Pehr-Johan Norbäck / Swedish Program

Course: The Economics of European Integration

Brexit, Euro-crises, rising populism and nationalistic parties, migration, security threats, refugee crises— there has been no shortage of problems in today's European Union (EU). Adding to all this, the present COVID19 crises with lockdowns of member countries and the breakdown of the Single Market, may produce the worst crises ever in the EU's roughly sixty years of existence. Yet, it is only a few years ago that the EU was awarded the Nobel Peace prize for its contributions in maintaining peace and stability in Europe. Why has the European integration project which for many years was running smoothly now seem to have run into a halt? How can we understand this development?

We start with an *overview* of the history of the European Union (EU) — beginning at the end of World war II and proceeding up to the present. We introduce the main European institutions, how they work and their evolution. We describe the enlargement from the original six to the present 27 members.

We will, of course, highlight the United Kingdom's difficult relationship with Europe: first staying out, then reluctantly joining —and then in 2016, on a small margin and after a volatile and intense campaign—choosing to leave the EU. How will the UK's relationship with the EU look like in the future after leaving on January 31, 2020? Only a Free trade Agreement? A No-Deal Brexit under WTO-rules (this looks increasingly likely under the new prime minister Boris Johnson)? Will the UK cave in to EU's demand on so-called "level-playing field regulation"; what about market access for British financial services? Tensions are rising in the trade talks with the EU's formidable chief negotiator Michel Barnier. We will see how Brexit unfolds during the summer and fall of 2020.

European Integration has foremost relied on economic integration. The idea was that deeper economic integration would draw Europeans into closer and intricate economic exchanges. This would eventually promote a shift to closer political integration. A closer political integration, in turn, would ensure a peaceful and stable future Europe.

In the Treaty of Rome in 1957, France, Germany, Italy and the Benelux countries agreed to the so-called "four freedoms": among the six there would be free movement of goods, services, people and capital. To administrate this European Economic Community (EEC), the six agreed to create common institutions such as the European Commission, the European Parliament, the Council of Ministers and the European Court of Justice.

The first part of the course looks at this early period of integration—the time before the Maastricht Treaty in 1991—and deals with the economic impact of the four freedoms. We will first show how free movement of goods create gains to trade when trade patterns are driven by comparative advantage. This "old trade "theory" explains why countries export some goods and import other goods (inter-industry trade). We will also study more recent models of trade with scale economies, product differentiation and imperfect competition which explain trade in similar types of goods and services (intra-industry trade). The latter "new trade theory" provides a solid understanding of the strong growth in trade and income that followed the initial integration in Europe in the 1950ies and 1960ies.

In general, we will show that the four freedoms lead to a more efficient resource allocation, conducive to economic growth. The better economic performance of the member countries makes it more attractive to other countries to seek membership, and the more countries that join, the worse it becomes to be left outside. Enlargement becomes self-sustaining. Successive enlargements occur over the years. The last is the Eastern enlargement which follows the fall of the Iron Curtain.

While integration creates overall gains through higher incomes and wealth, there are also “winners and losers”. Indeed, when we look at the budget of the European Union, we note that most of the EU’s limited resources is redistribution between different groups, regions or countries. And European integration does not take place in isolation. Concluding the first part of the course, we discuss the challenges arising from migration, globalization, offshoring of production to low wage countries and automation. We relate these findings to the outcome of the Brexit referendum, and the resistance against migration and free movement, as well as the rise of populist and nationalistic parties in Europe.

The second part of the course deals with monetary integration and the adoption of the single currency—or the EURO—following the Maastricht Treaty in 1991. One the one hand, the single currency can be viewed as a natural step in the integration process to further enhance economic efficiency and increase growth in Europe. One the other hand, the decision to adopt the single currency can be viewed as highly political: a quid-pro-quo deal between France and Germany, where the EURO was the ultimate price France demanded to agree to German unification. 19 out of the 28 present member countries in the EU have now adopted the EURO.

The financial crises in 2007 had a strong negative impact on the EURO zone which strengthened rising skepticism against the European project.

To understand why the downturn became so deep, we first review basic macro concepts such as interest parity, purchasing parity and the determination of exchange rates. We then look at how the choice of the exchange rate regime affects a government’s possibilities to pursue independent economic policy and relate this to the creation of the EURO. We note that the Eurozone members share a common central bank with behavioral rules substituting for a common fiscal backstop.

We look the theory of optimal currency areas which reveals why many economists (especially Americans with otherwise very different views such as Milton Friedman and Paul Krugman) were very skeptical to EURO-project. We discuss whether the core problem with the EURO even lies in philosophical differences between the founding countries of the Eurozone, particularly Germany and France. We also show how the omission of the financial sector and financial stability from the Maastricht Treaty, contributed to EURO crises. We end with a discussion of the future of the EURO, and the EU, and different suggestions to reform and revive the European integration project. We also discuss how the present COVID19 crises may bring necessary reforms of the EU, where the new proposed recovery fund which may be the start of an EU-wide fiscal policy.

Upon completion of this course, you will be able to:

- Explain **why economic integration** was chosen in Europe in favor of political integration.
- Have a basic understanding of the **main EU institutions** and **the historical evolution** of the EU institutions.
- Explain how **Europe has gained from integration** using economic theory (use, for instance, Ricardian comparative advantage, new trade theory models of imperfect competition and scale economies and Solow type growth models).
- Explain how integration can make **some groups worse off** and how this has shaped **EU policies**.
- Assess the EURO project using the theory **of optimal currency areas**.
- Explain why the aftermath of the **financial crises** has been **worse in Europe** than in the US.
- Discuss the **crises in Greece and in the Southern European** countries and relate to the EURO project.
- Discuss reasons for and consequences of **Brexit**
- **Discuss how the EU and its members countries have handled the COVID19 crises and how this may shape the EU in the future**

Practical Information

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Lectures: Tuesdays, 09.00-12.00
Room: See below
Visit hours: Tuesdays, 12.00 (after lectures)

Prerequisites: Two courses in macroeconomics, Two courses in microeconomics, and one course in calculus.

Examination and Grading: A maximum of 100 points can be achieved in the course.

All students will have to do **4 mandatory problem** sets during the course. There will be a **mid-term exam**, as well as an **end-term** exam. **Active** participation in class is also required.

40 points will be based on the problem sets, 30 points on the mid-term exam and 30 points on the end-term exam.

Students can also write **two optional small papers** which gives 5 points each to increase their grade (100 points will still be the maximum amount).

Problem sets
Students may cooperate when doing problem sets, but you will need to submit your own solution. Remember that problem sets are learning experiences. Try to do it on your own first,

and then ask your classmates. This strategy will help you on the mid-term exam and the final exam – if you just copy what somebody else did, you won't know what to do on the exams!

You should hand in solutions to a problem set on the next lecture (that is, normally, you will have one week to do them). I will then go through the solutions 08.15-08.30, in order not to take time from class which starts at 08.30. The run through of solutions is voluntary to attend.

Lecture notes

- Lecture notes will be posted on course web: https://classroom.google.com
- Lecture notes are used as additional material. I will present most of the material on the whiteboard.

Literature

"The Economics of European Integration", by Richard Baldwin and Charles Wyplosz, fifth the Edition.

"**International Economics",** by Robert C. Feenstra (University of California, Davies) and Alan M. Taylor (University of California, Davies), Worth Publishers, third edition, 2014.

The EURO and the battle of ideas, by Markus Brunnermeier, Horald James and Jan-Pierre Landau. Princeton University Press, 2016.

Course Outline: preliminary!

1	Lecture 1: Overview of European integration and European Institutions. (**BW 1-3).**
2	Lecture 2: Gains and losses from Trade in The Ricardian model, **(F/T 2).** The Eastern Enlargement. *Problem set #1 handed out.*
3	Lecture 3: Gains and losses from Trade in the Specific-Factors Model (**F/T 3**). *Problem set #2 handed out.*
4	Lecture 4: (**F/T 6** and **B/W 6**). Trade with increasing returns to scale and imperfect competition. The gravity model. Agglomeration.
5	Lecture 5: (**F/T 7, BW 7**). Offshoring of Goods and Services. Globalization, Digitalization and Inequality.

6	*Mid-term-exam*. (Material: **FT 2-FT3, BW 1-3, F/T 6** and **F/T 7)**
7	Lecture 6: Import Tariffs and trade policy **(FT 8). The UK, Brexit and the CAP.** *Problem set #3 handed out.*
8	Lecture 7: Labor market integration and Migration. Growth effects of European Integration **B/W 7 .** *Problem set #4 handed out.*
9	Lecture 8: European Monetary integration. “The impossible trinity” (**BW 13-14)** *Optional problem sets handed out*
10	Lecture 9: European Monetary integration The EURO and optimum currency areas. Swedish crises. (**BW 13-16, BHL 1-2)**
11	Lecture 10: Maastricht Treaty and the EURO, Financial markets. The EURO zone in crises. (**BHL 5-8, 10)**
12	Lecture 11: Future of European Economic Integration. **COVID-crises**. **(BW 16-19, BHL 1, 5-8, 10)**.
13	*Final exam*. (on material covered after midterm)