

Preface



In the summer of 2011, our preparation for the fourth edition was thrown off course by the Eurozone crisis – just as the Global Crisis of 2008 interrupted our preparation of the third edition. With hindsight, the strategy we adopted for the Third Edition – highlighting the Eurozone’s weak spots – was correct, as the result provided a guide for readers to interpret events that have unfolded in such a spectacular fashion in 2011. In fact, as this edition goes to print (October 2011), the Eurozone crisis it is getting deeper by the day. As we write, a number of commentators even predict disintegration and a breakup of the Eurozone.

Once again, history has presented us with a tough trade-off in addressing events that affect the core of our topic, European integration. On the one hand, a textbook has to take some distance from immediate events. On the other hand, these events are transforming the nature of the European economic landscape. We need to take these events into accounts, even though future events may well turn things in yet another direction. With so much uncertainty, the trade-off is between ignoring how European integration is being transformed on one hand, or addressing them but at the risk of drawing conclusions that subsequent events prove wrong on the other hand. Our response has been to deeply rewrite the macroeconomic chapters, to provide more information on the issues raised by the crisis – e.g. the US subprime mortgage loans or the functioning of financial markets – and to add a new chapter entirely dedicated to the European sovereign debt crisis.

Pedagogy, however, remains our main concern. Following a review of book users, we have decided on two important changes from the Third Edition:

- We have reverted to the traditional ordering of chapters. Parts I presents history and institutions, Parts II and III cover trade and market integration, and Parts IV and V are dedicated to monetary integration.
- We have also restructured the three chapters that used to present the macroeconomic tools, the issue of the choice of an exchange rate regime and the European Monetary System. In order to improve coherence, we merged three chapters into two. By streamlining the exposition¹ and avoiding repetitions, we thus made room for the new chapter on the crisis without making the book longer. We have also streamlined some of the material in the chapters on microeconomic essentials in order to make room for a fuller verbal treatment of the material.

In addition, we made a large number of small editions. It is impossible to list them all. For example, Chapter 1, which reviews the history of economic integration in Europe has been updated to account for the entry into force the Lisbon Treaty. The Lisbon Treaty changes have also been fully integrated into Chapter 2 (Facts, Law and Institutions). In the monetary integration part, we now provide a more detailed treatment of rational expectations and of budget constraints, if only because this is needed to make sense of the crisis.

As before, the goal of this book is to provide an accessible presentation of the facts, theories, policies and controversies that are necessary to understand Europe’s economic integration process. Our approach is rooted deeply in economic principles for the simple reason that economic integration has been the vanguard of broader European integration since the 1948 Organization for European Economic Cooperation.

¹ particular, we no longer present the IS-LM and AD-AS models, which can be found in most macroeconomic textbooks.

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 and in 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 macroeconomic 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 decision-making 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 competences 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, 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 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 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. 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, 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 just describing the policies, the chapter motivates and explains them by introducing the basic economic logic of anticompetitive 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 policies with the rest of the world. While trade policy is not as central to the EU as, say, the CAP and cohesion policies are, it is important. The EU is the world’s biggest 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 principles needed for the macroeconomic analysis are presented in Chapter 13. This chapter presents the macroeconomic theories and tools needed to analyze monetary integration. It is organized around three principles: interest rate parity, purchasing power parity, and the impossible trinity that affects the choice of exchange rate regimes.
- The long process of European monetary integration is recounted in Chapter 14. It starts back from ancient times when Europe was a de facto monetary union under the gold standard, reviews the Bretton Wood 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 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 benefits of forming a monetary union. In addition, the costs and benefits may be

endogenous. Europe fulfils some criteria but not others, which explains the unending debates on the merits of the European monetary union.

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 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 decade of the euro 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 enough budgetary discipline not to endanger the overriding price stability objective. Since the first edition of this book, we have underlined the Pact's serious shortcomings, now made plain by the sovereign debt crisis. We emphasize the economic and political difficulties inherent in preserving the last national macroeconomic instrument while ensuring fiscal discipline.
- Chapter 18 deals with the financial markets. The financial services industry has been transformed by the Single European Act of 1986 and by the adoption of a single currency. The chapter starts with a review of what makes this industry special and then introduces the microeconomics of capital integration. It then looks at the evolution of banks, bond markets and stock markets, discussing the shortcomings in regulation and supervision that have been illustrated during the crisis. The chapter also examines whether the euro is becoming a worldwide currency, alongside the US dollar.
- Finally, Chapter 19 offers an overview of the Eurozone crisis. It looks at the global crisis that started in the US and its transmission to Europe. The next step, the sovereign crisis, is then described and analyzed, bringing together much of the material presented in earlier chapters. It then looks at short and long term policy responses.

How to use this book

The book is suitable for a one-semester course that aims at covering both the microeconomics and the 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 to 8 and 16 to 19, or just 4 to 8 and 16 to 19.

Eclectic courses oriented towards policy issues can use, with some additional lecturing if the students are not familiar with basic theory, Chapters 1 and 2, 9 to 12 and 16 to 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 essay questions which can be given as assignments. We also provide additional readings; most of them are easily accessible to undergraduate students though, occasionally, when we did not find adequate references, we point to more advanced material. Students may find some of these readings rewarding.

The fourth edition continues with our tradition of providing many internet links that should allow students and lecturers alike to get 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 treatments in a way that allows students to realize the usefulness of the basics they have learned from the text.