Economic and Monetary Integration

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Questions answered

- What is economic and monetary integration?
- What are the advantages and disadvantages of economic integration?
- What are the characteristics of the integration process in Europe?
- What is the EMU?

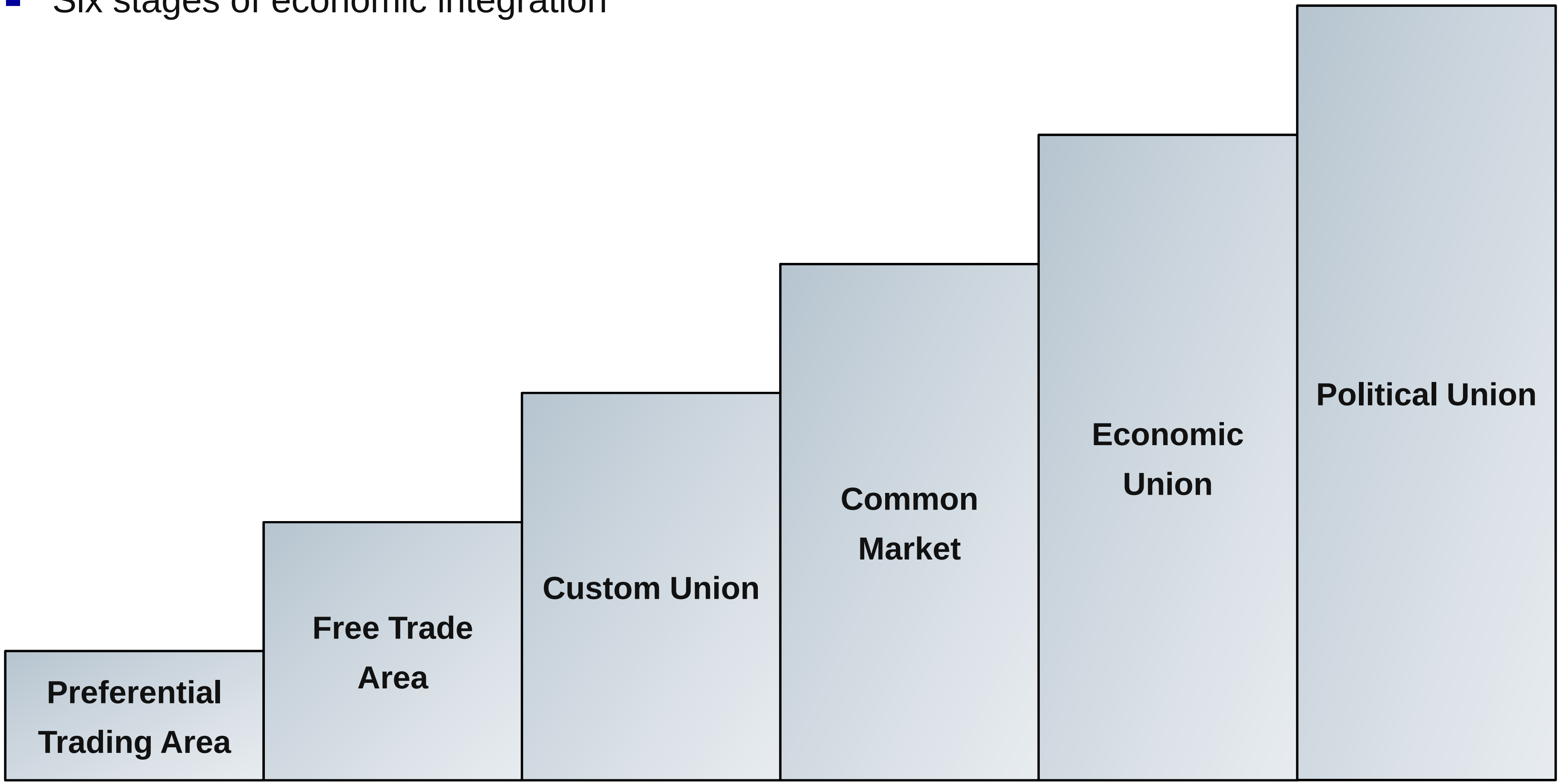
What is Economic Integration?

Economic Integration
Definition

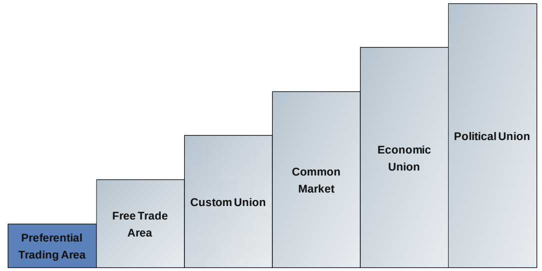
- Economic integration is the state or the process to eliminate or reduce trade barriers between independet nations.
- Barriers regarding
  - Flow of goods
  - Flow of services
  - Flow of labor
  - Flow of capital
- Establishment of certain elements of cooperation and coordination between the participating nations
- Dynamic process, in which the economies of these participating states gradually become more and more one entity

Economic Integration Stages

- Six stages of economic integration



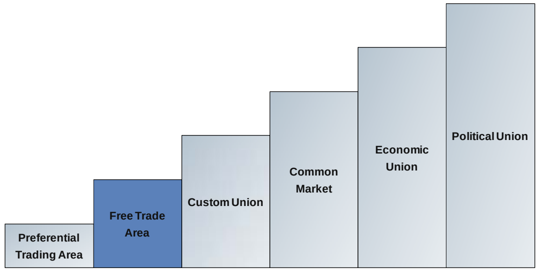
Preferential Trading Area



- **Definition**
  - A preferential trading area (PTA) is a **trade pact** between countries that **reduces tariffs** for **certain products** to the countries who sign the agreement.

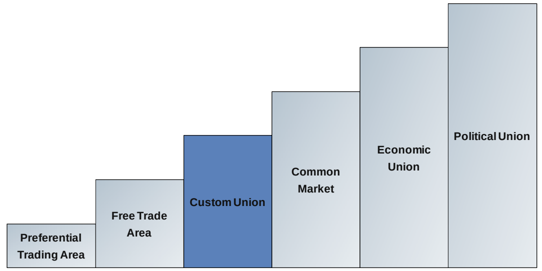
- **Characteristics**
  - Tariffs are not eliminated but lower than countries not party to the agreement
  - Differentation between bilateral and multilateral PTAs

Free Trade Area



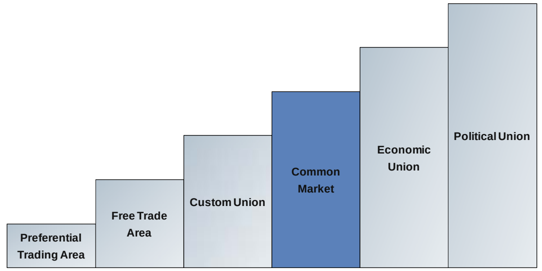
- **Definition**
  - A free trade area (FTA) is a **trade bloc** whose member countries have signed a free trade agreement (FTA), which **eliminates tariffs, import quotas**, and preferences on most (if not all) goods and services traded between them.
- **Characteristics**
  - No common external tariff to non-members
  - Differentation between bilateral and multilateral FTAs

Custom Union



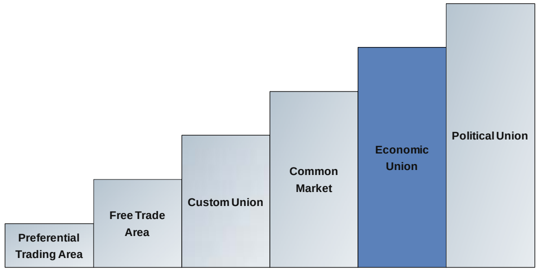
- **Definition**
  - A customs union is a **free trade zone with a common external tariff**. That is, the same customs duties, quotas, preferences and so forth apply to all goods entering the area, regardless of which country within the area they are entering.
- **Characteristics**
  - Common external tariff to non-members

Common Market



- **Definition**
  - Group formed by countries within a geographical area to promote **duty free trade and free movement of labor and capital** among its members. Common markets impose common external tariff (CET) on imports from non-member countries.
- **Characteristics**
  - Four freedoms
    - > Free movement of goods
    - > Free movement of labor
    - > Free movement of services
    - > Free movement of capital
  - No border controls

Economic Union



- **Definition**
  - An agreement between two or more countries that **allows the free movement of capital, labor, and all goods and services**, and involves the **harmonization and unification of social, fiscal, and monetary policies.**

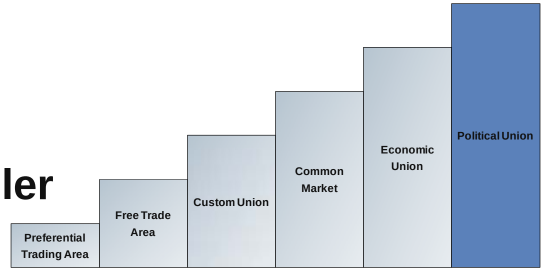
- **Characteristics**
  - **Weak version**
    > Fixed bilateral exchange rates (rigidly or within a band)

    > Each member undertakes monetary policies to defend the rate
  - **Strong version**
    > Individual currencies are replaced by a common curreny

    > Individual monetary authorities are replaced by a single authority

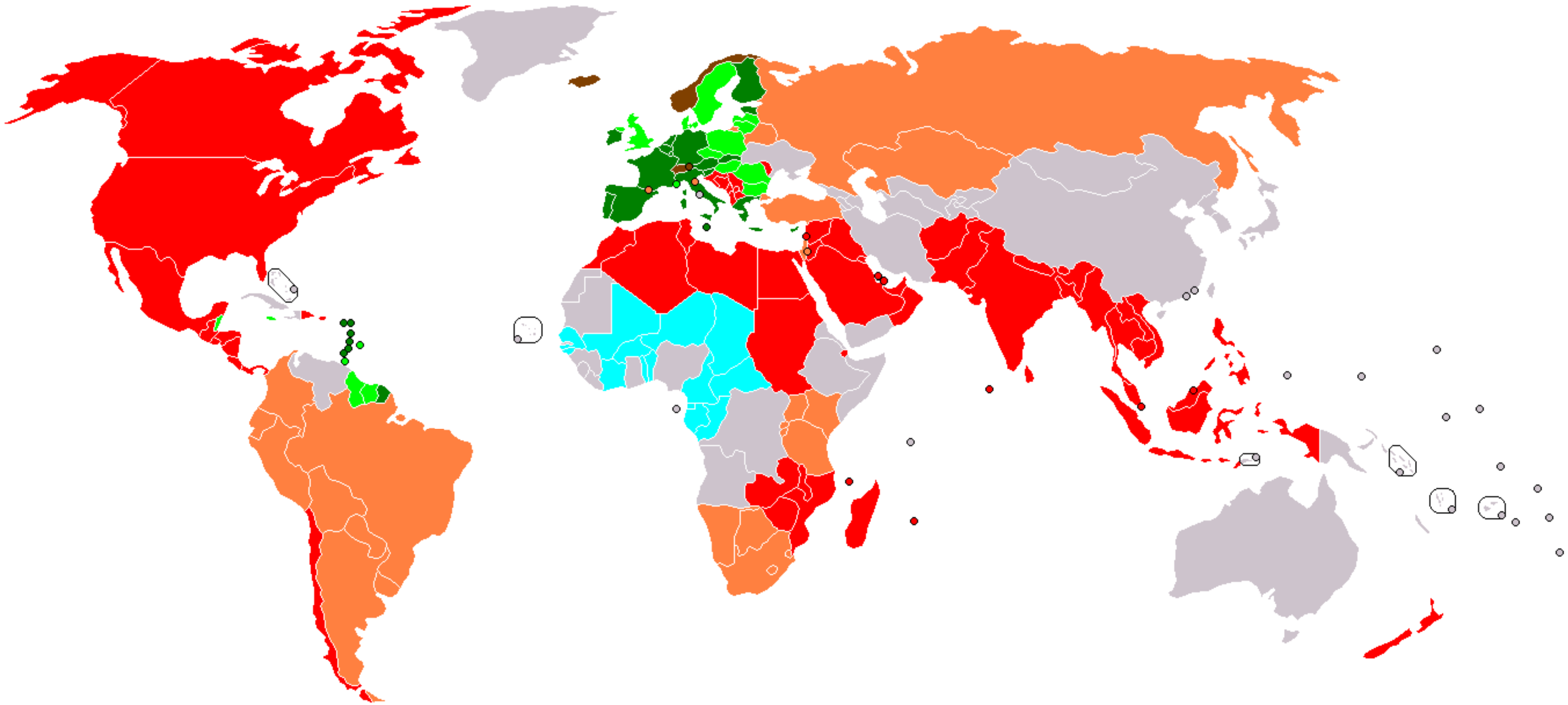
    > Harmonization of tax rates

Political Union



- **Definition**
  - Is a type of state which is **composed of or created out of smaller states.** The individual states share a common government and the union is recognized internationally as a **single political entity**.
- **Characteristics**
  - Free movement of goods, services, labor and capital
  - Common economic, monetary and fiscal policy
  - Common foreign policy and policy of defense

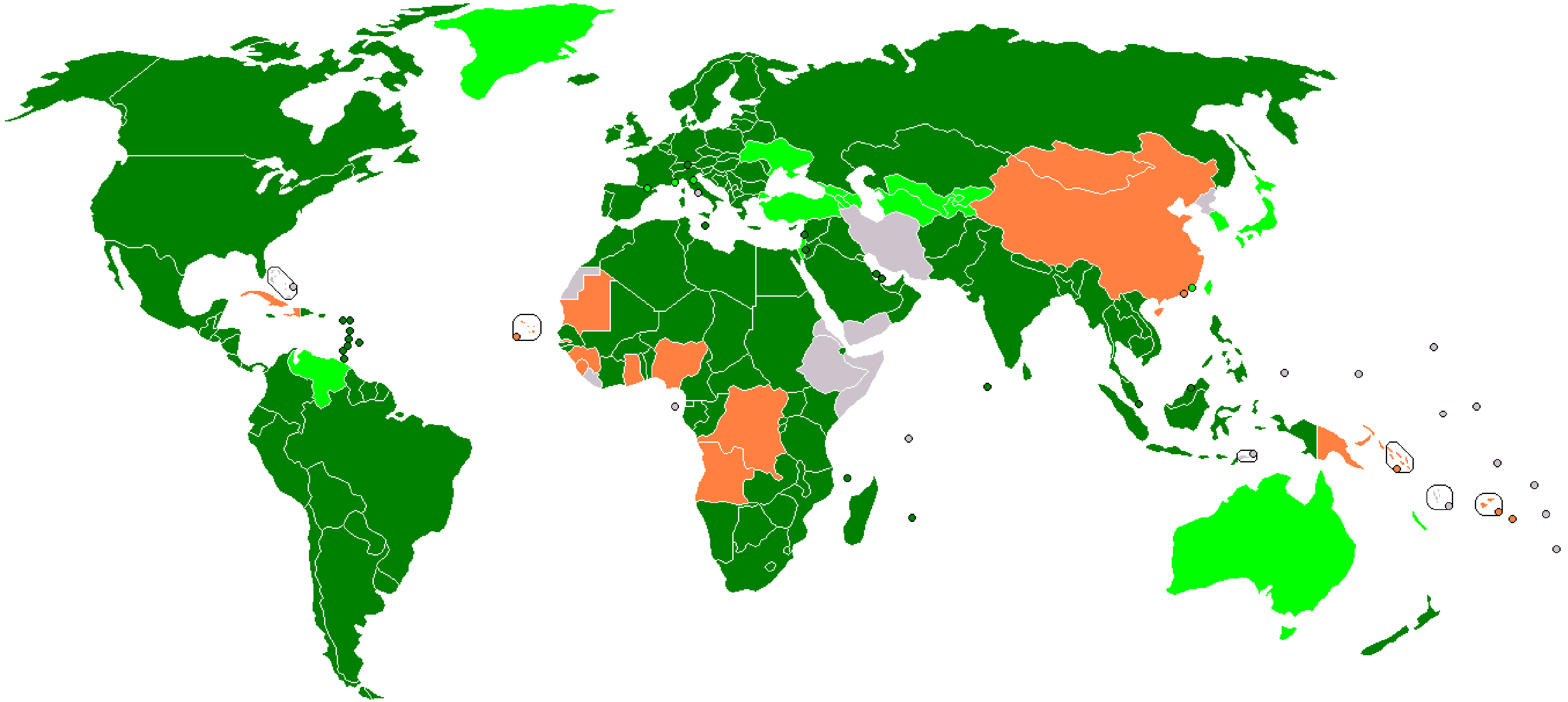
Stages of Economic Integration Overview



- Mulitlateral Free Trade Area
- Custom Union
- Customs and Monetary Union
- Custom Market
- Economic and Monetary Union
- Economic Union

Which Economic Integration examples do you know?

Free Trade Areas
Overview



- Multilateral free trade agreements or more advanced agreements
- Bilateral free trade agreements advanced agreements
- No free trade agreements, but World Trade Organization

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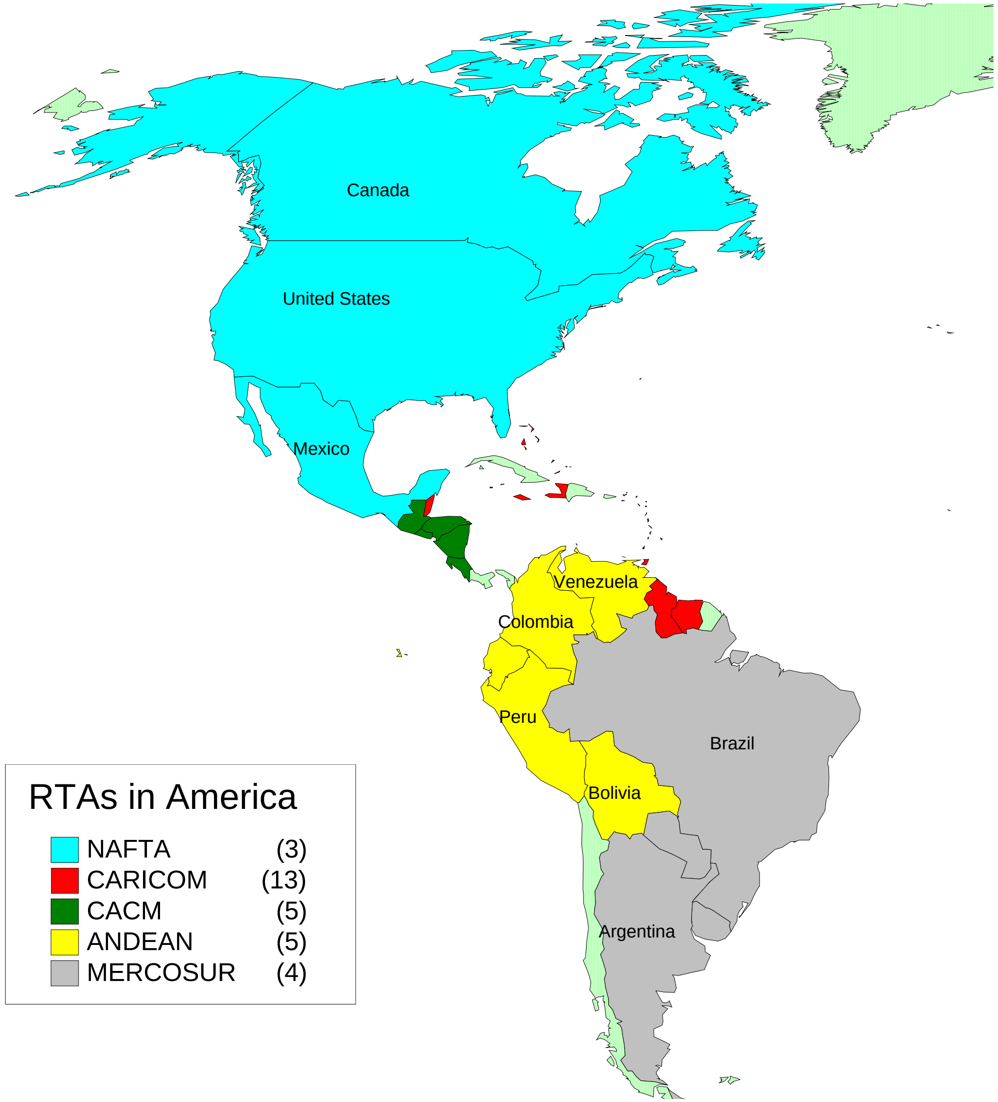
Regional Trade Agreements
European Union

- Countries of the European Union

Member countries

Candidate countries

Regional Trade Agreements
America



Regional Trade Agreements
ASEAN

What are the advantages and disadvantages of economic integration?

Advantages of the integration

- **Facilitation of international trade**
  - Competition and comparative advantages
  - Liberalization of capital flows and direct investments
  - Free movement of people as precondition for trade
  - Macroeconomic stability
- **Liberalization of Markets**
  - A common market → competition
  - A common currency
  - Economic stability
- **Political Liberalism**
  - Democracy
  - Political stability
  - Openness and free movement of people

Welfare Gains

- **Comparative – Static Effects**
  - Short-term growth (level effects) because of
    - Increased economic competition
    - Better allocation of production factors
    - Higher economic efficiency
  - That means:
    - Relatively low prices
    - Higher real income
    - Additional jobs
- **Dynamic Effects**
  - Long-term increase of the growth rate (acceleration effects) because of
    - Higher capital stock
    - Increasing economies of scale and scope
    - More investments in research and development
    - Higher innovation rate
    - Accelerated technical progress

Disadvantages of the integration

- **Creation Of Trading Blocs →** increase of trade barriers against non-member countries (Regional Trade Agreements)
- **Trade Diversion →** trade is diverted from a non-member country to a member country despite the inefficiency in cost.
  - e.g. a country has to stop trading with a low cost manufacture in a non-member country and trade with a manufacturer in a member country which has a higher cost.
- **National Sovereignty →**requires member countries to give up some degree of control over key policies like trade, monetary and fiscal policies
  - The **higher the level of integration**, **the greater the degree of controls** that needs to be given up particularly in the case of a political union economic integration which requires nations to give up a high degree of sovereignty.

Economic Integration
Conclusion

- Distinguishing between preferential trade area, free trade area, custom union, common market, economic union, political union
- Economic integration in general increase welfare through trade, but the discriminatory nature may make the net welfare effect negative
- Increased popularity of regionalism rather than mulilaterlism may be bad for the world economy

What are the characteristics of the integration process in Europe?

European Union – History
Main Facts

- **1st Phase 1945 - 1960: initial attemps and the customs union**

1946	speech of Winston Churchill in Zurich „The United States of Europe“
1950/51	Robert Schuman‘s plan for the foundation of a Eauropean Coal and Steel Community (ECSC); Members: Benelux, France, Germany, Italy
1957	Roman Treaty: European Economic Community and Euroatom founded

European Union – History
Main Facts

- **2nd Phase 1960 - 1973: establishing the process of deepending and enlargement**

1965 merger of the European Economic Community, Euroatom and the Eureopean Coal and Steel Community to the European Community (EC)

1968 Custom Union completed

1973 UK, Ireland and Denmark join the EC

→ EU-9

European Union – History
Main Facts

- **3rd Phase 1973 - 1987: single market and the second and third enlargement**

1979	European Monetary System enters into force
1981	Greece joins the EC
1985	Schengen Agreement
1986	Spain and Portugal join the EC
1986	Single European Act

→ EU-12

European Union – History
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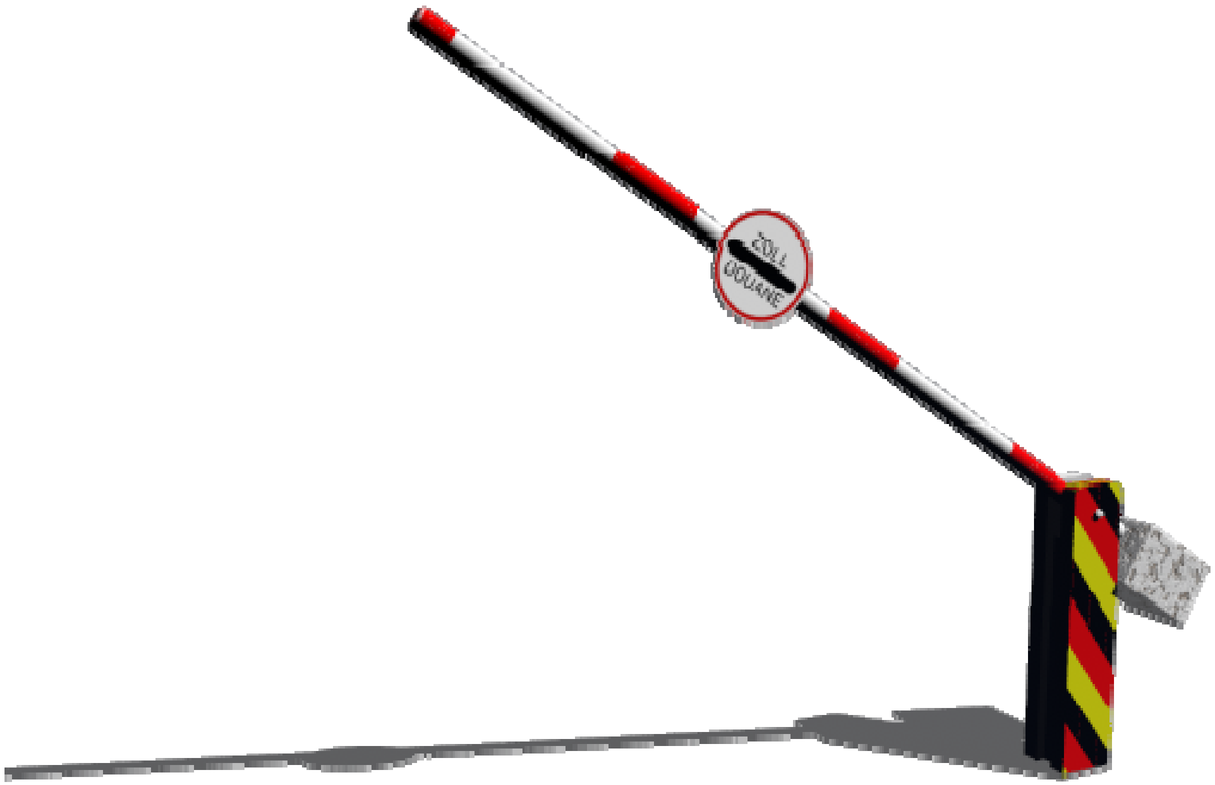
European Union – History
Main Facts – Single European Act

excursus

- Establishing a common market with **four freedoms**
  - Free movement of goods
  - Free movement of services
  - Free movement of persons
  - Free movement of capital



European Union – History
Main Facts – Single European Act

excursus

- **Free movement of goods and services**
  - Freedom of trade in goods and services
  - Freedom of choice for enterprises
  - Common **competition** policy and control of states aid e.g. similar goods which can be produced at lower costs will become more competitive since no tariffs apply
- **Free movement of persons**
  - Free mobility of labor
  - Sufficient adjustment capacities
  - Workers move from areas with low wages to areas of high wages
  - **Redistribution effects** motivates conservative resistance
- **Freedom of capital**
  - Capital moves from areas where the return on capital (interest rate) is low to areas where the return is high
  - Movement of capital to areas with high interest rate tends to **reduce the interest** rate in these areas and **increases the interest rate** in areas with low rates
  - As for labor there are significant **redistribution effects** that motivate conservative resistance

European Union – History
Main Facts

- **4th Phase 1987 - 1995: European Monetary Union and the fourth englargement**

1989 Delors Report on the introduction of European Monetary Union

1992 Maastricht → Treaty on European Uniom
- Aim: monetary and political union
- Foundation of the European Union

1995 Austria, Sweden and Finnland join the EU

→ EU-15

European Union – History
Main Facts

- **5th Phase 1995 - 2002: preparation and entry into the European Monetary Union**

1999 Non-physical introduction of the Euro to the world financial market

→ start of the European Monetary Union

2002 lauching of Euro as physical coins and banknotes

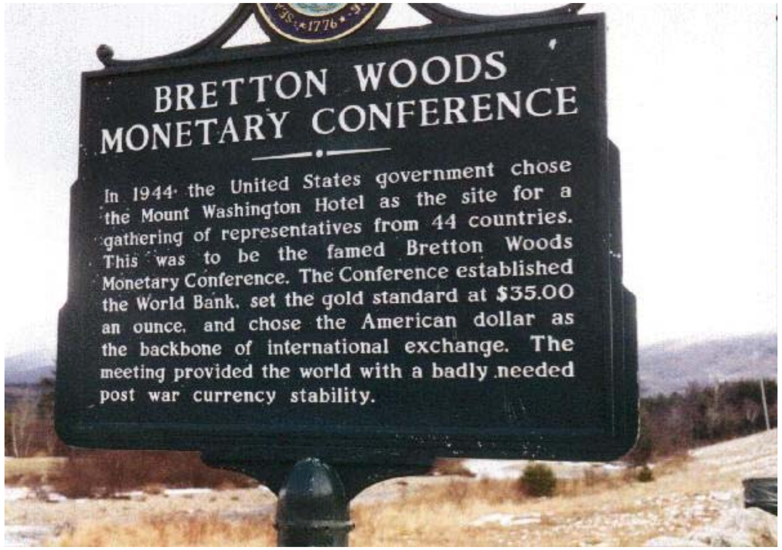
European Union – History
Main Facts

- **6th Phase 2002 - today: fifth enlargement**

2004	10 new memeber states join the EU: Cyprus, Czech Republic, Estonia, Hungary, Lativa, Lithuania, Malta, Poland, Stovakia and Slovenia → EU-25
2007	Bulgaria and Romania become EU members → EU-27

Which examples of monetary integration do you know?

International Monetary Integration – Example (1)
Bretton Woods 19444 – 1971/73



- **Origins**
  - The Great Depression 1930th
  - Wartime devastation of Europe and East Asia

- **Mechanism**
  - „pegged rate“ currency regime
  - US linked the dollar ar the rate of 35 per ounce of gold
  - Other countries had to peg their currencies to the US Dollar and had to buy or sell US Dollars to keep market exchange rates within +/- 1% of parity
  - Institutions established: IMF and World Bank

International Monetary Integration – Example (1)
Bretton Woods 19444 – 1971/73

- **Crisis and Breakdown**
  - US trade balance deficit
  - War in Vietnam
    - More and more dollars were printed to pay for military expenses
    - Member states had to buy more and more dollars to keep the fixed rates
    - System breakdown

- **Aftermath**
  - All major currencies were floating
  - Institutions remained (IMF, World Bank)
  - New monetary regimes emerged

International Monetary Integration – Example (2)
European Monetary Integration

Aims

- Intensificiation of economic and political integration
- Euro as a counter balance to the US-$
- Declining of transaction costs
  - Costs of information
  - Costs of uncertainty
  - Costs of exchange (e.g. trade, tourism)
- Economic stability
  - Improving monetary and fiscal credibility which leads to decreasing interests on capital

International Monetary Integration – Example (2)
European Monetary Integration

First Attempts

1958 **Treaty of Rome**
Art. 2: „… the Community shall have as ist task, by establishing an economic and monetary union, to promote throughout the communityy a harmonious and balanced development of economic activities.“

1971 **Werner Plan**
To strengthen coordiniton of economic policies; the member states promise to coordinate their budgetary and monetary policies and reduce the margins of fluctuation between their currenies

1972 **Setting up the currency „snake“**
The six member agree to limit the margin of fluctuation between their currenies to 2,25%

July 1972 First severe crisis of the „snake in the tunnel“ (leaving of Italy until 1979 and UK until 1990)

Dec 1978 The European Council meeting in Bremen agrees the French-German proposal to launch the European Monetary System (EMS 1)

International Monetary Integration – Example (2)
European Monetary Integration

European Monetary System I (1979 – 1998)

- Established in 1979 as the subsequent operation of the European „currency snake“

- **Purposes**
  - Launch of a fixed exchange rate regime
    - > Stability of currency (less currency risks)
    - > Boost trade between member-countries
  - Increase of stability within all member-countries
    - > Idea of an European Moneatry Union came up
  - Strengthening of the international currency system

International Monetary Integration – Example (2)
European Monetary Integration

European Monetary System I (1979 – 1998)

- **Incidences**
  - **March 1979**
    - > European Monetary System (EMS 1) comes into force
    - > Eight participating member states (without UK) are required to maintain their exchange rates
    - > Eleven realignments between 1979 and 1987
  - **1981**
    - > Creation of the European Currency Unit (ECU)
- **Member countries**
  - All members of the European Union (EU) that introduced the European Exchange Rate Mechanism (ERM)
- **Methodology**
  - Fixed currency exchange rate margins, but varibale within those margins (+/- 2,5%)
  - Basement: European Currency Unit (ECU) → a weighted average of the participating countries

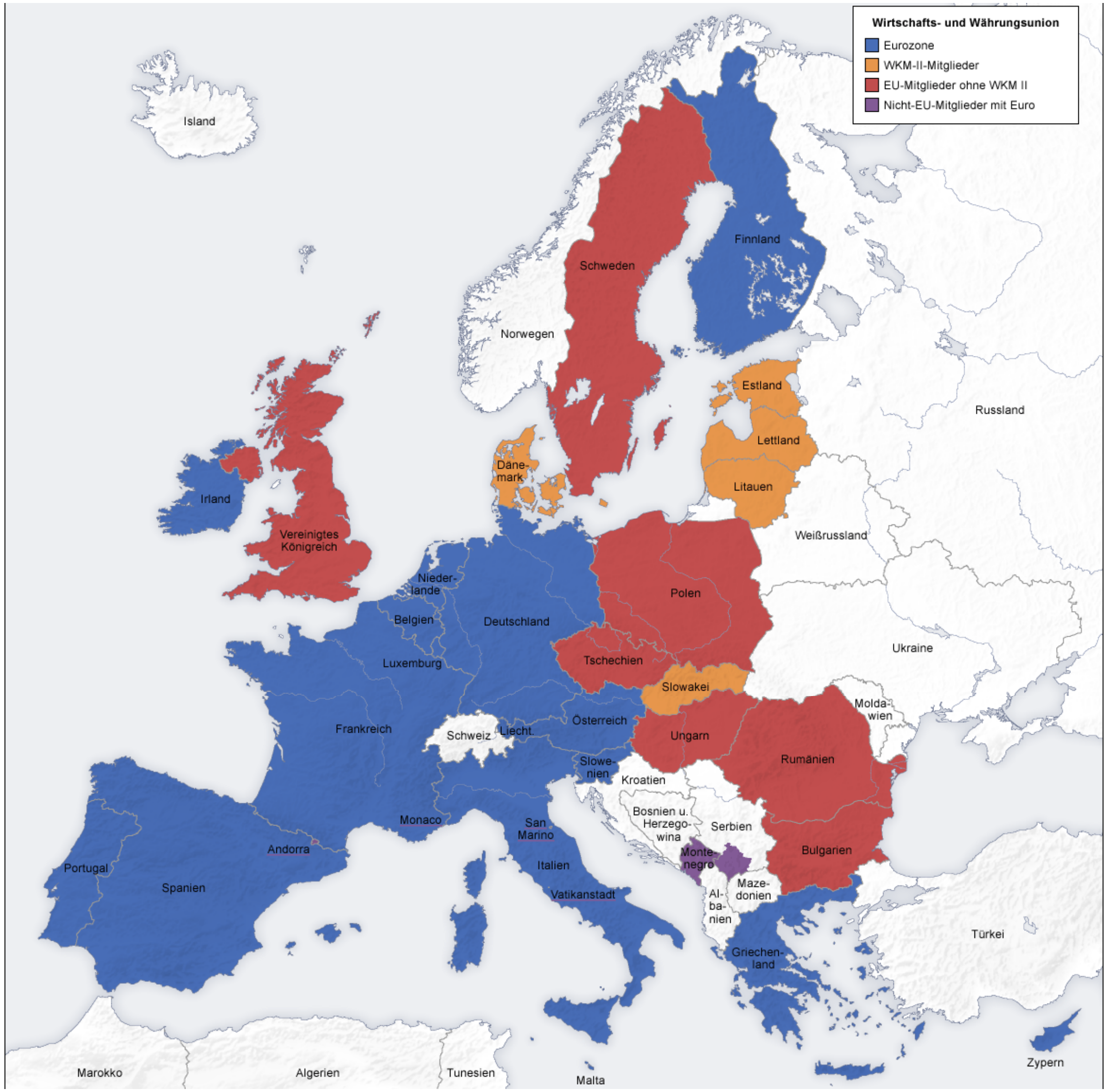
International Monetary Integration – Example (2)
European Monetary Integration

European Monetary System (EMS II) since 1999

- Successor of the EMS
- „waiting room“ for joinig the Economic and Monetary Union of the European Union
- Introduction of the ERM II for all European countries that where not member of the EMS at this point of time
- Launch of the EURO as a single European currency (national notes and coins still exist)
- Member countries: 7

International Monetary Integration – Example (2)
European Monetary Integration

- Eurozone



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International Monetary Integration – Example (2)
European Monetary Integration

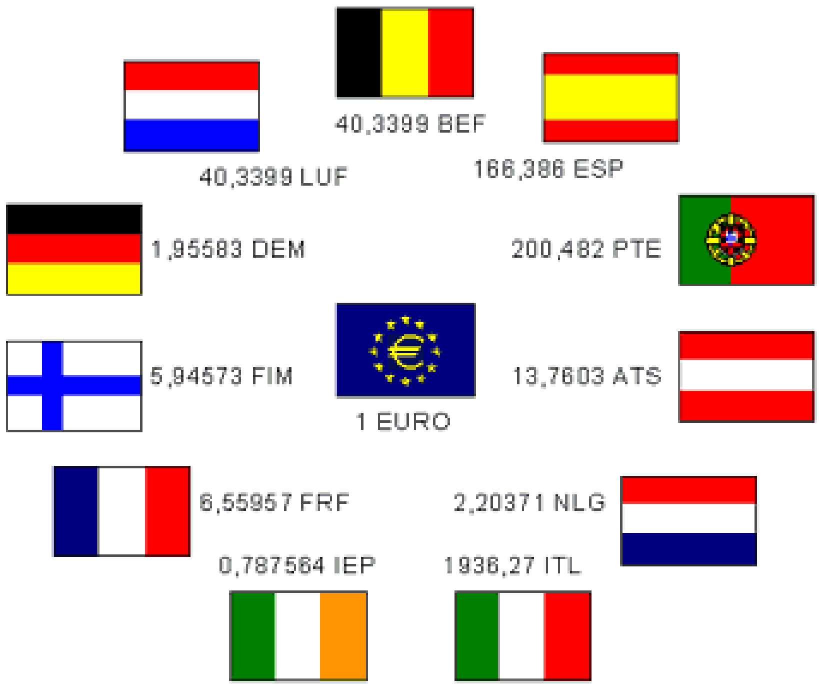
European Monetary System (EMS II) since 1999

- A condition of entry to the EU is to fulfill the requirements for the monetary union withan a given period of time
- To adopt the EURO a country has to have ist currency in the European Exchange Rate Mechanism II für two years without frictions
- **1. Stage**
  - 1990 liberalization of all capital movements
  - 1992 treaty of Maastricht → convergence criteria
  - 1993 treaty came into effect
- **2. Stage**
  - 1997 origin of the EURO and set up of ERM II
    Stability and Growth Pact
  - 1998 11 countries that will participate the third stage are selected
  - 1998 Europen Central Bank (ECB) is created

International Monetary Integration – Example (2)
European Monetary Integration

European Monetary System (EMS II) since 1999

- **3. Stage**
  - 1999 the Euro is now a real currency
    fixed exchange rates
  - 2001 Greece joins
  - 2002 Coins and notes
  - 2007 Slovenia joins
  - 2008 Malta and Cyprus joins



International Monetary Integration – Example (2)
European Monetary Integration

Convergence Criteria

- also known as Maastricht criteria
- criteria for European member states to enter the third stage of EMU and adopt the euro
- Criteria have to be fulfilled even after entering the EMU → Stability and Growth Pact
- In case of not fulfilling one or more criteria, states are imposed a fine

- **Purpose:** maintain price stability

International Monetary Integration – Example (2)
European Monetary Integration

Convergence Criteria

- **Inflation rate**
  - Not more than 1,5% points higher than the three best-performing member states of the EU (based on inflation)
- **Government finance**
  - Annual government deficit must not exceed 3% of GDP
  - Gross government debt must not exceed 60% of GDP
- **Exchange rate**
  - Applicant countries have to join the ERM II for two consecutive years
- **Long-term interests**
  - Nominal long-term interest rate must not be more than 2,0% points higher than the three best-performing member (based on inflation)

Thank you for your attention!