



# Preface

European integration keeps amazing its supporters and critics alike. No other region has displayed similar willingness to jettison important components of sovereignty in pursuit of shared, yet thoroughly imprecise goals. And, in its own peculiar way, European integration keeps forging ahead at a pace that is too fast for some and too slow for others. No one would deny, though, that the transformation of the past half century is spectacular – a clean break with centuries of intra-European warfare. This integration is clearly important for the 500 or so million Europeans it directly affects, but since Europe accounts for a quarter of the world economy, half of world trade and a third of world capital markets, European integration also affects the lives of most non-Europeans.

A subtle interplay of strictly economic and much broader, high-minded goals has driven European integration forward along political, cultural and economic dimensions. The goal of this book is to provide an accessible presentation of the facts, theories and controversies that are necessary to understand this process. Our approach is rooted deeply in economic principles for the simple reason that economic integration has been the vanguard since the Organization for European Economic Co-operation was founded in 1948. Yet economics is not enough; historical, political and cultural factors are brought into the picture when necessary.

## 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.

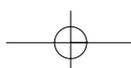
The book is written at a level that should be accessible to second- and third-year undergraduates in economics as well as advanced undergraduates and graduate students in business, international affairs, European studies, and political science. Some knowledge of economics is needed to absorb all the material with ease – a first-year course in the principles of economics should suffice – but the book is self-contained in that it reviews all essential economics behind the analysis. Diligent students should therefore be able to master the material without any formal economics background.

## What is in this book

The book is organized into six parts that can be grouped into three categories – essential background (Part I), the microeconomics of European integration (Part II and III), and the macroeconomics of European integration (Parts IV, V and VI).

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, which will probably be useful to all students. Even students who are familiar with the main events should profit from this Chapter since it stresses, wherever possible, 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. Chapter 2 also presents





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information on the vital EU institutions and the EU's legislative processes as well as the main features of the EU budget.

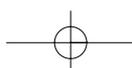
- Chapter 3 presents an economic framework for thinking about EU institutions. The first part explains how the 'theory of fiscal federalism' can be used to consider the appropriateness of the allocation of powers between EU institutions and EU member states. The second part explains how economic reasoning – game theory in particular – can be used to analysis EU decision-making procedures for their decision-making efficiency as well as their implications of 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 European Union such as the Constitutional Treaty and the 2004 enlargement.

Part II presents the critical microeconomics 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, the key economic welfare concepts of consumer and producer surplus, and uses these 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 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 affects 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. The chapter also covers the main elements of the EU's competition policy and state aids policy.
- 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 theory are covered, as are the basic facts and empirical evidence. The chapter also discusses the economics, facts and evidence on capital and labour market integration.

Part III covers the two main EU policies – the Common Agricultural Policy (CAP) and Regional Policy.

- Chapter 8 looks at the 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) and the 2004 enlargement.
- Chapter 9 presents the economic 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 nations and between nations. To organize thinking about these facts – and to understand how EU Regional Policy might affect it – the chapter presents the locations 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 2004 enlargement.





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Part IV is where macroeconomics starts. It lays the ground for the analysis of monetary integration.

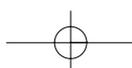
- Chapter 10 returns to Europe's history, this time from the monetary angle. It recalls ancient times when Europe was a de facto monetary union under the gold standard, whose adjustment mechanism is now back at work. The disastrous inter-war period encapsulates all the policy mistakes that today's policy makers are determined to avoid. The chapter closes by showing how the European Monetary System paved the way to the adoption of a single currency.
- Chapter 11 takes a step sideways. It deals with a very general question, the choice of an exchange rate regime. It presents a short summary of the basic macroeconomic principles needed to grasp the significance of exchange rate regimes. It then explains how to assess the desirability of each of the main arrangements, including the two-corner strategy that underlies Europe's shift to the euro while explaining why others have chosen to stay out.
- Chapter 12 deals with the European Monetary System, the now defunct first version and the new version designed to provide a transition for future monetary union members. It shows that the successes of the EMS have provided a powerful incentive to go further and create a single currency, while its shortcomings have made the adoption of the euro look like the least unacceptable of all solutions.

Part V provides a detailed analysis of the monetary union, and proceeds in two steps: theory and practice.

- Chapter 13 presents the optimum currency area theory that helps to understand the main costs and benefits from sharing a common currency. The theory does not provide a black and white answer; rather it develops a set of economic, political and institutional criteria to evaluate the costs and the benefits of forming a monetary union. In addition, the costs and benefits may be endogenous. Europe fulfils some criteria, not others, which explains the unending debates on the merits of the European Monetary Union.
- The main features of the European Monetary Union are laid out in Chapter 14. This includes a description and an analysis of the institutions created by the Maastricht Treaty. 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 few years of the euro, assessing the performance of the ECB, including the democratic accountability gap.

Part VI moves away from purely monetary questions, taking up three issues important for the macroeconomic functioning of the monetary union.

- Fiscal policy is the last national macroeconomic instrument remaining once national monetary policy has been lost. Chapter 15 looks at the Stability and Growth Pact, designed to deliver enough budgetary discipline not to endanger the overriding price stability objective. The analysis reveals how uncomfortable it is to preserve the macroeconomic instrument and to enforce strict enough rules.
- The financial services industry is likely to be transformed by the adoption of a single currency. Chapter 16 starts with a review of what makes this industry special. This makes it possible to interpret the changes that have taken place and those that have not yet materialized. Financial markets are also important for monetary policy effectiveness, raising delicate questions: Is the single monetary policy symmetrically affecting member countries? How are financial institutions regulated and supervised? The chapter also examines whether the euro is becoming a worldwide currency, alongside the US dollar.





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- The last chapter looks at economic integration and the labour markets. The high level of unemployment that prevails in several countries, especially the largest ones, may greatly complicate the working of the euro area. It is natural to ask whether the euro will help to cure the unemployment problem or aggravate the situation. This calls for an analysis of labour market institutions and the political economy of reform.

