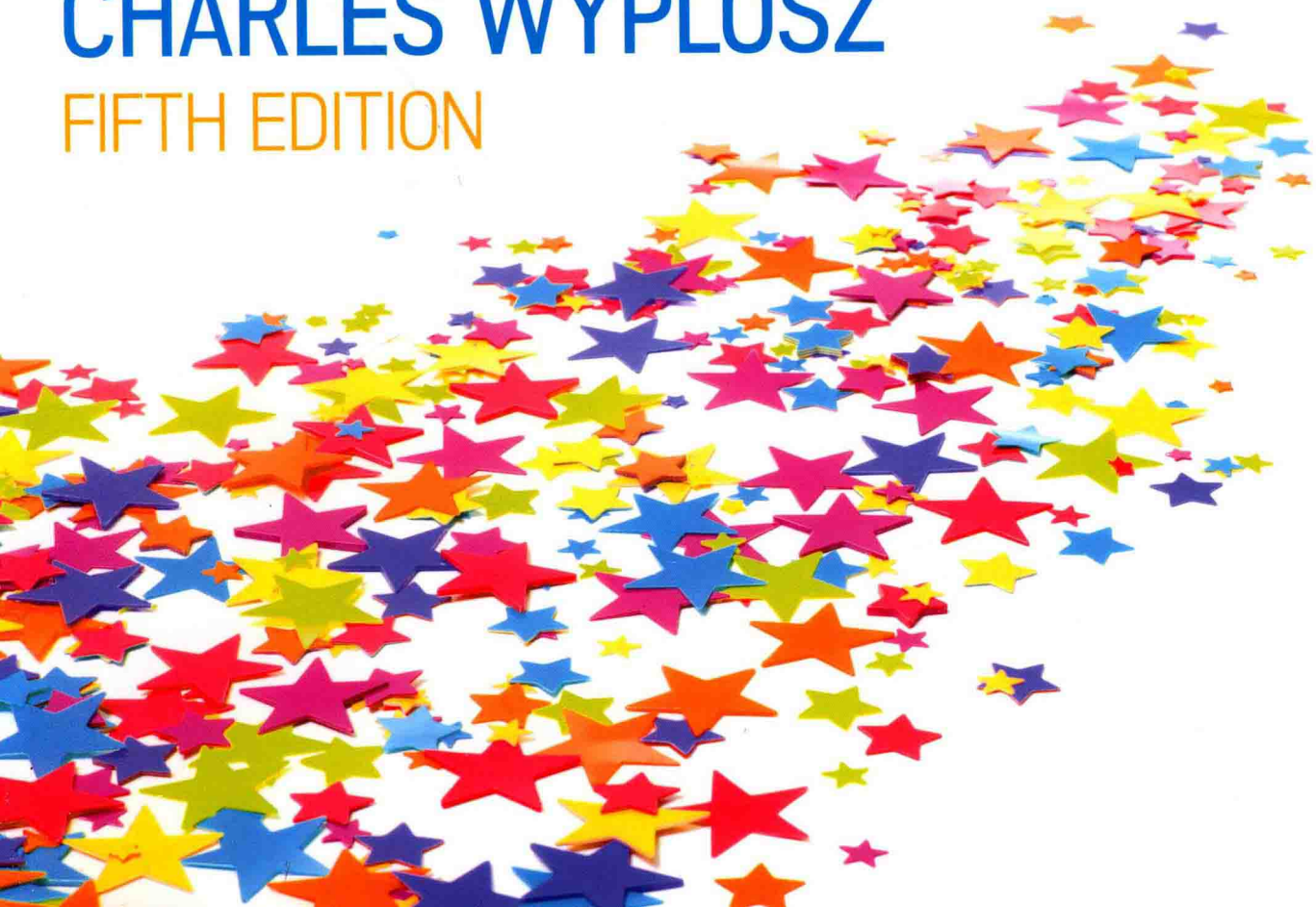


THE ECONOMICS OF EUROPEAN INTEGRATION

RICHARD BALDWIN
CHARLES WYPLOSZ

FIFTH EDITION



The Economics of European Integration

Fifth edition

Richard Baldwin & Charles Wyplosz



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The Economics of European Integration

Dedication

For Sarah, Ted, Julia and Nick - R.B.

In memory of my parents, whose sufferings inspired my yearning for a
Europe at peace, and who taught me the pleasure of learning - C.W.

About the Authors



Richard Baldwin is Professor of International Economics at the Graduate Institute, Geneva since 1991, a part-time visiting research professor at the University of Oxford since 2012, Director of CEPR since 2014, and Editor-in-Chief of Vox since he founded it in June 2007. He was Co-managing Editor of the journal *Economic Policy* from 2000 to 2005, Policy Director of CEPR since 2006, and Programme Director of CEPR's International Trade programme from 1991 to 2001. He has previously been a Senior Staff Economist for the President's Council of Economic Advisors in the Bush Administration (1990-1991), on leave from Columbia University Business School where he was Associate Professor. He did his PhD in economics at MIT with Paul Krugman and has collaborated with him on several occasions. He was visiting professor at MIT in 2002/03 and has taught at universities in Australia, Italy, Germany and Norway. He has also worked as consultant for the numerous governments, the Asian Development Bank, the European Commission, OECD, World Bank, EFTA and USAID. The author of numerous books and articles, his research interests include international trade, globalization, regionalism and European integration.

Charles Wyplosz is Professor of International Economics at the Graduate Institute in Geneva where he is also Director of the International Centre for Money and Banking Studies. Previously, he has taught at INSEAD and at the Ecole des Hautes Etudes en Sciences Sociales in Paris. He is a Fellow of CEPR and of the European Economic Association. His main research areas include financial crises, European monetary integration, fiscal policy and regional monetary integration. He is the co-author (with Michael Burda) of the leading textbook *Macroeconomics, A European View* and has published several books and many professional articles. He serves as consultant to many international organizations and governments and is a frequent contributor to public media. He was a Founding Managing Editor of *Economic Policy*. A French national, Charles Wyplosz holds degrees in Engineering and in Statistics from Paris and a PhD in Economics from Harvard University.



Preface

What's up?

Talking about European integration has at times appeared strange during the last few years when disintegration seemed around the corner. As we close this new edition, it seems that the worst is over, but one can never be sure. Over the last three years, between the fourth and fifth editions, the sovereign debt crisis has worsened and then improved. In the first three editions, we noted the many flaws in the integration process, especially those concerning the Eurozone. In the fourth edition, we were lamenting the policy responses to the crisis, pointing out what had to be done. Since then, much has been done, often along the lines that we mentioned. This edition takes stock of these changes, which concern both institutions and policies. The European Union has been transformed, and so has this book.

The most drastic changes concern both the pedagogy and the content. In terms of pedagogy, we have retained the five-part structure but:

- Presentation of the macroeconomic theory has been entirely revised. Chapter 13 now includes a compact presentation of the closed economy centred on the standard *IS-LM* model, except that *LM* is replaced by *MP*, a graphical representation of the Taylor rule, which is arguably what central banks use. It then moves to the open economy version (the Mundell–Fleming model) and introduces the interest arbitrage condition. The remaining chapters make extensive use of this framework, which has become the thread running through Parts IV and V. Chapter 15 also includes an explicit treatment of the theory of central banking.
- Chapter 15, which presents the optimum currency area (OCA), has been entirely redesigned. It presents a more extensive analysis of the benefits accruing from a currency union, including a detailed discussion of central bank independence. The presentation of the OCA criteria is also systematically followed by a critical appraisal.
- A new section has been introduced at the beginning of Chapter 18 to present the characteristics of financial markets and the essential principles needed for the rest of the book.

Concerning content, this edition fully takes on board the many institutional changes that have occurred over the last three years. The book therefore offers an integrated and up-to-date presentation of the European Union. The main changes are:

- The new Stability and Growth Pact, including the Six Pack–Two Pack directives and the Treaty on Stability, Coordination and Governance (TSCG)
- The Banking Union
- The various programmes put in place by the Eurosystem (SMP, LTRO, OMT)
- The enlargement of the Eurozone, which changes the functioning of the Governing Board of the Eurosystem

Obviously, the latest developments are fully covered. The information is included in context within every chapter. Chapter 19, which presents the crisis, has been entirely rewritten, as well as significant portions of Chapters 17 (fiscal policy) and 18 (financial markets). With all relevant data updated, these chapters are effectively new.

What this book is

This is a textbook for courses on European economic integration. Its emphasis is on economics, covering both the microeconomics and macroeconomics of European integration. Understanding European economic integration, however, requires much more than economics, so the book also covers the essential aspects of European history, institutions, laws, politics and policies.

The book is written at a level that should be accessible to second- and third-year undergraduates in economics as well as advanced undergraduates and graduate students in business, international affairs, European studies and political science. Some knowledge of economics is needed to absorb all the material with ease – a first-year course in the principles of economics should suffice – but the book is self-contained in that it reviews most essential economics behind the analysis.

What is in this book

The book is organized into five parts: essential background (Part I), the microeconomics of European integration (Part II), microeconomic policies (Part III), the macroeconomics of monetary integration (Part IV) and macroeconomic policies (Part V).

Part I presents the essential background for studying European integration.

- An overview of the post-Second World War historical development of European integration is presented in Chapter 1. The chapter should be useful to all students, even those who are familiar with the main historical events, as this chapter stresses the economic and political economy logic behind the events.
- A concise presentation of the indispensable background information necessary for the study of European integration is presented in Chapter 2. This includes key facts concerning European economies and a brief review of the EU's legal system and principles (fully updated to reflect the Lisbon Treaty changes). Chapter 2 also presents information on the vital EU institutions and the EU's legislative processes as well as the main features of the EU budget.
- Chapter 3 presents an economic framework for thinking about EU institutions. The first part explains how the 'theory of fiscal federalism' can be used to consider the appropriateness of the allocation of powers between EU institutions and EU Member States. The second part explains how economic reasoning – game theory in particular – can be used to analyse EU decision-making procedures for their efficiency as well as their implications for the distribution of power among EU members. While these are not classic topics in the study of European integration, they are essential to understanding the current challenges facing the EU, such as the 2004 enlargement and the debates around the Lisbon Treaty. This is more relevant than ever as the Eurozone crisis is almost sure to produce a shifting of some competencies from the national level to the supranational level – or, at the very least, a serious debate over such shifts.

Part II presents the microeconomic aspects of European integration.

- An introduction to the fundamental methods of trade policy analysis is presented in Chapter 4. The chapter introduces basic supply and demand analysis in an open economy and the key economic welfare concepts of consumer and producer surplus, and then uses them to study the simple economics of tariff protection.
- An in-depth analysis of European preferential trade liberalization is given in Chapter 5. The focus is on how the formation of a customs union or free trade area affects people, companies and governments inside and outside the integrating nations.
- A thorough study of how the market-expanding aspects of European integration affect the efficiency of European firms is presented in Chapter 6. The main line of reasoning explains how integration in the presence of scale economies and imperfect competition can produce fewer, bigger and more efficient firms facing more effective competition from each other. Again, the ongoing enlargement of the European Union makes this sort of logic more relevant than ever.
- Chapter 7 gives a detailed study of the growth effects of European integration. The emphasis is on the economic logic linking European integration to medium-run and long-run growth effects. Neoclassical and endogenous growth theories are covered to the extent that they help students understand the growth–integration linkages. The basic facts and empirical evidence are also covered.

- Chapter 8 deals with the labour markets. It recalls the basics of labour economics in order to explain unemployment and develop the notion that social requirements may have seriously negative effects in terms of jobs, wages and growth. The chapter uses these insights to study the effects of integration. It deals with many controversial issues such as social dumping and migration, trying hard to stay above the fray by presenting economic analysis as one logic, but not the only one.

Part III presents the main microeconomic policies of the EU.

- Chapter 9 looks at the Common Agricultural Policy (CAP), presenting the economics and facts that are essential for understanding its effects. The chapter takes particular care to examine the economic forces behind recent CAP reform in the light of international trade negotiations (the Doha Round), the eastern enlargement and the reforms that are being discussed for the post-2013 financial period.
- Chapter 10 presents the economics that link European integration to the location of economic activities. This includes a presentation of the main facts on how the location of economic activity has shifted both within and between nations. To organize thinking about these facts – and to understand how EU regional policy might affect it – the chapter presents the location effects of integration in the light of neoclassical theories (Heckscher–Ohlin), as well as the so-called new economic geography. The chapter also presents the main features of the EU's regional policy and considers the implications of the eastern enlargement.
- Chapter 11 covers the basic elements of the EU's competition policy and state aid policy (EU jargon for subsidies). Instead of merely describing the policies, the chapter explains them by introducing the basic economic logic of anti-competitive practices. It has been updated to include several recent cases that illustrate the difficulties of applying simple economics to the complex world of international business.
- Chapter 12 addresses EU trade policy, i.e. its commercial relations with the rest of the world. While trade policy is not as central to the EU as are, say, the CAP and cohesion policies, it is important. The EU is the world's largest trader, and trade policy is probably the only EU 'foreign policy' that is consistently effective. The chapter covers EU trade policy by presenting the basic facts on EU trade, covering the EU's institutional arrangements as concerns trade policy, and finally summarizing the EU's policies towards its various trade partners. It has been fully updated to reflect changes introduced by the Lisbon Treaty.

Part IV continues the approach of Part II by providing the basic principles behind macroeconomic and monetary integration.

- The essential principles needed for the macroeconomic analysis are presented in Chapter 13. This chapter presents the macroeconomic theories and tools needed to analyse monetary integration. It is organized around the Mundell–Fleming model and establishes three principles: interest rate parity, purchasing power parity and the impossible trinity that affects the choice of exchange rate regimes. This chapter can serve either as a refresher for economics students or a (fast) introduction to economics for others.
- The long process of European monetary integration is recounted in Chapter 14. It starts briefly with ancient times when Europe was a *de facto* monetary union under the gold standard, reviews the Bretton Woods period when Europe's exchange rates were tied together via the US dollar and then moves to the European Monetary System, past and present. The process of euro adoption is briefly reviewed.
- Chapter 15 presents the optimum currency area theory, the framework needed to think about the working of a monetary union. The basis is provided by the principles developed in Chapter 13. Looking at the costs and benefits resulting from sharing a common currency, the theory is essential to understanding what works and does not work in the Eurozone. It is used extensively in further chapters.

Part V is the counterpart to Part III, as it presents the main macroeconomic policies of the EU.

- The main features of the European monetary union are laid out in Chapter 16. This includes a description and analysis of the institutions created by the Maastricht Treaty and how they have evolved since, including during the crisis that started at the end of 2009. It explains the importance attached to price stability and the measures adopted to achieve this objective. The chapter also provides a review of the first decade of the euro up until the crisis.
- Fiscal policy is the last national macroeconomic instrument remaining once national monetary policy has been lost. Chapter 17 looks at the Stability and Growth Pact, designed to deliver just enough budgetary discipline so as not to endanger the overriding price stability objective. Since the first edition of this book, we have underlined the pact's serious shortcomings; the crisis has led to a strengthening of the pact, but fundamental economic and political difficulties remain.
- Chapter 18 deals with the financial markets. It starts with an analysis of financial markets in general. It then explains how and why the financial services industry was transformed by the Single European Act 1986 and by the adoption of a single currency and how it has been fragmented by the crisis. The measures taken to deal with this unexpected development are presented and evaluated, including the creation of the Banking Union. The chapter concludes by questioning whether the euro can challenge the US dollar as a world currency.
- Finally, Chapter 19 offers an overview of the Eurozone crisis. It looks at the global crisis that started in the USA and its transmission to Europe. The next step, the sovereign crisis, is then described and analysed, bringing together much of the material presented in earlier chapters. The policy responses are presented and critically evaluated. The chapter ends with a discussion of the remaining challenges and an analysis of what the break-up of the Eurozone would mean.

How to use this book


The book is suitable for a one-semester course that aims at covering both the microeconomics and macroeconomics of European integration. If the course is long enough, the book can be used sequentially for two courses.

Shorter courses may focus on the trade and competition aspects; they can use only Parts I, II and III. Conversely, a course dealing only with the macroeconomic aspects can use Parts IV and V, and finish with labour market issues as covered in Chapter 8 (which does not really require the previous microeconomic material).

Eclectic courses that focus on theory and cover trade, competition and macroeconomics can use only Chapters 1–8 and 16–19 or just 4–8 and 16–19. Eclectic courses oriented towards policy issues can use, with some additional lecturing if the students are not familiar with basic theory, Chapters 1–2, 9–12 and 16–19. In general, all chapters are self-contained but, inevitably, they often refer to results and facts presented elsewhere.

Each chapter includes self-assessment questions designed to help the students check how well they master the material, and some chapters also provide essay questions which can be given as assignments. We also provide additional readings that are easily accessible to undergraduate students.

The fifth edition continues our tradition of providing many internet links that should allow students and lecturers alike to gain the latest information on the EU's many fast-developing areas. We have observed that the internet is an excellent way to stimulate students' interest by bringing classroom teaching to real issues they see every day in the media. The links we provide go well beyond journalist treatment in a way that allows students to realize the usefulness of the basics they have learned from the text.



Acknowledgements

Our thanks go to the following reviewers for their comments at various stages in the text's development:

Bruno Merlevede, Ghent University
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We would also like to thank Ralf Fendel for the material which he provided for the textbook and its accompanying online resources.

Each new edition lengthens our indebtedness to colleagues, former and present students and editors. It also increases our pleasure when the time has finally come to thank them all. In the current and previous editions, a number of colleagues have made useful suggestions and identified mistakes. While we alone are responsible for the remaining old and new mistakes, we thank our reviewers for their no-holds-barred evaluations, which have been both challenging and most useful. We have tried hard to respond to each and every criticism and to follow the many constructive suggestions that we received.

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We would also like to thank the students who provided face-to-face feedback while we were teaching the fourth edition material. Richard Baldwin would in particular like to thank the students at the University of Geneva.

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Guided Tour

Introduction

How the European monetary union functioned, explained the genesis of this treaty and difficulties have arisen, which should not be developed countries is a first and it is also to have got it 100 per cent correct right from the start to deal with problems as they arise and one chapter presents the present situation.

Section 16.1 lays out the principles of the treaty, priority given to price stability and the role of the Eurozone was based on five conventional principles. The original central banking structure of the central banks. Together they make up the system of governance is presented in Section 16.4.

Chapter introduction

Each chapter opens with an introduction outlining the ideas and concepts that will be addressed in the following pages.

Maps and diagrams

These are provided throughout the text to show the geographical impact of changes in EU integration across the continent.

Box 16.5 A challenge from the C

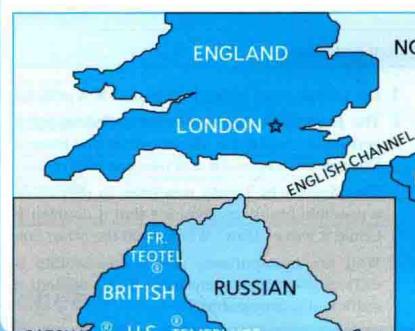
The main risk to central bank independence is the creation, a threat to price stability (see Box 16.5). The Eurosystem has taken bold steps to control the quantities of money and even committed to countries offered combined IMF and Eurozone. They have taken the view that these actions bring the price stability. They have asked the German government to violate the German constitution (the so-called financing governments but it is explained in the market.²

After more than one year of deliberation...

Figures and tables

Figures and tables feature throughout the text to help illustrate important statistics and data about the European Union and its Member States.

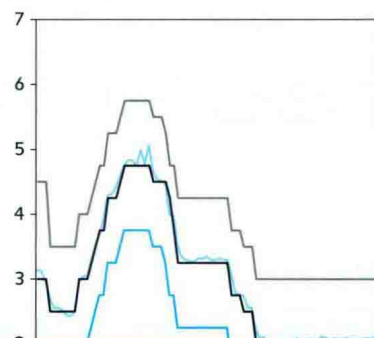
Figure 1.2 The four-way division of Germany



Example boxes

Each chapter contains a number of boxes that provide further examples and explanations of key facts, events or economic ideas relating to the European Union.

Figure 16.10 ECB interest rates, January 1999–July 2000



16.8 Summary

The monetary union is an elaborate co... was signed in 1991 and the single cur... currency was not issued until 2002. T... unique nature of the undertaking.

The main objective assigned to th... an inflation rate close to but below 2... pursued only if price stability is not in... granted considerable independence. I... degree of transparency.

Self-assessment questions

Self-assessment questions are included to allow students to test themselves on the economic concepts and facts featured in each chapter.

Essay questions

- 1 Devise the entry conditions using OCA principl
- 2 The Eurosystem asserts in its deliberations th... economic conditions. The reason is that there is... Discuss this approach and imagine alternative
- 3 The Maastricht Treaty describes in minute de... a possible break-up. Imagine that a country is... Could it leave? How? What could the other cou
- 4 Why are transparency and accountability s... difficulties can you envision if the system is... sufficiently transparent?

Further reading, useful websites and references

For students who want to explore key concepts, each chapter contains a list of extra sources to help further research.

Annex: A study

Year	Date	Event	Ex
1948	16 April	OEEC	Or (O
1950	9 May	Schuman Plan	Fr est (E bu Da
1952	1 January	ECSC	Th

Chapter summaries

Recaps of the key ideas and discussions are featured at the end of each chapter.

Self-assessment questions

- 1 What shape is the *MP* schedule and how doe... stability and ignores growth? Answer the sam... growth and disregards price stability.
- 2 Consider a bank that cares only about price... flexible exchange rate regime to see what hap
- 3 A Eurozone member has a fixed exchange... happens when:
– when demand for domestic goods declines;
– when interest rates abroad rise; – when th... policy.
- 4 Why are central banks ultimately responsible

Essay questions

Essay questions feature at the end of some chapters and encourage students to write full answers to explore ideas in more detail as practice for exams.

Further reading: the aficionado's

The first decade of the euro as reviewed by the **European Central Bank**, www.ecb.int/pub/pc/49ee63d0ce0e8.

And by independent observers:

Aghion, P., A. Ahearne, M. Belka, J. Pisani
on the Eurozone, BRUEGEL, Brussels. Dov
Fatás, A., H. Flam, S. Holden, T. Japelli, I.
Denmark, Sweden and the UK Join?, Stoc
www.sns.se.

Annex

Where appropriate, Annex sections offer further economic explanations, data or background information. The annexes enable further study to complement the chapter, covering more advance concepts and providing greater detail.

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Online Learning Centre

www.mheducation.co.uk/textbooks/baldwin5



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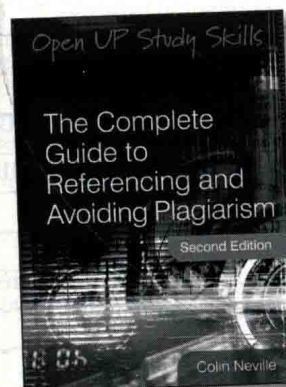
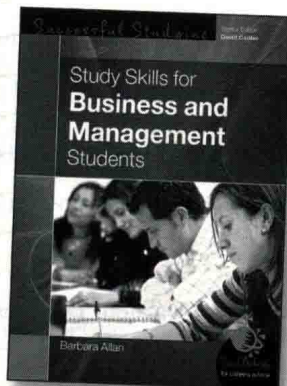
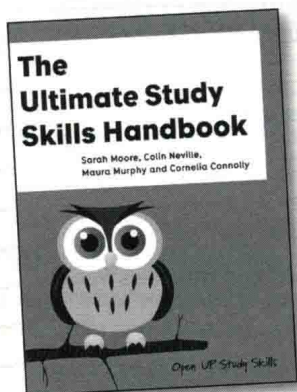
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