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Theory and Politics of European Integration

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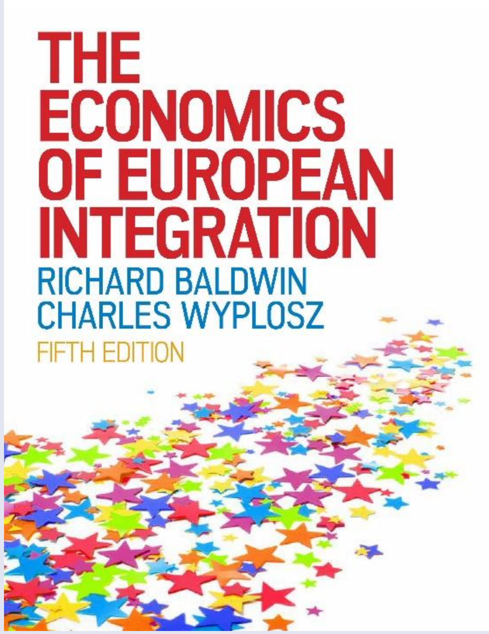
Today's Lecture

- Overview
  - Schedule and structure of lecture
  - Main topics
- First Lecture
  - Why and how European Integration
  - Enlargement rounds
  - Key events

Reading

- Baldwin, R. and C. Wyplosz (2015), "*The Economics of European Integration*", 5thedition, McGraw-Hill.
- Occasionally journal articles



3-Bloc-Structure I/III

- **Bloc 1**: **History, institutions and decision making**
  - Why did the EU emerge? Why achieved Europe a level of supranational integration which is unique in the world?
  - How does the EU operate? Which institutions govern the EU? Are they efficient? What are efficient ways to run supra-national institutions?
  - How is the decision-making process organized? Is it efficient? What is the right mix between intergovernmental, supranational executive and legislative decision-making? Is the allocation of power fair? What are the consequence for resource allocation?

3-Bloc-Structure II/III

- **Block 2: Integration of goods and factor markets**
  - Is it efficient to dismantle trade barriers between EU Member States but to maintain vis-a-vis the rest of the world? What are the implications of market integration on efficiency and competition? What is the impact on economic growth? What are the implications for trade and competition policies?
  - Is the integration of capital markets efficient? Who are the winners and losers?
  - What are the consequences of free labor mobility in a Common Market with large income differences? What is the impact on labor markets in sending and receiving countries and at the EU level? Which groups and countries win, which lose? Does equal treatment result in welfare-shopping?

3-Bloc-Structure III/III

- **Bloc 3: Monetary Integration**

  - Is the EU an Optimum Currency Area? Are asymmetries high? How can the ECB deal with asymmetric shocks?
  - How can fiscal discipline be assured in the Monetary Union? What are the strength and weaknesses of the European Growth and Stability Pact?
  - What are the causes of the Euro Crisis? Fiscal discipline? Real Estate Bubbles? How can the EU avoid state bankruptcies and bank runs? Do we need monetary transfers? How should we organize them? Is it reasonable that the ECB buys government bonds? Do we need a European banking regulation?
  - Should we return to national currencies? If so: How?

Lecture overview

22 October	Lecture 1 – History of EU
5 November	Lecture 2 – EU Institutions and Decision Making
19 November	Lecture 3 – Microeconomics of Trade, Tariffs and Preferential Trade Liberalization
3 December	Lecture 4 – Market Size and Scale Effects, Trade and Competition Policies
17 December	Lecture 5 – Economic Growth and Capital Market Integration
7 January	Lecture 6 – Migration and Labor Markets
21 January	Lecture 7 – Optimum Currency Area Theory and European Monetary Union
4 February	Lecture 8 – Euro Crisis

Today‘s Lecture

- Overview
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  - Main topics

- Lecture 1 – History of European Integration
  - Why and how European Integration
  - Enlargement rounds
  - Key events

History, Facts and Institutions

Yet all the while there is a remedy . . . It is to re-create the European Family, or as much of it as we can, and to provide it with a structure under which it can dwell in peace, in safety and in freedom. We must build a kind of United States of Europe.

Winston Churchill (Zurich, 19 September 1946)

Early Post War Period: climate for radical change

London in late 1940

Dresden in 1945

Why European Integration?

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"The desire to avoid another war in Europe"

Table 1.1 Death and destruction in the Second World War

	Death toll	The economic setback: pre-war year when GDP equalled that of 1945
Austria	525,000	1886
Belgium	82,750	1924
Denmark	4,250	1936
Finland	79,000	1938
France	505,750	1891
Germany	6,363,000	1908
Italy	355,500	1909
Netherlands	250,000	1912
Norway	10,250	1937
Sweden	0	(a)
Switzerland	0	(a)
UK	325,000	(a)

(a) GDP grew during the Second World War.

Source: GDP data from Crafts and Toniolo (1996), p. 4; death toll from http://encarta.msn.com

The prime question in 1945

“How can Europe avoid another war?”

- What caused the war?
  - Blame loser (Germany);
  - Blame capitalism;
  - Blame nationalism.
- These answers implied 3 very different solutions
  - Neutralize Germany, Morgenthau Plan of 1944;
  - Adopt communism;
  - Pursue European integration.

European integration ultimately prevailed, but this was far from clear in the late 1940s.

Emergence of a divided Europe

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- Germany was divided into US, UK, French and Soviet zones.

- The Soviet Union “spread” communism in East Europe.

- America and Britain rejected the Soviet vision and this confrontation lead to the “Cold War”:
  - US, UK, and French zones merged in 1947/8;
  - “Berlin Blockade” and “Berlin air bridge” in 1948;
  - The Federal Republic of Germany established in 1949.

- The merger of the French, US and UK zones was a defining moment in Europe and a precursor of European integration.

First steps

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- The USA offered financial assistance if countries agreed on a joint programme for economic reconstruction = the Marshall Plan (1948):
  - The Organization for European Economic Cooperation (OEEC) administered this aid and prompted trade liberalization.
  - The European Payment Union (EPU) facilitated payments and fostered trade liberalization.
- New view: trade liberalization could be pro-growth and pro-industrialization.

Need for deeper European integration

- As Cold War got more war-like, West German rearmament became necessary.

- But strong and independent Germany was a scary thought for many, including many Germans.

- Widespread feeling: best to embed an economically and militarily strong West Germany into a supranational Europe.

Two strands of European integration

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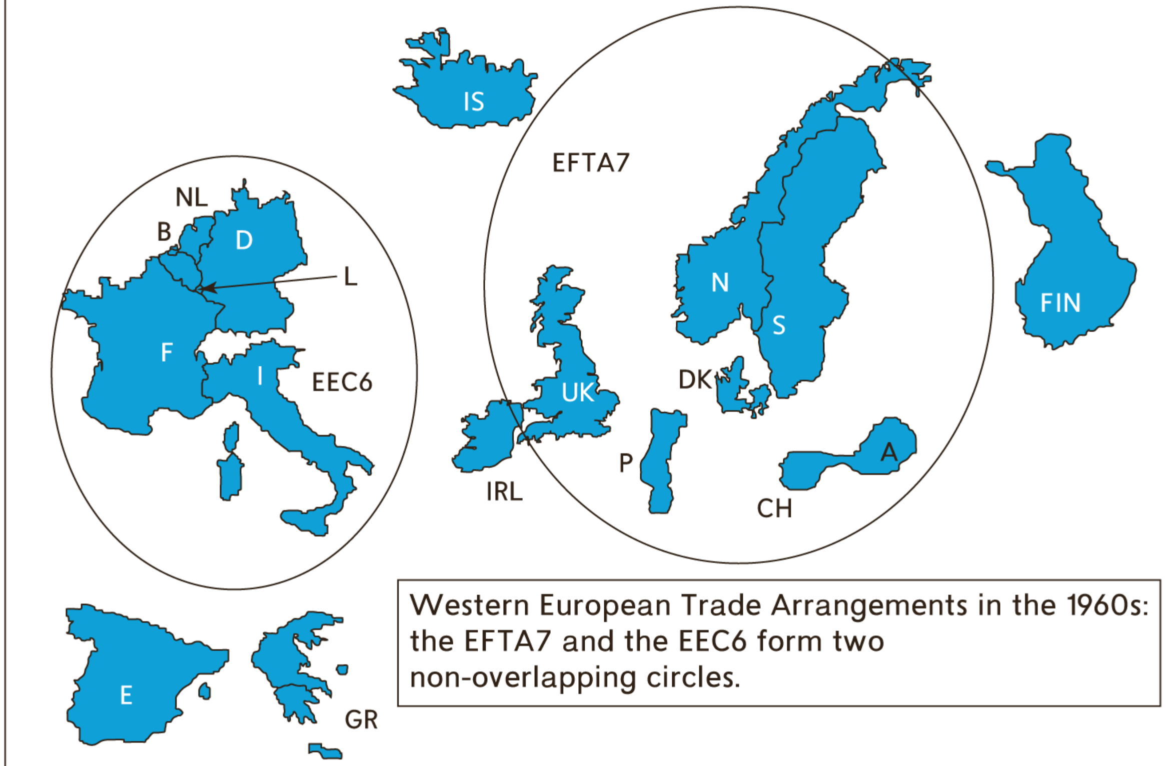
- Federalism versus intergovernmentalism: the disagreement about depth of European integration:

- **Intergovernmentalism**: nations retain all sovereignty
  - OEEC (1948), Council of Europe (1949), Court of Human Rights (1950), and EFTA (1960).

- **Federalism**: supranational institutions
  - European Community for Steel and Coal (ECSC) (1951): Belgium, France, Germany, Italy, Netherlands and Luxembourg (the ‘Six’) place their coal and steel sectors under the control of a supranational authority.;
  - European Economic Community (EEC) (1957): riding on the success of the ECSC, the Six committed to form a customs union, promise free labour mobility, capital market integration, free trade in services and a range of common policies.

Two non-overlapping circles

- Situation by the late 1960s:



Western European Trade Arrangements in the 1960s: the EFTA7 and the EEC6 form two non-overlapping circles.

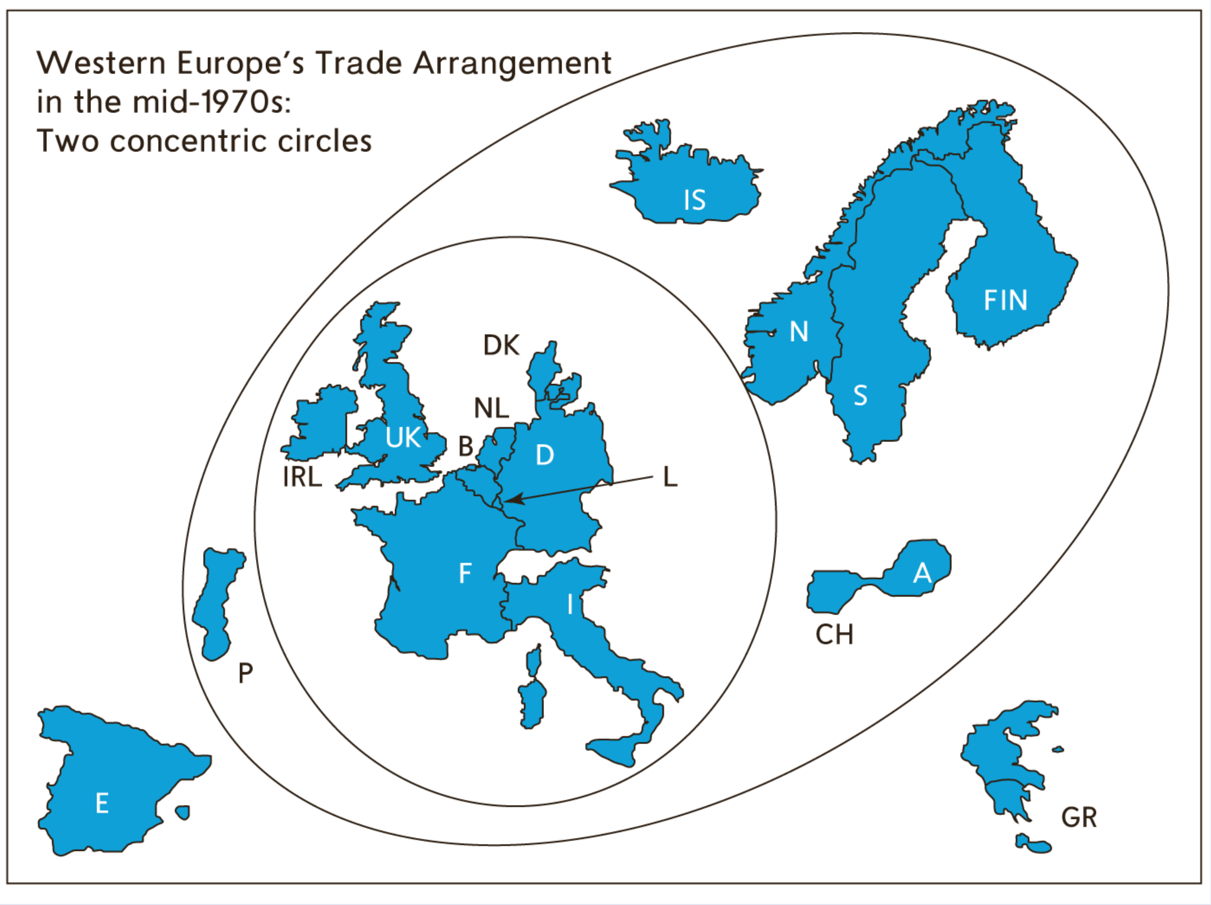
B = Belgium, NL = Netherlands, D = Germany, L = Luxembourg, F = France, I = Italy, E = Spain, GR = Greece, IS = Iceland, IRL = Ireland, UK = United Kingdom, P = Portugal, N = Norway, DK = Denmark, S = Sweden, CH = Switzerland, A = Austria, FIN = Finland

Evolution to two concentric circles: domino effect I

- Falling trade barriers within the EEC and within EFTA lead to discrimination.
- The GDP (i.e., potential market size) of the EEC much larger than that of EFTA (and EEC incomes were growing twice as fast)
- Thus, the EEC club was far more attractive to exporters and this lead to new political pressure for EFTA nations to join the EEC.
- The UK applied for membership in 1961 and Denmark, Ireland, and Norway also followed since they would otherwise face stronger discrimination (other EFTA nations did not apply because of political reasons).

Evolution to two concentric circles: domino effect I

Charles De Gaulle stopped UK membership twice. Denmark, Ireland, and UK join in 1973 while Norwegians said no in a referendum.



Euro-pessimism, 1973-1986

- Political shocks:
  - ‘Luxembourg Compromise’ + enlargement = decision-making jam;
  - Plans for extensive economic integration promised postponed.

- Economic shocks:
  - Bretton Woods falls apart, 1971-1973;
  - Failed EEC monetary union;
  - 1973 and 1979 oil price shocks with stagflation;
  - Introduction of ‘technical barriers to trade’ as substitute for tariffs.

- Bright spots:
  - Democracy in Spain, Portugal and Greece lead to their accession;
  - EMS set up in 1978 works well;
  - Merger Treaty (1965) and direct election of EU Parliament (1979).

Deeper circles: Single Market Programme

- Jacques Delors launches completion of the internal market.

- The Single European Act (SEA, 1987) aims to create "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured” (i.e., the four freedoms promised by the Treaty of Rome).

- It also implemented important institutional changes: majority voting instead on unanimity on issues related to the Single Market.

Single Market Programme

- Basic elements:
  - **Goods trade liberalization**
    - Streamlining or elimination of border formalities;
    - Harmonization of VAT rates within wide bands;
    - Liberalization of government procurement;
    - Harmonization and mutual recognition of technical standards in production, packaging and marketing.
  - **Factor trade liberalization**
    - Removal of all capital controls;
    - Liberalization of cross-border market-entry policies, including mutual recognition of approval by national regulatory agencies.

Deeper circles: Domino effect II

- Deeper integration in EC12 strengthened the ‘force for inclusion’ in remaining EFTA nations.

- New ‘forces for inclusion’ lead to a domino effect:
  - EEA initiative (1989) to extend single market to EFTA nations;
  - Membership applications by all EFTA nations except Iceland and Liechtenstein:
    - Norwegian rejected (again) membership in a referendum;
    - Switzerland only adopted a EEA-like bilateral deal with EU.

- The fourth enlargement (1995) adds Austria, Finland, Sweden and leads to the EC15.

The enlargement rounds … Founding members

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First enlargement…

Second and third Enlargement … political?

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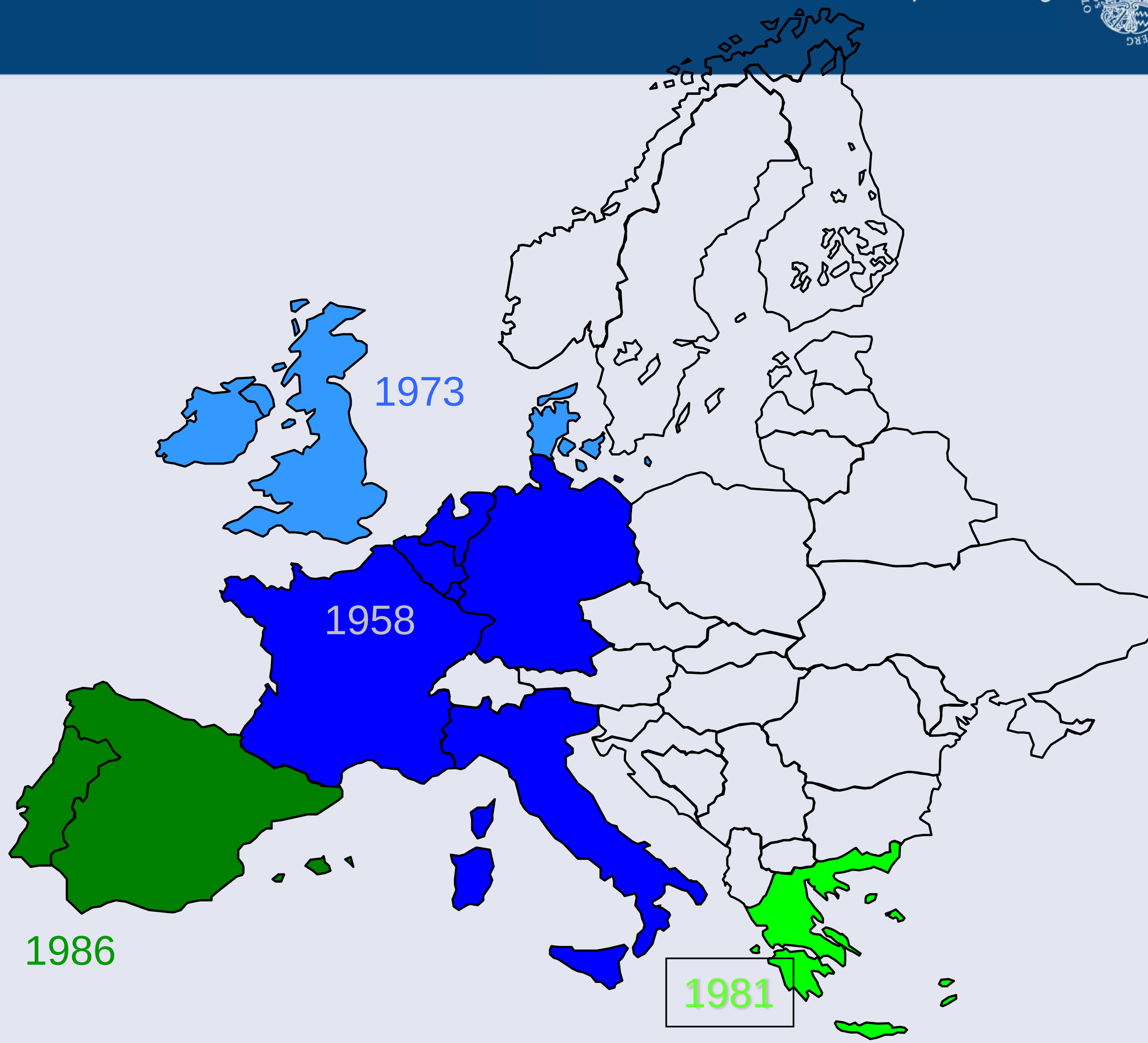
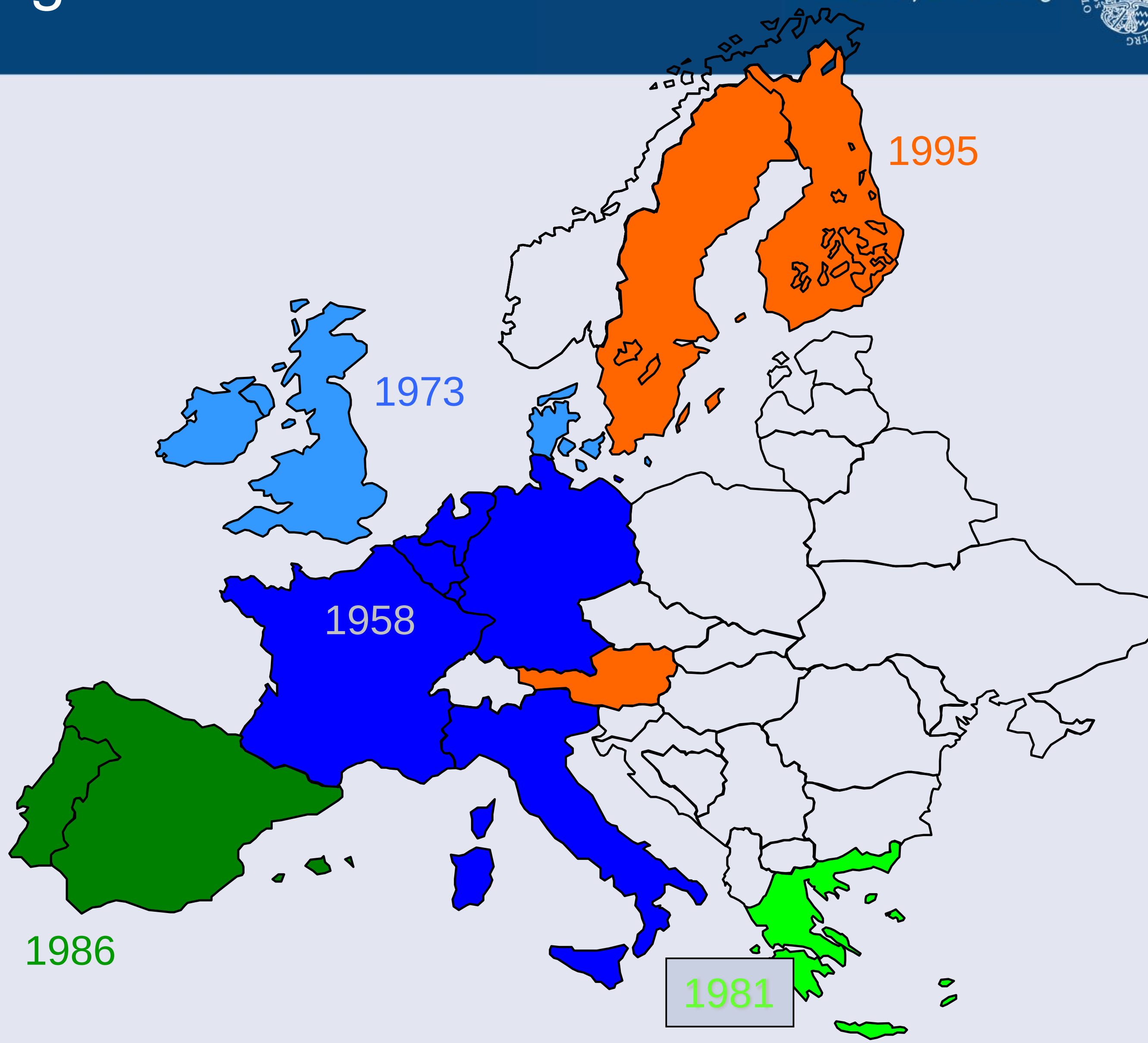


Fourth Enlargement …



The road leading to Eastern Enlargement

- By the 1980s, Western European system clearly superior due to the creeping failure of planned economies.
  - per capita GDP at PPP in USSR 20 per cent of US
  - Per capita GDP at PPS of GDR 25-50 per cent of FRG
- Up to 1980s, Soviets thwarted reform efforts (economic and military pressure).
- Changes in USSR due to inadequacy economic system in the Gorbachev era:
  - timid pro-market reforms (*perestroika*)
  - openness (*glasnost*).

Communism’s spectacular collapse

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- Division of Europe was cemented by the Berlin Wall (1961).

- By the 1980s, West’s economic system provided a far better way of life.

- Up to 1980s, Soviets thwarted reform efforts but inadequacy of Soviet system forced changes in USSR:
  - timid pro-market reforms (perestroika);
  - openness (glasnost).

Velvet revolutions in CEECs

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- Pro-democracy forces in the central and eastern European countries (CEECs) had been repeatedly put down by military force hereto but found little resistance from Moscow in the late 1980s:
- June 1989: Polish labour movement ‘Solidarity’ forced free parliamentary elections and communists lost. Moscow accepted new Polish government.
- Moscow’s hands-off approach to the Polish election triggered a chain of events:
    - Hungary opened its border with Austria and many East Germans moved to West Germany via Hungary and Austria;
    - mass protests in East Germany; Wall falls 9th November 1989;
    - end of 1989: democracy in Poland, Hungary, Czechoslovakia;
    - end of 1990: German re-unification.

USSR collapses

- End of 1990: independence of Estonia, Latvia and Lithuania;
- End of 1991, the USSR itself breaks up.

- The Cold War ends without a shot and with it, the military division of Europe ends.

Fall of the Berlin Wall in 1989

© Mary Evans Picture Library/Interfoto Agentur

The Maastricht Treaty

- On the success of the Single Market, Delors proposes 2nd radical increase in European economic integration: monetary union.

- Maastricht Treaty signed 1992 committed EU countries to achieve monetary union by 1999, and a single currency to put into circulation by 2002.

- Ratification difficulties:
  - Britain opted out of common currency;
  - Danish voters rejected the Treaty and reversed their choice only once Denmark opted out of common currency.

Reuniting East and West Europe

- At first, no promise of eventual membership but ‘Europe Agreements’: free trade agreements with promises of deeper integration and some aid.

- In 1993, the EU sets the Copenhagen criteria for accession of CEECs:
  - political stability of institutions that guarantee democracy, the rule of law, human rights and respect for and protection of minorities;
  - a functioning market economy capable of dealing with the competitive pressure and market forces within the Union;
  - acceptance of the Community ‘acquis’ (EU law in its entirety) and the ability to take on the obligations of membership.

- Copenhagen summit (2002) says CEEC nations plus Cyprus and Malta join in 2004 (5th enlargement).

Preparing for Eastern Enlargement

- Impending enlargement required EU to reform its institutions.

- **Five tries:**
  - Amsterdam Treaty, 1997;
  - Nice treaty, 2000;
  - draft Constitutional Treaty, 2003;
    - Reconsidered by IGC 2003;
  - Constitutional Treaty, 2004;
  - Lisbon Treaty, 2007.

Fifth Enlargement …

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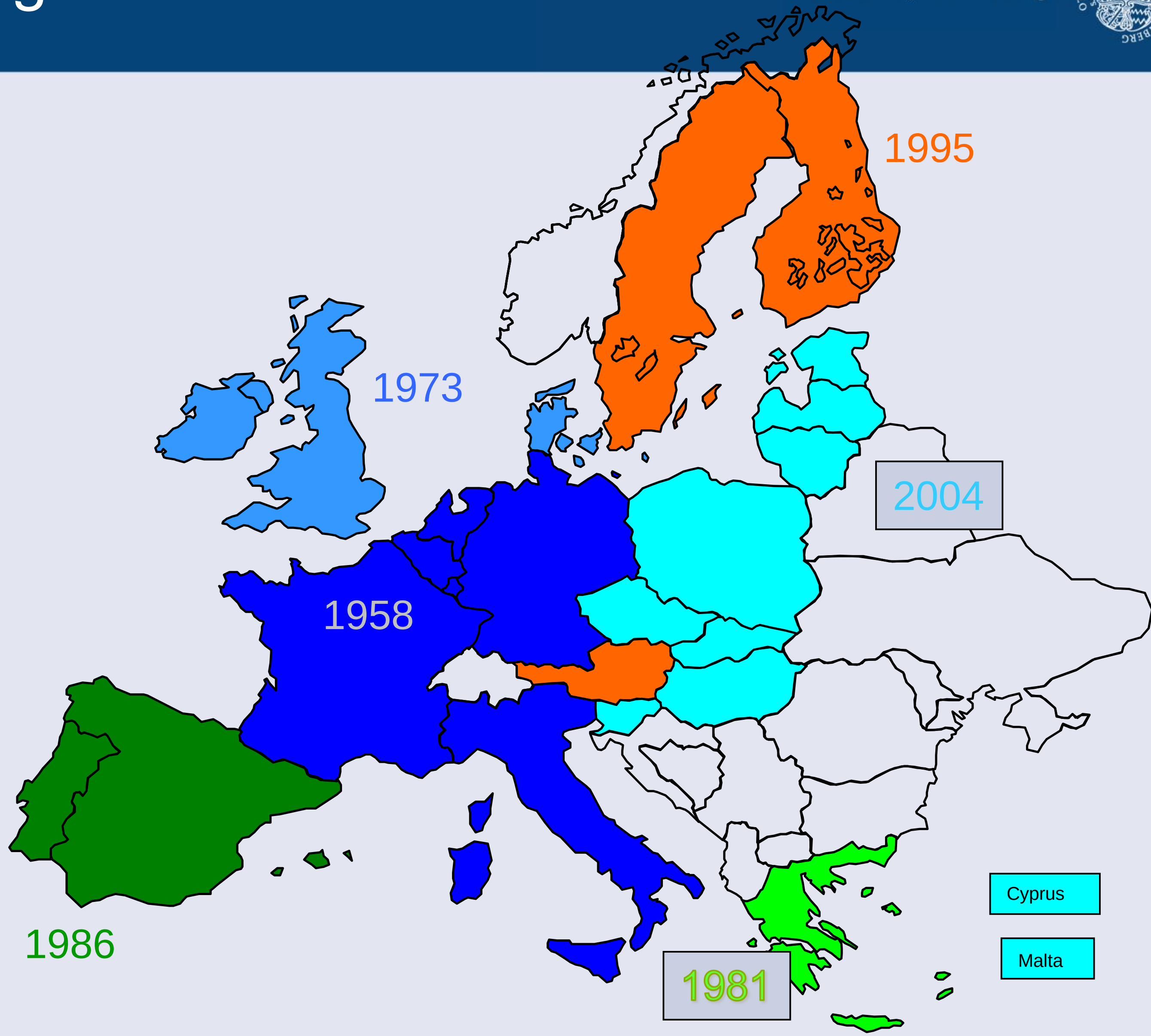
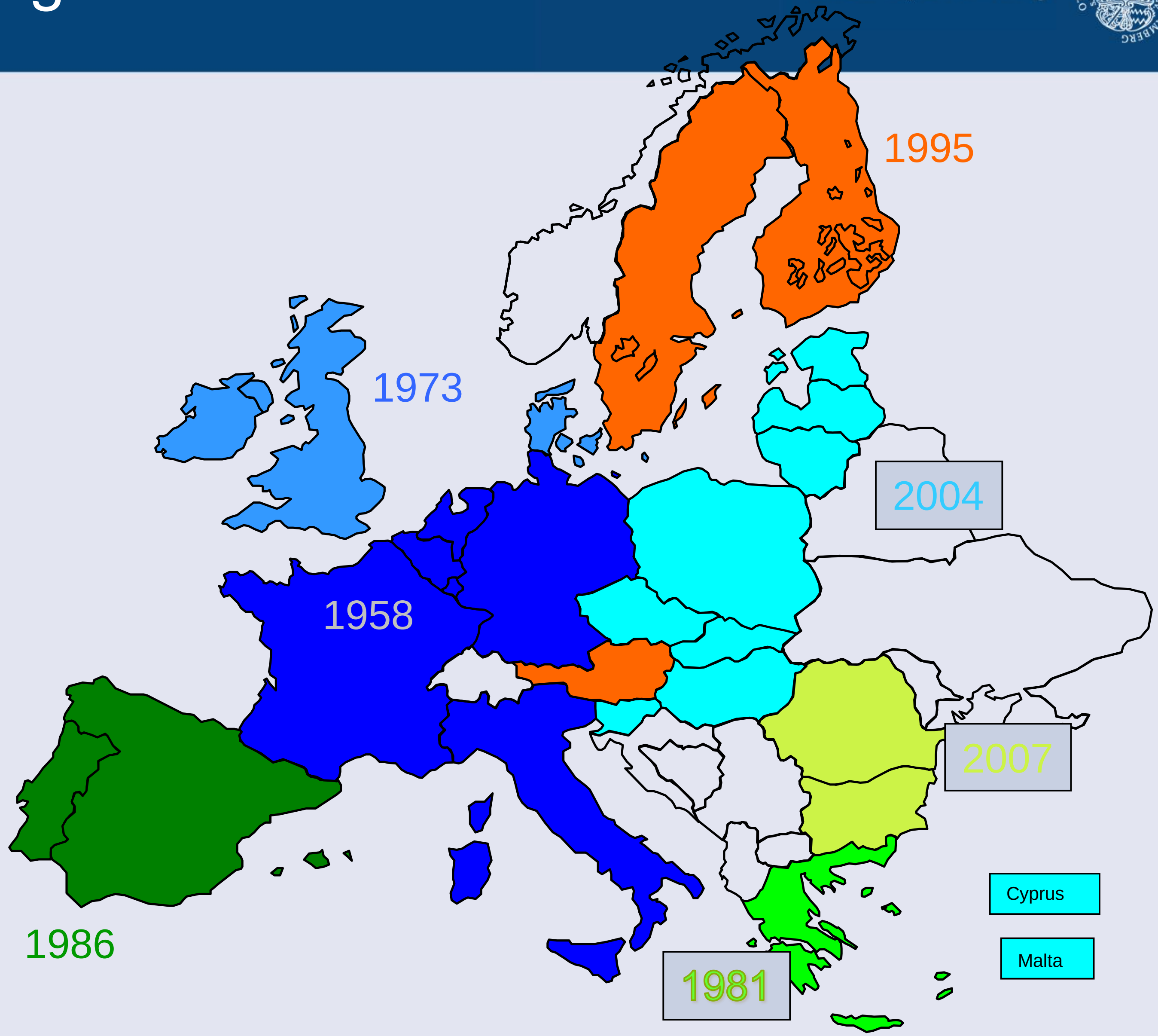


Sixth Enlargement …



Seventh Enlargement …

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What next?

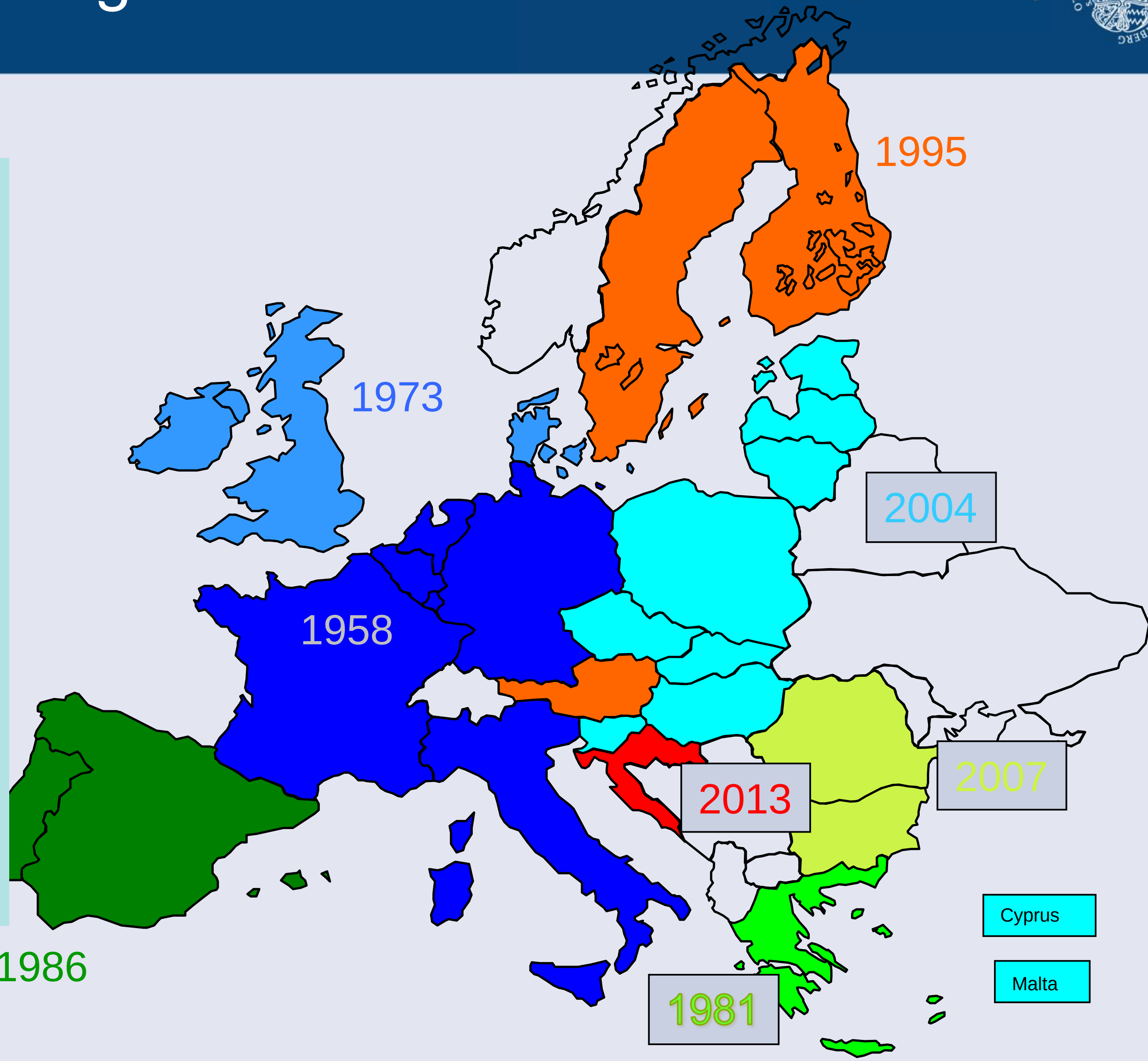
Who is waiting to join?

Turkey: Candidate forever?

Albania, Serbia, Bosnia, Montenegro, Makedonia, Kosovo?

Next candidates?

Ukraine?



Amsterdam Treaty

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- Failed to agree main reforms set out as the goal for the Treaty.

- But, it did tie up the Maastricht Treaty:
  - more social policy;
  - Parliament powers modestly boosted;
  - flexible integration, ‘closer cooperation introduced’.

- But no agreement on reform of Commission, reform of Council voting rules, or on list of areas to move to QMV. The “Amsterdam leftovers” would be addressed by a future Treaty.

Nice Treaty

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- Not a success!
- The critical Amsterdam leftover issues – the size and composition of the Commission, extension of majority voting in the Council of Ministers and reform of Council voting rules – were not fully solved.
- Irish voters initially rejected the Treaty. After some concessions were granted to Ireland, Irish voters accepted the Treaty.

Constitutional Treaty

- One year after Nice Treaty, EU leaders adopt the “Laeken Declaration” and set up the “Convention on the Future of Europe” to outline a new Treaty.
- The Convention decided to write a “Constitution”, which was signed in Rome in 2004.
- France and Netherlands rejected the Constitutional Treaty in referendums in 2005 and EU leaders suspend the ratification process.

Lisbon Treaty

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- Under the German EU Presidency (2007), EU leaders declared the Constitutional Treaty to be dead and agreed on the basic outlines of its replacement: the Reform Treaty, known as the Lisbon (2007).

- Much of the Constitutional Treaty is taken up in the Lisbon Treaty:
  - all the grandiloquent language and gestures to supranationalism were dropped;
  - all references to symbols of statehood were eliminated;
  - the word ‘constitution’ was banished.

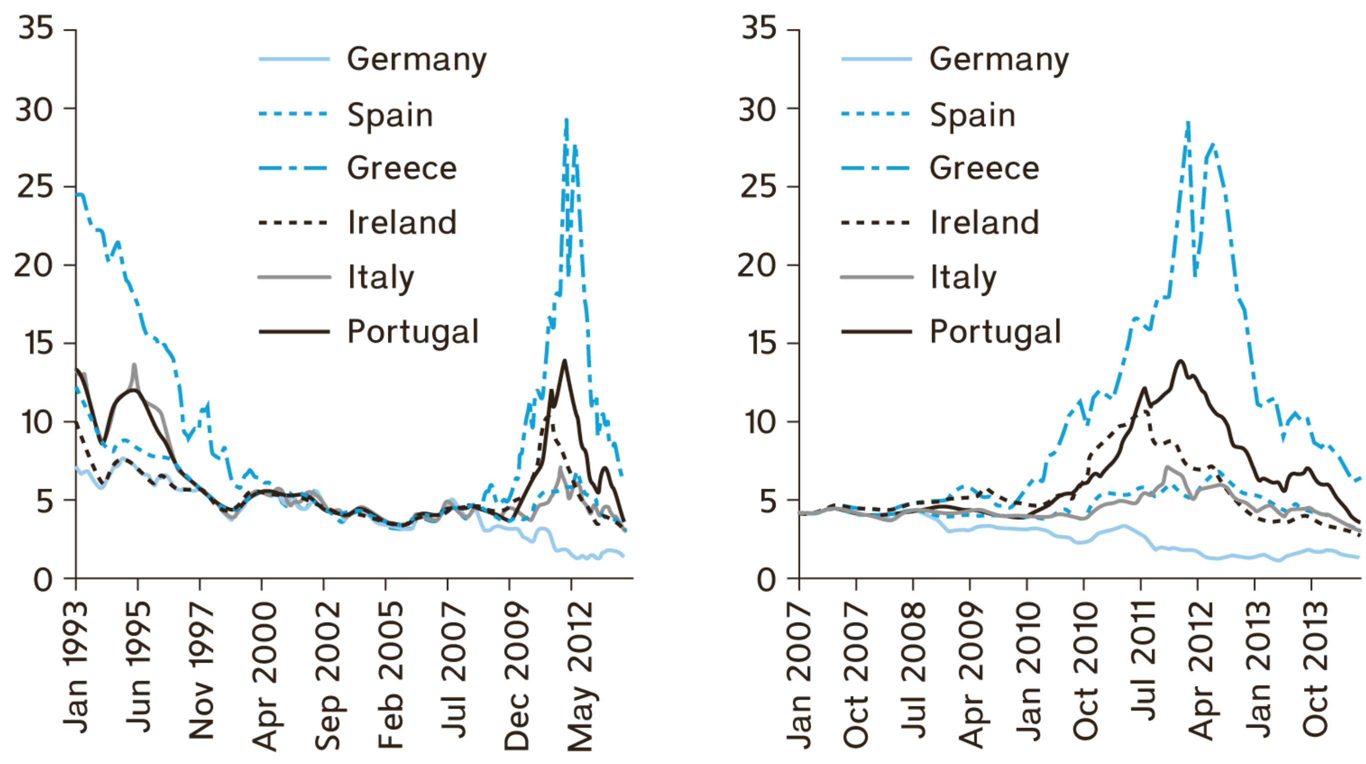
- Goal was to avoid referendums without changing the substance. But Irish Constitution required a referendum: Irish voters initially rejected the Treaty, reversing their vote after some concessions.

- The Lisbon Treaty came into effect in December 2009.

Eurozone Crisis

- Interest rate convergence caused by EMU formation.
- Sharp divergence triggered by the crisis

Figure 1.11 Eurozone long-run interest rates, 1993–2014



Source: Authors' elaboration on ECB data

Eurozone Crisis

- Emergency loans and packages:
  - Greece (May 2010),
  - Ireland (February 2012),
  - Portugal (May 2011),
  - Spanish banks (July 2012) and
  - Cyprus (May 2013).

- Massive institutional reforms and with transferring sovereignty to the Eurozone level and new rules, such as
  - Balanced budget rules,
  - Six Pack,
  - European Stability Mechanism,
  - European banking Union.

The Greek crisis

- Deficit of 104% of GDP at EURO accession
- Increase to 130% in course of financial crisis 2009
- Current deficit of 12,7% instead of reported 3,7%
- Large rescue package incl. credits of 109 bn EURO by EFSF and IMF, plus 37 bn EUROs by private debtors
- Debt package was linked to tight savings and reform program
- GDP declined by 30 per cent, unemployment rate climbed to 27 per cent
- Syriza led coalition government came in power 2015
- Dramatic renegotiation of debt package, 80 bn EUROs and tight saving and reform program
- Was adopted in Greek parliament, Syriza government reelected

Outlook

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- Banking regulation pending
- Reform of EU treaties regulating new transfer mechanisms and redefining the role of the ECB is pending as well
- New rules for the growth and stability pact (zero debt target)
- Coordination of social policies
- Paradoxically, the Eurocrisis may lead to deeper integration

The refugee crisis I

- About 65 million refugees world-wide, 20 million in other countries
- Most conflicts in EU neighbourhood
- EU and Member States signed Geneva Convention
- Dublin agreements failed
  - first save third country has to take care of refugees
  - implies that countries at EU borders have to bear all costs
  - refugees are not registered there and motivated to migrate to Germany and some other countries
  - ‘race-to-the-bottom’ in standards
- No majority for quota system and other distribution system of refugees and/or costs

The refugee crisis II

- Refugee crisis is good example for coordination failure
- National asylum policies create strong incentives for ‘race-to-the-bottom’ in humanitarian standards
- Countries have either the alternative to maintain levels and receive a large share of the burden or to reduce standards as well
- This would call for coordination at EU-levels, but difficult to implement, since it would create losers relative to the status quo
- Common denominator so far: Closing external EU-borders via agreements with Turkey and Northern Africa
- Open question: humanitarian component, e.g. refugee quotas (“relocation and resettlement programs”)

Brexit

- Referendum on EU-membership voted 52:48 for “Leave” (June 2016)
- Free movement of workers, EU product market regulation, EU decision-making and bureaucracy main topics in debate
- Formally, exit negotiations start when UK makes a formal announcement
- Exit agreement has to be ratified by EU Commission, EU parliament and all EU Member States
- Yet not exit agreement, UK may leave the EU and has same status as third countries (hard vs. soft Brexit)
- Controversial issues: free movement of workers, EU “passport” guaranteeing financial market access for third-country banks settling in the City of London, financial contributions, product market regulation, special access for Republic of Ireland, among others
- Increasing supporter for a second referendum (October 2018)

Concluding remark

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- European integration was always a construction side with cycles of crisis and deeper integration
- Eventually, deeper integration prevailed from the long-term perspective
- At present, it is the first time of the EU history where disintegration forces look stronger than integration forces, given that the crisis has multiple dimensions
  - Economic: EURO crisis
  - Coordination failures: Refugee crisis, Trade Agreements
  - Political: Mounting nationalism, missing legitimacy of EU decision-making
  - Brexit: First time that a country decided to leave the EU

Next Lecture: November 5

- Begin: 11:00 hours
- Lecture 2: EU institutions and decision making
- Reading: Baldwin/Wyplosz, Chapter 2 + 3

THANKS FOR YOUR ATTENTION!