International Economic Policy | 4. Integration vs fragmentation

"People only accept change when they are faced with necessity,
and only recognize necessity when a crisis is upon them." —Jean Monnet

https://www.economist.com/europe/2020/03/21/more-europe-or-less

1. Third big topic in the course: tension between integration and fragmentation

Arguably, the fundamental international economic policy decision by a government is the degree to which the domestic economy is integrated with the rest of the world (its level of openness or how much globalized the economy is). The integration decision has a series of related issues attached.

- Why become integrated? The natural answer is that the reason why an economy increases its degree of integration is improvement in collective welfare. There are some conjectures, more or less supported by empirical evidence.
  - The openness-development connection. There appears to be a correlation between two characteristics of an economy: be wealthy (or sufficiently advanced, developed) and be open (sufficiently globalized, integrated).

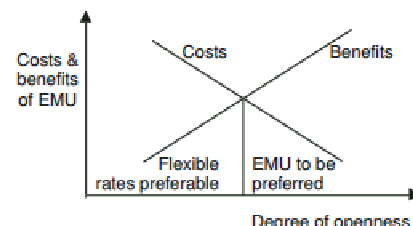
    (i) There is an empirical literature studying the openness → growth/development link, in part motivated by the fact that the most recent examples of economies joining the club of sufficiently advanced economies chose to catch up with the wealthiest economies by promoting and successively upgrading the export sector (Japan and South Korea being paradigmatic examples). This link supports a liberal policy recommendation: if you want to become a developed economy, open your economy and raise to the challenge of competing with the rest of economies.

    (ii) The reverse causality development → openness has attracted less attention: could it be not that an economy can afford to become open precisely when it is sufficiently developed? If this is the case, then integration is not a means to become more developed but one of its consequences. This then would point to making developing the first priority (perhaps adopting illiberal policies).

- The trade-peace connection. There is also a large literature concerned with the link between economic integration and peace. In this context, the liberal argument holds that engaging in trade with another country lowers the probability of conflict with that country. The argument is that economic interdependence makes it more costly to resort to conflict (war, as the extreme option) as a way of resolve disputes. Again, it is difficult to ascertain the degree of circularity is the trade-peace link: do not countries, in the first place, establish more economic relationships between them when they have already achieved some high level of peaceful interaction? So it may be that, initially, the stronger causality goes from peace to trade (see the origin of the European Economic Community in the 1950s) and, after a sufficient level of economic interdependence is achieved, the stronger causality goes from trade to peace (war between eurozone members is, at present, unthinkable).
- The integration-similarity connection. The two previous links suggest that integration may be good for growth and stability. This third link relates integration with 'distribution': do more integrated countries become more alike and, in this respect, adopt similar policies and institutions? For instance, joining the European Union has been viewed as a strategy to become more democratic (and more merely wealthier or peaceful). As before, causality may not be unidirectional: countries with a high degree of integration and sharing common institutions and principles may only be interested in extending that integration to countries with already similar institutions and principles.

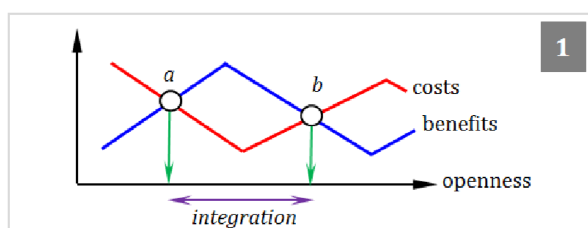
- How much integration to choose? The benefits of integration do not come for free: integration involves making changes, which tend to be costly. Also, there is the time required for the benefits to arise: some benefits need not be immediate, which means that they at least have an opportunity cost associated (the possible more immediate benefits lost if less integration were chosen). Moreover, the benefits of integration need not evenly distributed among domestic groups. This means that, even if all are winners in absolute terms, integration will most likely create winners and losers in relative terms. Hence, to avoid conflict with the losing groups (more so if such groups have enough political power), governments may be forced to select a level of integration that is socially and politically acceptable (that is, a level that does not create excessive social or political domestic tensions). On top of that, integration need not proceed at the same speed in all areas: some economic sectors may favour a slower path of integration, which also limits the extent to which integration may proceed in the rest of sectors. The timing and spread of integration then becomes a crucial policy decision.
- For how long maintain integration? Historical evidence shows that all integration processes are reversible. Civil wars testify to the widespread attempt to break political integration (or to impose one's integration views on the rest). Brexit is a recent example of the reversibility of economic integration. Protectionist measures are less dramatic instances of decreasing economic integration. The last European migration crisis also illustrates the forces of de-integration. The 2020 COVID pandemic has the potential of collapsing what appeared to be consolidated integration outcomes (in 2019, around 83 millions tourists visited Spain, a country with 47 million people). In times of trouble all is subject to revision, integration included.

2. Very simple models to explain integration as a policy decision

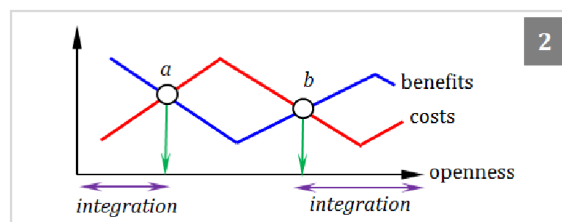


The figure on the right (taken from Korkman, 2005) shows a simple model on the decision to join an EMU (economic and monetary union). This model provides a basic rule: it is only if your degree of integration is already sufficiently high that it may be worthwhile to participate in an EMU.

The two graphical models below offer straightforward variations. The oscillating pattern of the costs and benefits functions are motivated by the need to introduce reforms (change the institutional infrastructure) to address the tensions generated, and materialize the potential advantages, by a rising integration (the 2010 eurozone crisis may illustrate the additional costs created by an integration level not matched by the necessary institutional update).



Model 1 implies that (given a *ceteris paribus* institutional assumption) full integration is not optimal: beyond point *b* the current institutional organization cannot handle further integration, as this generates more costs than benefits within that institutional framework (for instance, a high level of integration may require a supranational fiscal authority —a supranational treasury— that does not exist when the costs and benefits functions were drawn; or it may require the central bank to directly finance the national governments' debt, but the functions are drawn assuming that possibility to be forbidden). Thus, if integration moves beyond *b* and the functions remain valid because no institutional change is introduced, then de-integration will be observed. Similary, integration levels to the left of *a* will be unstable: with costs higher than benefits, the tendency will be to reduce integration to the minimum.



Model 2 offers a mirror outcome. Integration processes initially have an upper threshold: starting from minimum integration, the process will stop at *a*. If that point is surpassed, the tendency will be to revert to some point to the left of *a* (where benefits are larger than costs). To reach maximum integration some exogenous shock must place the country beyond *b*, where integration can deepen endogenously. Model 2 shares with model 1 the message that full integration need not be the final outcome: if integration occurs gradually, point *a* will not be surpassed and, consequently, a state of low integration is stable. By contrast, model 1 excludes the possibility of a permanent state of very low integration.

Korkman, Sixten (2005): *Economic policy in the European Union*, Palgrave Macmillan, Basingstoke, UK.

3. Trichet's (2011, 2013) economic and fiscal federation proposal

Jean-Claude Trichet's federation proposal is an example of institutional changes that could modify the shape of (or shift) the functions in models 1 and 2 (Trichet was the second president of the European Central Bank, 2003-2011). The current system (the Macroeconomic Imbalance

Procedure) is one of 'fines' (a percentage of GDP) for countries whose improper conduct (materialized in excessive macroeconomic imbalances) puts at risk the stability of the EMU. Since such fines have not proved effective to deter countries in undesirable behaviour, Trichet has suggested replacing this system with a new decision making process he calls 'the activation of an economic and fiscal federation by exception', in which fiscal sovereignty can be limited in exceptional cases by a majority vote of the members of the European Parliament from Euro area states.

- "The scope of interventions and the measures taken by the federal institutions would so rely, even in the much longer term, on the principle 'as little as possible in normal times, but as much as necessary in exceptional times'." It appears that the ECB applied this principle during the eurozone debt crisis (July 2012: Draghi's 'whatever it takes' speech).
- Trichet also proposes the setting up of a Ministry of Finance of the eurozone. "This ministry would have the responsibility of the activation of the economic and fiscal federation when and where necessary. It would be responsible for the handling of the crisis management tools like the ESM [European Stability Mechanism]. It would also be responsible for the handling of the banking union, within the limits of the executive branch responsibility. And it would represent the Euro area in international institutions and informal groupings."

Trichet (2013) argues that European prosperity and influence depends on setting the correct path of European integration, both economic and political. Europe's EMU is itself viewed as a historically unique achievement: "a 'society of states' of a completely new type." He lists successes of the EMU: price stability and stable expectations on the value of the euro (future price stability), with these results attained in the presence of important global oil and commodity shocks and not at the expense of sacrificing employment creation. He also lists several EMU economic governance weaknesses. In particular:

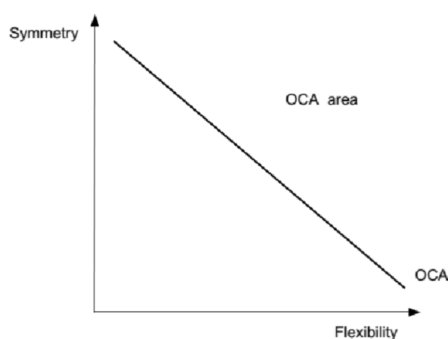
- "the Stability and Growth Pact designed to ensure sound fiscal policies in the Euro area has not been correctly implemented."
- "at the start, the governance of the Euro area did not comprehend any serious monitoring and surveillance of competitiveness indicators, of nominal evolutions of prices and costs in any particular nation and of national external imbalances within the Euro area."
- The lack of an effective banking union (given the high correlation between the creditworthiness of a state and its banks).
- Neglect in the implementation of crisis management tools when the euro was created.
- Market integration (particularly, in services) has not been fully achieved.
- "The slow and hesitant implementation of the structural reforms foreseen in the Lisbon agenda and in the 2020 program."

Trichet, Jean-Claude (2011): "Tomorrow and the day after tomorrow: A vision of Europe", Humboldt University, Berlin.

Trichet, Jean-Claude (2013): "International policy coordination in the Euro area: Toward an economic and fiscal federation by exception," Journal of Policy Modeling 35, 473-481.

4. Another model (De Grauwe, 2006) to identify conditions to make a monetary union

"The conditions that are needed to make a monetary union among candidate Member States attractive can be summarized by three concepts: Symmetry (of shocks); Flexibility; Integration. Countries in a monetary union should experience macroeconomic shocks that are sufficiently correlated with those experienced in the rest of the union (*symmetry*). These countries should have sufficient *flexibility* in the labour markets to be able to adjust to asymmetric shocks once they are in the union. Finally they should have a sufficient degree of trade *integration* with the members of the union so as to generate benefits of using the same currency."



"Figure 1 presents the minimal combinations of symmetry and flexibility that are needed to form an optimal currency area by the downward-sloping OCA line. Points on the OCA line define combinations of symmetry and flexibility for which the costs and the benefits of a monetary union just balance. It is negatively sloped because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility. To the right of the OCA line, the degree of flexibility is sufficiently large given the degree of symmetry to ensure that the benefits of the union exceed the costs. To the left of the OCA line, there is insufficient flexibility for any given level of symmetry.

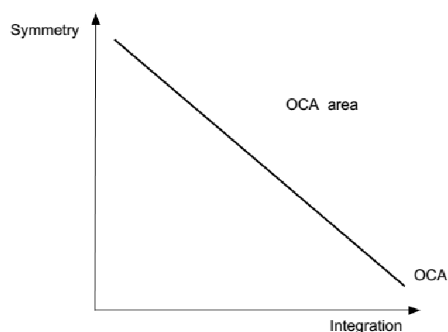


Figure 2 presents the minimal combinations of symmetry and integration that are needed to form an optimal currency area. The OCA line represents the combinations of symmetry and integration among groups of countries for which the cost and benefits of a monetary union just balance. It is downward sloping for the following reason. A decline in symmetry raises the costs of a monetary union. These costs are mainly macroeconomic in nature. Integration is a source of benefits of a monetary union, i.e., the greater the degree of integration the more the member countries benefit from the efficiency gains of a monetary union. Thus, the additional (macroeconomic) costs produced by less symmetry can be compensated by the additional (microeconomic) benefits produced by more integration. Points to the right of the OCA line represent groupings of countries for which the benefits of a monetary union exceed its costs. The presumption of many economists at the end of the 1980s was that the EU countries should be located to the left of the OCA lines in Figures 1 and 2, i.e., given the degree of integration achieved in the EU there was still too much asymmetry and too little flexibility for the EU to form a monetary union whose benefits would exceed the costs."

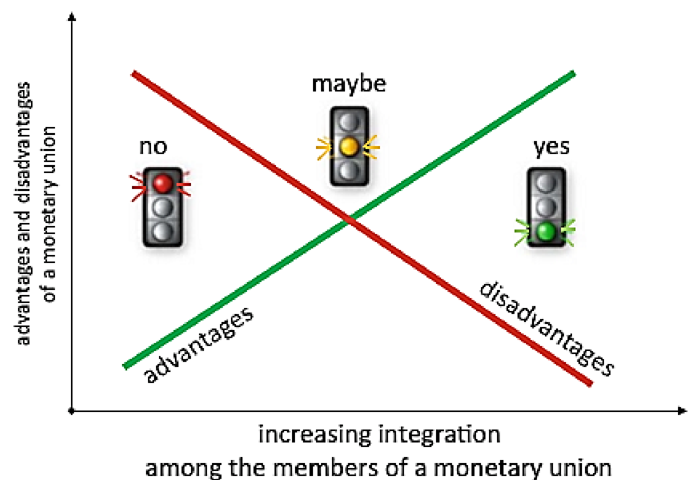
De Grauwe, Paul (2006): "What have we learnt about monetary integration since the Maastricht Treaty?", Journal of Common Market Studies 44(4), 711-730.

5. When to create a monetary union?

"When is it appropriate to have a monetary union? It turns out that the trade-offs between the economic advantages and disadvantages of a common currency are essentially a function of the

degree of economic and cultural integration between the member countries. As illustrated in Fig. 8.5 [on the right], the advantages of a common currency tend to increase, whereas the disadvantages tend to decrease, when the involved economies are more interconnected."

Nils Herger (2019): *Understanding central banks*, Springer.



6. European integration

The European integration experience is worth studying in itself (to better understand integration processes and, in particular, its difficulties) but also as a test for the potential of world integration (if a group of economically, politically, socially and culturally similar countries fail to integrate, one cannot expect a better outcome when more and more diverse attempt to integrate). The recent events in the European integration process provide traumatic illustrations of what go wrong in the process.

• Soros (2014) identifies basic deficiencies in the constitution of the eurozone.

"The crash of 2008, however, revealed many other deficiencies. In retrospect, the most important was that by transferring the right to print money to an independent central bank, member countries ran the risk of default on their government bonds. In a developed country with its own currency, the risk of default is absent because it can always print money. But by ceding or transferring that right to an independent central bank, which no member-state actually controls, the member-states put themselves in the position of Third World countries that borrow in a foreign currency."

"Rather than an association of equals, the eurozone became divided into two classes: creditors and debtors. In a financial crisis, the creditors call the shots. The policies they are imposing perpetuate the division because the debtors have to pay risk premiums, not only on government bonds but also on bank credit. The additional cost of credit, which is a recurrent burden, makes it practically impossible for the heavily indebted countries to regain competitiveness. This is not the result of an evil plot. It was caused by a lack of understanding of an extremely complicated reality.

• According to Varoufakis (2016):

"Europeans have taken far too long to understand that 2008 was our version of the tragic generation's 1929 (…) In 1929 protectionism took the form of devaluing one's currency vis-à-vis others (…) In 2010 it took the form of devaluing one's labor vis-à-vis others."

• Bootle (2016) views the creation of the euro as the greatest monetary experiment in history.

"…the EU may have been established primarily for political rather than economic reasons, yet even so, much of its early development was focused on economic integration (…) The European single currency, the euro, has become the focus of European integration – and it could yet prove to be the cause of the EU's disintegration (…) I cannot think of any example of major states of roughly equal status sharing a common currency – apart from the members of the eurozone."

"No arrangements were put in place for a fiscal union, but instead there was a no-bailout clause in the Maastricht Treaty, which stated that there would be no external or Union-wide support for any national government that got into financial difficulties. This was supposedly to instil a sense of responsibility in individual fiscal authorities and a sense of caution in those in the financial markets who might lend to them."

"Moreover, the countries of the currency area agreed to a Stability and Growth Pact, which laid down limits to their fiscal deficits. Unfortunately, this pact was very far from watertight, as both France and Germany proceeded to exceed the deficit limits without incurring any penalty."

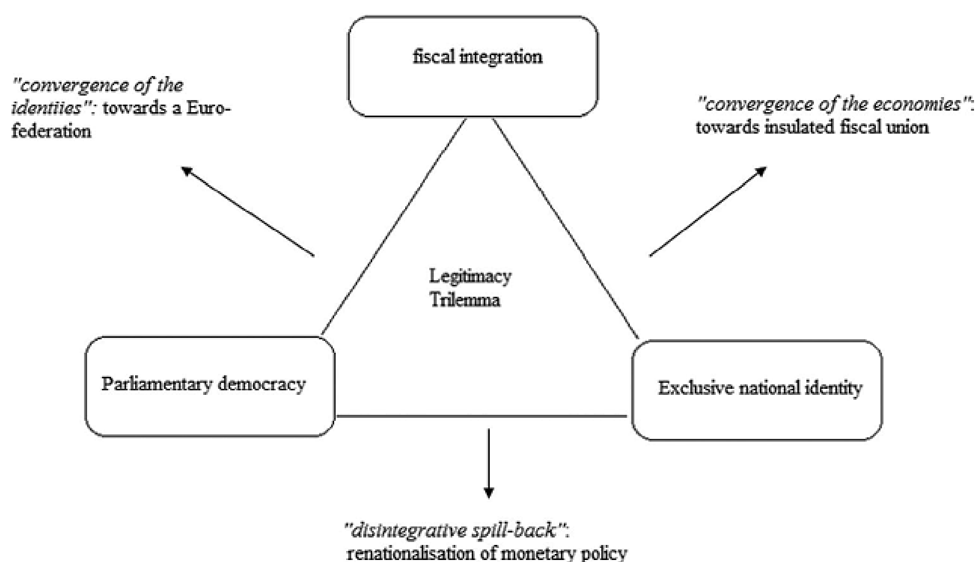
"Both the no-bailout clause and the Stability and Growth Pact were paper tigers. So, in practice, there was no effective fiscal union to accompany the monetary union that was unleashed by the euro. There was no political union either."

"… umpteen sovereign countries with different fiscal, political and parliamentary traditions have to agree on how each other's fiscal policy should be run and coordinated, and on political institutions for the whole eurozone that will exercise this power, while being democratically accountable. This is all the more difficult because different member countries have different ideas about the role of the nation state. While Germany seems to be prepared to submerge its identity in some common Europeanness, this does not appear to be how France views its future (…) We are where we are because of the astounding arrogance and incompetence of the European political elite."

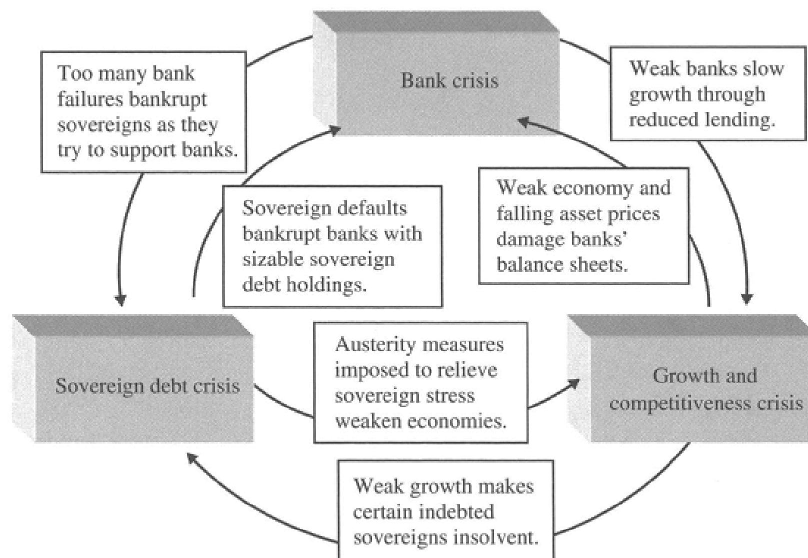
• De Grauwe (2006) describes the EMU flaws as follows.

"The European monetary union is a remarkable achievement. Yet it also remains fragile because of a flaw in its governance. This is the absence of a sufficient degree of political union which includes a central European government with the power to spend and to tax, and which is independent of national governments. Such a government is necessary to complement the macroeconomic management of the euro area which is now entrusted exclusively to the ECB. In addition, a central European government is the only institution that can fully back the ECB."

"Finally, the absence of a minimal degree of budgetary integration that can form the basis of an insurance mechanism is another flaw in the design of European monetary union. (…) It is difficult to conceive how a union can be politically sustainable if each time a country of the union gets into trouble because of asymmetric developments, it is told by the other members that it is entirely its own fault and that it should not count on any help. Such a union will not last."



- Nicoli (2017) claims that the European economic integration is subject to the legitimacy trilemma summarized just above.
- Shambaugh (2012) explains the challenge to the euro's viability in 2012 by the confluence of three interdependent crises (see the sketch on the right). (i) Banks had liquidity problems (banking crisis). (ii) Governments had funding problems, with yields on government bonds sky-rocketing (sovereign debt crisis). (iii) Economic activity slowed down (growth crisis). The euro implied that severe economic problems can no longer be contained within the countries initially experiencing the problems, as now these problems easily cross national borders.



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Varoufakis, Yanis (2016): And the weak suffer what they must? Europe's crisis and America's economic future, Nation Books, New York.

• The covers of *The Economist* masterly illustrate the troubles of both the eurozone (the debt crisis) and the EU (Brexit).

January 15th–21st 2011

May 26th-June 1st 2012

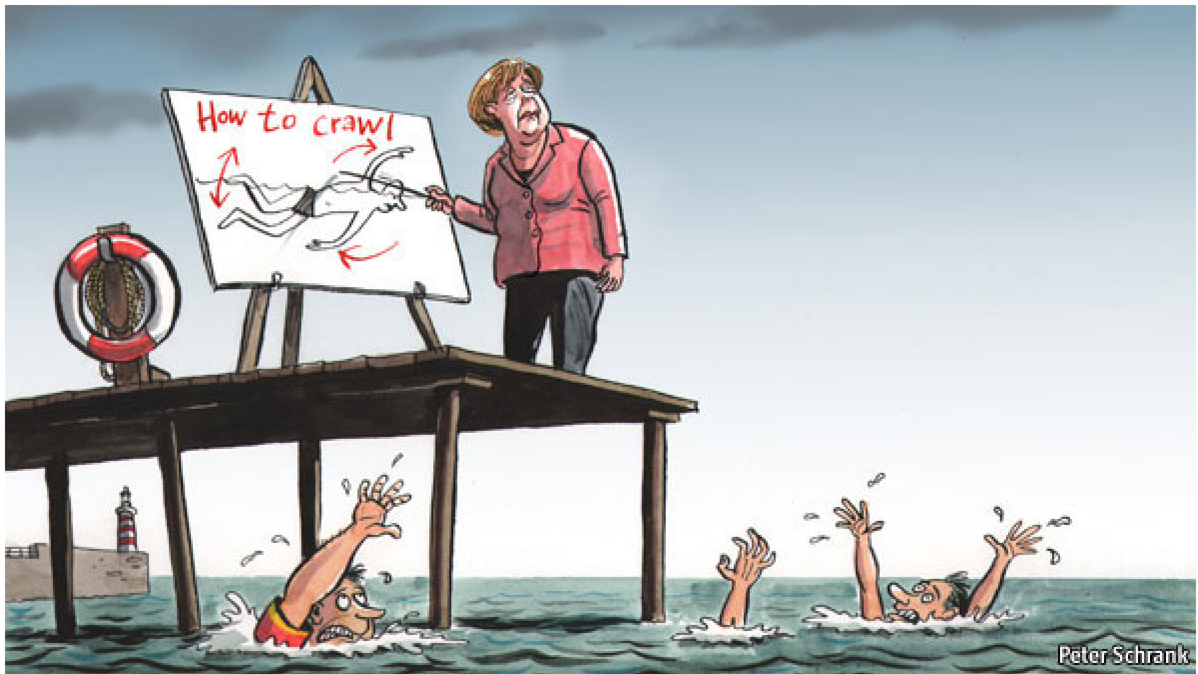
September 14th–20th 2013

July 22nd, 2017

November 24th, 2018

July 27th, 2019

• A good cartoon conveys nicely the essence of a problem or situation.



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April 18 2013

https://www.ft.com/content/44c56806-a556-11e4-ad35-00144feab7de

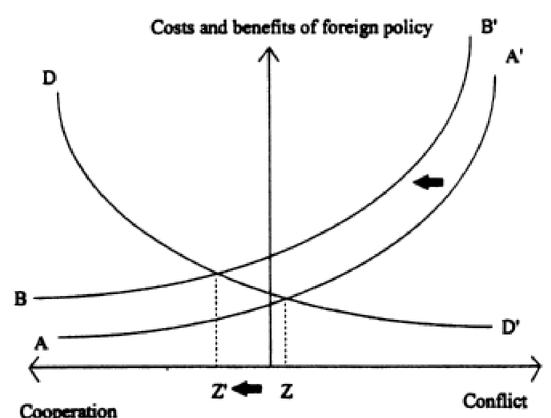
January 27 2015

7. Cooperation vs competition (models of economic cooperation)

The problem of international policy cooperation is one for which easy and simple models have been developed to understand under which condition cooperation dominates and under which it is competition that dominates. Some papers illustrating this approach are selected in the penultimate bibliography section.

8. Conflict (models of economic sanctions, trade friction and trade wars)

Game-theoretic models are well-suited to model conflict situations in economic contexts. Two such situations are associated with the decision to raise trade barriers (or retaliate existing barriers) and the decision to impose economic sanctions on some other country. The last bibliography section includes some such formal papers. Polachek (1980), in particular, devised a model to ascertain the optimal level of conflict; the graph on the right represents the model graphically (where the upward sloping function AA' represents marginal cost, the downward sloping function DD' represents marginal benefits and the intersection determines the equilibrium level of conflict Z; the graph shows what happens to this level when the marginal cost function shifts to the left, to BB').



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