Re-Examining EU Policies from a Global Perspective

Scenarios for Future Developments

Edited by Monica Răileanu-Szeles

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Introduction

Monica Răileanu Szeles

This book provides a critical perspective on six key European Union (EU) policies, highlighting the difficulties encountered by the European integration process in the global economy, particularly in the context of the global economic crisis. The EU's monetary, social, agricultural, trade, energy and fisheries policies are analysed using a common approach which examines the most important steps made in the development of European policies: the peculiarities, mechanisms and instruments specific to each policy; the outcomes and effectiveness of the policies at both EU and new member state levels; the challenges induced by economic, social and demographic changes in the global economy; and several scenarios for future developments.

The European policies selected to be analysed in this book are currently among the most debated and controversial ones. The authors identify an imminent turning point in their functioning, determined by the global economy, which calls for a new approach and design that is adapted to the new economic, social and demographic context. A short description of each chapter is provided below.

The European monetary policy and the launching of the euro represent key steps in the process of European integration. Chapter 1 begins with a historical perspective on the European Monetary Union and then continues by discussing the main achievements and challenges of the eurozone over time, in the context of the global economy. The theoretical foundation of the euro, examined here using the optimum currency area theory, allows us to explain the sustainability of the euro in the long term. The current stage of economic and financial convergence, the achievement of the nominal convergence criteria and the weaknesses of the euro area in facing the challenges of the global economic crisis are also examined. The chapter ends by advancing several euro perspectives and enlargement scenarios.

The main issues approached in Chapter 2, which discusses European welfare states and social policies, are the current architecture of the European welfare system, the failure of the traditionally generous welfare states, the reforming process and the critical points still requiring common and national solutions. After presenting the main steps undertaken in the development of the European social policy, the European welfare state and social models are critically examined. The chapter also covers the economic and demographic challenges of current European social policy, and their implications for the sustainability of this system, with a special focus on the ageing process and pension systems in the EU. Different national reforming paths are comparatively analysed and, at the end, future challenges for European social policy are also advanced.

Chapter 3, which concerns the EU's energy policy, explains the evolution of this policy and shows how changes to it served the cause of economic and political integration. Initial concerns with energy security during the Cold War years were later replaced by strong commitment to a common market in the energy sector, and by environmental protection initiatives. The instruments of these major policy strands (security of supply, cost reduction and environmental protection) are explored critically, especially the change from explicit taxes, subsidies, and national rules and regulations to the use of Europe-wide market mechanisms. Despite the financial crisis, there is little evidence to support the view that energy policy-making since 2008 has changed direction, as no policies have been put on hold pending a return to economic growth and normality.

The Common Agricultural Policy (CAP), discussed in Chapter 4, is one of the most controversial elements of European integration, and has had a major impact on external EU relations. Its objectives and complex mechanisms have changed over time, but the purpose has stayed the same: to shelter European farmers from international competition and guarantee them a decent living. The CAP has been successively reformed to reduce expenditure and to cope with external pressures. Its focus has shifted from agricultural support to rural development. Moreover, the change in agricultural regimes in the new member states has reduced the impact of EU enlargement. The economic crisis has brought controversial issues for the CAP. To stay legitimate and efficient, the move from quantity to quality and to more ecological value should continue, along with investments in the agro-food chain.

Chapter 5 discusses how the EU common trade policy started with the customs union, which involved removing tariffs among member states and introducing the common external tariff. Internal non-tariff barriers were dropped over time, leading to the single market, but the EU kept using protectionist measures against third-country exports. The EU gradually became the world's largest trading bloc. It concluded various bilateral and multilateral trade agreements, with different degrees of preference. Unfortunately these were accompanied by complex compliance rules. During World Trade Organization negotiations the EU exhibited a mixed position, favouring openness in several fields, but remaining a reluctant agricultural liberalizer, which led to trade disputes, especially with the USA. In the aftermath of the crisis, the EU refrained from introducing new trade barriers, defending its liberal position.

Chapter 6 on the Common Fisheries Policy details the historical need for an EU fisheries policy, in the absence of sufficient international regulations. It is argued that the value and difficulties of reaching agreement on the Common Fisheries Policy should not be underestimated. Nevertheless, the current challenges are significant. If overfishing in EU waters had been tackled more rigorously in the past the difficulties now facing the EU fishing industry would not be so acute. The current situation requires decentralized actions to avoid creating areas of chronic unemployment for generations. If these actions are to be successful then member states must learn lessons from other sectors of the economy that have undergone structural change.

This book addresses not only the academic world and researchers, but also public institutions, governmental bodies and civil society institutions with an interest in the field of European integration studies. Its target audience is represented by those who want to improve their knowledge of European policies, stay connected to the latest developments in this field and become aware of the new threats and challenges launched by the global economy.

The idea behind the presentation of European policies following the same structure is that the new European development model, which stems from the difficulties posed by the current global economic crisis, should envisage and respond to the challenges posed by the changing global economy. This requires new, reformed European policies, aiming to support sustainable, inclusive, green economic growth that will lead to economic development and better living conditions for European citizens. Acknowledging the necessity to rebuild the European policies and the European integration process in the aftermath of the global economic crisis is an important step towards a new phase of EU enlargement and development.

1
The European Monetary Policy and Euro Drift in the Aftermath of the Economic Crisis

Monica Răileanu Szeles

Monetary unification – a step towards in-depth European integration

A historical perspective on the European Monetary Union

The adoption of the euro as their common currency by 11 member countries of the European Union (EU) in 1999 represented a major step in the European integration process. It was aimed at consolidating internal economic unity and giving the EU a stronger position in international affairs.

The story of the European monetary policy begins with Pierre Werner, who was prime minister of Luxembourg from 1959 to 1974 and again from 1979 to 1984. He is considered to be the "father of the euro", given that during his political career he conducted a large-scale campaign for a single European currency and European monetary policy. The idea of a single European currency was first officially presented at a summit in The Hague (December 1969). According to Werner's plan, the introduction of a single European currency was not a goal in itself. The final phase of his plan concerned the achievement of total convertibility of member states' currencies, the full liberalization of capital movement and the irrevocable fixing of exchange rates.

Despite the initial enthusiastic debates about the prospects for launching a European single currency, the European Monetary Union (EMU) project entered a short period of high instability in 1971, when the Bretton Woods system ended. After introducing the system known as the "snake in the tunnel" (a managed floating of currencies around the dollar) in 1972, most of the member states abandoned the monetary arrangement, and only Germany, Denmark and the Benelux countries continued to use the system.

Even though the introduction of a single currency was not stipulated in the Treaty of the European Economic Community (EEC, Rome, 1957), subsequent treaties and treaty revisions approached this goal and formulated directions to achieve it. The Single European Act (1986) introduced a new article into the EEC Treaty, regarding the necessity of strengthening the European monetary system and developing the European Currency Unit (ECU). The Treaty of Maastricht (1991) advanced the objectives of developing a common monetary policy and launching a single currency called the euro and an independent European Central Bank (ECB) in the member states. Three steps that would precede the formation of the EMU were envisaged in the Treaty of Maastricht as preparing the member states for entering into monetary union:

1. The free movement of capital between member states (from 1 July 1990 to 31 December 1993).
2. The coordination of member states' monetary policies by the European Monetary Institute and the convergence of their economic policies (from 1 January 1994 to 31 December 1998).
3. The introduction of the euro as the common currency of the member states (as of 1 January 1999) and the setting up of a common monetary policy coordinated by the ECB.

In fact, the Maastricht Treaty is the founding document of the EMU. Some countries approved the treaty by a public vote, while others ratified it by a legislative vote. Besides announcing the launching of the euro, the Maastricht Treaty also established a number of criteria for the accession of EU countries to the EMU, criteria which are known as the *Maastricht criteria* or *nominal convergence criteria*.

The creation of the EMU and the euro was not a simple step in the European integration process, but a complex procedure which developed in several phases. This old European project was actually born in early 1979 when the European Monetary System (EMS) was launched by France, Germany, Italy, Belgium, Luxembourg, Ireland, Denmark and the Netherlands. A forerunner of the EMU, the EMS was conceived by the European Community as a network of mutually pegged exchange rates intended to coordinate the monetary policies of the member states, to counter inflation among them and to stabilize foreign exchange. Periodic adjustments have been made in time to keep the currencies within the official fluctuation band. In the initial phase of its creation, the EMS met with many technical difficulties, such as the setting of a correct rate for all countries or the managing of the system based on the different degrees of involvement of the participating countries. Together with the launching of the EMS, a basket of currencies called the ECU was conceived to be used as the internal accounting unit of the European Community member states.

The EMS lasted from 1979 until 1999, during which four periods of different but significant developments emerged. The first phase of the EMS (1979–1985) was characterized by capital controls, high differentials in inflation rates, budget deficits, public debt and frequent adjustments of official parities. The second phase of the EMS developed from 1986 to 1992 and represented a significant step towards monetary integration. The adoption of the Single European Act in 1986 was naturally followed by the report of the Delors committee about the feasibility of the monetary union (which was to be finally approved in 1989). During this period of time, monetary integration was seen as necessary for the good functioning of the single market. In this second phase, the old discussions around the theory of the optimum currency area (OCA) were revived to theoretically support monetary integration. The third phase, from September 1992 to March 1993, was associated with the crisis of the EMS arrangement. In the context of Germany's tight monetary policy, the Danish voting against the Maastricht Treaty and the inflationary pressures being experienced in some EU countries, a series of speculative attacks against the overvalued currencies was launched. The UK and Italy had to leave the Exchange Rate Mechanism (ERM), but Italy rejoined it in 1996. The fourth phase lasted until the launch of the euro and was replaced on 1 February 1999 with the ERM II system. In the new system, the euro became a currency anchor for the other participating countries.

The functioning of the EMS was based on the ERM, which was set up to limit the exchange rate fluctuations of participating currencies. Not all EMS members agreed to also participate in the ERM.[1] Until

1993, most exchange rates were allowed to fluctuate within a band of 2.25% relative to an assigned par value, but from 1993 onwards the bands were widened to 15% due to speculative attacks.

The system of fixed exchange rates was maintained until 1992, when the asymmetrical macroeconomic pressures in Germany and its partners generated by the reunification of eastern and western Germany in 1990 imposed its replacement. In 1993, the fixed exchange rate system with a variation band of 15% was reinforced and ran until the euro's introduction in 1999.

On 1 January 1999, the euro officially replaced the ECU, but not all countries joining the ECU basket of currencies also participated in the eurozone (the UK and Denmark did not join). Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain fulfilled the Maastricht criteria in 1998 and therefore entered the eurozone. The UK and Denmark chose not to participate in the EMU in the first round, but were allowed to permanently participate without being required to enter into the third EMU stage. Greece joined the eurozone in 2001, Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009 and Estonia in 2011. Latvia will adopt the euro on 1 January 2014, and Lithuania will adopt the euro in 2015 if the budgetary deficit does not hit the reference value and if price stability can be maintained until April 2014. The rest of the EU countries (Hungary, Poland, the Czech Republic, Bulgaria and Romania) plan to enter the euro area later, in 2016–2020, if they have qualified by then. Despite being obliged to adopt the euro sometime in the future in accordance with the Maastricht Treaty, Sweden has no plans to replace the krona soon.

Since the launch of the euro, responsibility for applying the single monetary policy has been held by a supranational central banking system, the Eurosystem, which comprises the ECB and the national central banks of those EU countries that have adopted the euro.

To ensure the stability of exchange rates within the EU, the currencies of those EU countries not joining the EMU in the first round (either because they did not fulfil the Maastricht criteria or because they were unwilling to join the EMU) are linked by the euro through a new exchange rate mechanism, the ERM II. This sets a fixed exchange rate that can fluctuate by up to 15%. Also, the ECB coordinates the monetary and exchange-rate policies, as well as the intervention mechanisms of EU countries participating in ERM II.

Often regarded as a waiting room for euro adoption, the ERM II plays an important role in ensuring macroeconomic stability within the single market and in preparing for the next waves of EMU enlargement. Besides, the EMU enhances the credibility of national monetary policies, supports the structural reforms of the member states, contributes to the stability of the EU's exchange rates and helps the member states to reduce inflation rate fluctuations. Although participation in the ERM II is voluntary, member states must stay in the ERM II for at least two years to qualify for membership of the EMU. Participation in the ERM II is not only a prerequisite for adoption of the euro, but is also a test of economic convergence. Currently, nine member states participate in the ERM II: Denmark, Greece, Estonia, Latvia, Lithuania, Slovenia, Slovakia, Cyprus and Malta. Bulgaria, Romania, the Czech Republic, Poland and Hungary must join the ERM II before adopting the euro.

The euro and the OCA

A brief literature review on the OCA theory

The OCA theory plays a small, but important part in theories of monetary integration. In fact, there is no unitary theory of monetary integration, but rather a set of complementary theories, such as the OCA theory and the cost–benefit approach.

The theory of the OCA develops a set of conditions that countries willing to join a currency union should meet in order for the benefits of participating in the monetary union to be higher than the costs. Originated in the Keynesian tradition, the "pioneering phase" of the OCA theory is related to the seminal contributions of Mundell (1961). Friedman (1953), Meade (1957), McKinnon (1963) and Kenen (1969) also contributed to the early literature on the OCA, which centred on the properties and costs of the OCA. During the 1970s, the OCA theory was reinforced by new theoretical studies which added more consistency to the previous ones. From 1970 to 1980, studies on OCA theory were inconclusive and inconsistent (Tavlas, 1994) and therefore the analytical framework of this theory, as well as the entire process of European integration, slowed down.[2]

The main innovative ideas proposed by the traditional OCA theory in the first phase of its development can be summarized as follows:

- Inter-regional and inter-industrial factor mobility, especially labour mobility,[3] and price and wage flexibility are fundamental in forming an OCA (Mundell, 1961).
- Degree of openness also contributes to the success of an OCA. The highly open countries may draw lower benefits from flexible exchange rates. But to get this benefit, that is, to restore the equilibrium of the balance of payments, open economies should use alternative instruments such as fiscal policy (McKinnon, 1963).
- Product diversification should first be considered when analysing an opportunity to form an OCA, since labour mobility is rarely met in practice. Countries with diversified production are less likely to experience asymmetric shocks. Fiscal transfers between regions could help the economies of a common currency area to counteract the effects of diverse shocks (Kenen, 1969).
- In the financially integrated currency union areas, labour mobility is not a compulsory precondition. In these areas, under asymmetric shocks, there is no decline in output because the costs of absorbing the shocks are spread over time. The asset diversification which results from a better allocation of capital in the common currency areas helps share international risks (Mundell, 1973)[4].
- There is not just one condition, but a set of criteria that matter in assessing the effectiveness of an OCA. Besides the other criteria discussed in the literature, differences in inflation rates and wage increases should also be taken into account (Ishiyama, 1975).

The traditional OCA theory, as briefly summarized above, was based on a macroeconomic environment characterized by a negatively sloped Philips curve, short-term rigidity of prices, employment adjustments to shocks, highly elastic supply and the existence of a trade-off between inflation and unemployment in the long term.

The reassessment phase of the OCA, which ran between the 1980s and early 1990s, led to the "new theory of OCA". The new theory incorporated a deeper understanding than the traditional one and emphasized the benefits of the OCA. The most important contributions developed within this phase are:

- The endogeneity hypothesis states that a country joining a monetary union area can satisfy the OCA criteria ex-post even if it did not satisfy them ex-ante, due to increased business cycle correlations (Frankel, 1999).
- A country joining a monetary union area will gain from abandoning the national monetary policy in favour of a common one when there is a high association of shocks between the client and the anchor (Alesina, Barro and Tenreyero, 2002).
- If the business cycles inside a common currency area are synchronized, then the cost of losing the national monetary policy is minimized (Krugman, 1993; Frankel and Rose, 1996).
- The "Balassa effect" shows that the real exchange rate of a candidate country should appreciate (Coudert and Couharde, 2005).
- The type of labour market centralization (De Grauwe, 2003), the effectiveness of exchange rate adjustments (Mongelli, 2002) and the character of shocks (Buiter, 1995) are other criteria for joining a common currency area.

Apart from the contributions outlined above, there is a strong trend of opinion in the literature that characterizes the OCA theory as weak, irrelevant and inconsistent. The erroneous assumptions that make the theory nonoperational, the "immobility" of certain factors, the irrelevance of business cycle asynchrony across countries in the analysis of monetary independence, the impossibility of objectively evaluating the increase in welfare due to the OCA and the fact that the OCA criteria are self-enforcing are among the most important criticisms of the OCA theory.[5]

According to the OCA theory, a country will benefit from participating in a monetary union when several criteria are met (Krugman and Obstfeld, 2009):

- high degree of trade openness with capital mobility and high wage flexibility across the region;
- similar business cycles and economic structures to those of other countries in the monetary union;
- fiscal transfers should be able to counteract asymmetric shocks;
- high degree of fiscal policy integration;
- labour mobility across the region.