms. But how should these teeth be designed to bite? The Europe 2020 agenda recently put forward by the EU Commission, as well as National Reforms Programmes should be taken very seriously. Yet we also know that sustainable growth and innovation need the support of a sound and efficient financial system.

It follows that the third lesson is that enhanced financial regulation and supervision should not suffocate whatever valuable in financial innovation and should encourage further financial integration and deepening across the EU/Eurozone. In fact, future sustainable growth depends on it. The newly revamped financial regulation and supervision should provide a powerful counterbalance.

Observation 10

Hence, as in the past, macroeconomic shocks can spur advancements in the EU. A shock as big as the current financial crisis requires a leap forward. All three lessons above can be absorbed by the existing institutional framework. In fact, existing institutions can be strengthened rather than completely overhauled or creating additional ones. We have also made a rough new encounter with forgotten powerful deterrents. In the aftermath of the crisis we have learnt that financial market based discipline can swing back and haunt high-deficit countries and that the political costs of lack of fiscal discipline can also be daunting. These deterrents are likely to linger for a long time. Such realisation should definitely support the Stability and Growth Pact.

While Europe has profoundly changed, the global economy has also changed. All EU countries now face very similar domestic and external challenges - as well as opportunities - that are rapidly redefining world economic balances. Some of the forces at work are 'too big to handle' for any country on its own. Yet, the main challenge now facing most Eurozone countries is about their national economic governance and adaptability. It seems almost a paradox. We are again calling for renewed political commitment, will and vision, although this time reform efforts must be oriented inward. Such efforts can find support in the price stability environment and the increased resilience secured by the euro. But there is also the support of over 50 years of economic, financial, monetary and institutional integration that is continuing to deliver important benefits: a large single market.

References

Balassa, B (1961), *The Theory of Economic Integration*, Irwin, Homewood, Illinois.

Buti, M, S Deroose, V Gaspar, and J Nogueira Martins (2010), *The Euro*, Cambridge: Cambridge University Press

Dorrucci, E, M Fratzscher and FP Mongelli (2004), 'The Link between Institutional and Economic Integration: Insights for Latin America from the European Experience', *Open Economies Review*, 15: 239-260.

ECFIN (2008), 'EMU@10: successes and challenges after 10 years of Economic and Monetary Union'.

ECB Monthly Bulletin (2008) 'The Euro at Ten: Special Anniversary Issue'.

Jonung L, M Larch and J Fischer (2008), '101 Proposals to Reform the Stability and Growth Pact. Why so many? A Survey', *Public Finance and Management*, 8(3): 502-560.

Mongelli, FP (2010), 'On the benefits and costs of participating in a monetary union', CEPR Policy Insight 46.

Mongelli, FP, E Dorrucci, and I Agur (2007), 'What does European institutional integration tell us about trade integration?', *Integration and Trade*, (IADB), 11(26):151-200.

Wyplosz, Charles (2010), 'Europe's macro mess: Dysfunctional diversity that gets the job done', VoxEU.org, 20 March.

Francesco Paolo Mongelli is Senior Adviser in Directorate Monetary Policy at the ECB, and honorary Professor at the Johann Wolfgang Goethe University of Frankfurt. He holds a B.A. in Economics from the Free University for Social Studies (LUISS) in Rome, and also a Master's degree and a Ph.D. in Economics from The Johns Hopkins University in Baltimore. He has worked at the ECB since 1998 holding various positions, including as organiser of the analytical agenda of DG Economics, and editor of the ECB Occasional Paper Series. Prior to that he spent several years as an economist at the International Monetary Fund in Washington. Mr. Mongelli's main area of research pertains to the effects of the euro on the functioning of EMU, the links between monetary policy and heterogeneity in the euro area, the links between economic integration and institutional integration, and comparing monetary policy preparation and the decision making in the main central banks. He also teaches Economics of Monetary Unions at the Johann Wolfgang Goethe University of Frankfurt. His papers have been published in various scientific and policy-oriented journals, such as the *Open Economies Review*, the *Journal of Money Credit and Banking*, the *Journal of Common Market Studies, Integration and Trade, Economie Internationale, Bancaria*, and the *Journal of Economic Integration*.