

The economics of EMU

Background studies

for *European Economy* No 44

'One market, one money'

List of authors

Filip Abraham, Centrum voor Economische Studiën, Katholieke Universiteit Leuven

George Alogoskoufis, Birkbeck College, University of London, and CEPR

Richard E. Baldwin, Graduate Institute of International Studies, Geneva, CEPR and NBER

David Begg, Birkbeck College, University of London, and CEPR

Michael Emerson, Director for the evaluation of Community policies, Directorate-General for Economic and Financial Affairs, Commission of the European Communities

Alberto Giovannini, Columbia University, New York, CEPR and NBER

Dirk Heremans, Centrum voor Economische Studiën, Katholieke Universiteit Leuven

Richard Lyons, Columbia University Business School, New York, CEPR and NBER

Willem Molle, Netherlands Economic Institute, Rotterdam

Robert Morsink, Netherlands Economic Institute, Rotterdam

Manfred J.M. Neumann, University of Bonn and CEPR

Jean Pisani-Ferry, Economic Adviser, Directorate-General for Economic and Financial Affairs, Commission of the European Communities

Frederick van der Ploeg, Centre for Economic Policy Research, Tilburg University

Richard Portes, Birkbeck College, University of London, and CEPR

Paul Van Rompuy, Centrum voor Economische Studiën, Katholieke Universiteit Leuven

Axel A. Weber, University of Siegen and CEPR

Charles Wyplosz, European Institute of Business Administration (Insead), EHESS and CEPR

Contents

List of authors	3
Introduction	11
<i>Jean Pisani-Ferry and Michael Emerson</i>	
I. Economic integration, efficiency and growth	19
1. On the microeconomics of the European monetary union	21
<i>Richard E. Baldwin</i>	
1. Introduction	21
2. Static real effects of moving to a single currency	21
3. Medium-term growth effects: induced capital formation	27
4. EMU, the riskiness of investment and induced capital formation	28
5. Long-term growth effects of European economic and monetary union	30
6. Measuring the quantifiable effects	32
7. Summary and concluding remarks	34
References	35
2. Direct investments and monetary integration	36
<i>R. L. A. Morsink and W. T. M. Molle</i>	
1. Introduction	36
2. Theoretical background	36
3. European direct investment in Europe: the data set	42
4. Empirical validity of the model	45
5. Conclusions	52
Appendix	53
References	55
3. External economies and European integration: the potential for self-fulfilling expectations	56
<i>Richard E. Baldwin and Richard Lyons</i>	
1. Introduction	56
2. The logic of self-fulfilling expectations	57
3. A selective survey of models with multiple equilibria	59
4. Self-fulfilling expectations in unemployment: an illustrative model	62
5. Conclusions	70
Appendix 1: A simple exposition of Krugman's model	70
Appendix 2: Unemployment hysteresis	72
References	74

II. Monetary policy and price stability	77
4. Central bank independence as a prerequisite of price stability	79
<i>Manfred J. M. Neumann</i>	
1. Introduction	79
2. The political economy of inflation	79
3. Constitutive features of an independent central bank	83
4. Central bank independence as a commitment to price stability	87
5. Central bank independence and EMU	88
References	91
5. Money demand and monetary control in an integrated European economy	93
<i>Alberto Giovannini</i>	
1. Introduction	93
2. Gresham's law with fiat currencies	93
3. Money demand and currency substitution	94
4. The management of foreign-exchange reserves during the transition to monetary union	102
5. Summary and concluding remarks	105
References	106
III. Macroeconomic policy and public finance	107
6. Economic federalism and the EMU	109
<i>Paul Van Rompuy, Filip Abraham and Dirk Heremans</i>	
1. Introduction	109
2. Economic federalism: theory and facts	109
3. The relevance of economic federalism for the EMU	121
4. General conclusions	132
References	134
7. Macroeconomic policy coordination issues during the various phases of economic and monetary integration in Europe	136
<i>Frederick van der Ploeg</i>	
1. Introduction	136
2. General issues of macroeconomic policy on the road to economic and monetary integration	136
3. European coordination of macroeconomic policies during the various phases of economic and monetary integration: stabilization aspects	141
4. European coordination of macroeconomic policies during the various phases of economic and monetary integration: public finance aspects	147
5. Counterproductivity of macroeconomic policy coordination	155
6. Conclusions	158
References	160

8.	Monetary union and fiscal policy discipline	165
	<i>Charles Wyplosz</i>	
	1. Introduction	165
	2. Long-term channels of externalities	166
	3. The budget constraint	172
	4. Externalities	177
	5. New fiscal policy needs in a monetary union	179
	6. Conclusion	182
	Appendix: The Frenkel-Razin model	182
	References	184
IV.	Shocks and adjustments in a monetary union	185
9.	EMU and asymmetries and adjustment problems in the EMS — Some empirical evidence	187
	<i>Axel A. Weber</i>	
	1. Introduction	187
	2. Are shocks asymmetrical and exogenous?	187
	3. Summary and conclusions	203
	Appendix: Data descriptions	205
	References	206
10.	Alternative exchange rate regimes: the role of the exchange rate and the implications for wage-price adjustment	208
	<i>David Begg</i>	
	1. Introduction	208
	2. An outline of the model	208
	3. Long-term equilibrium	209
	4. Dynamics in the absence of shocks	211
	5. Temporary shocks	214
	6. Permanent shocks	215
	7. Calibrating the model	217
	8. Conclusions	218
	Appendix: EMU versus the EMS: a formal model of dynamic adjustment	219
	References	227
V.	The international dimension	229
11.	International costs and benefits from EMU	231
	<i>George Alogoskoufis and Richard Portes</i>	
	1. Introduction	231
	2. European monetary union and international institutions	231
	3. The international role of the ecu	234
	4. EMU, international exchange rate regimes and the coordination of macroeconomic policies	241
	References	245