

Course: The Economics of European Integration

Revised 24/8, 2022

Euro-crises, Brexit, rising populism and nationalistic parties, migration, security threats, refugee crises, internal conflicts— there has been no shortage of problems for the European Union (EU). On top of this, Covid and soaring energy prices following the Russian invasion of Ukraine threaten the economic recovery. Yet, the EU has survived past crises, and post-Covid, it has equipped itself with new policy instruments unthinkable only a few years ago. This course will give you an overview of the long and windy road of European Integration, from past to present.

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 leading European institutions, their roles, 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 complex 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. We discuss the Trade and Cooperation Agreement between the EU and the UK and the Withdrawal Agreement with the contentious Northern Ireland protocol, over which we will see increased conflict during the autumn.

European Integration has foremost relied on economic integration. The idea was that deeper economic integration would draw Europeans into closer and more intricate economic exchanges. Economic integration would eventually promote a shift to tighter political integration. A closer political integration, in turn, would ensure a peaceful and stable future in 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 the free movement of goods creates gains to trade under trade 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 trade models 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.

We will show that the four freedoms lead to a more efficient resource allocation conducive to economic growth. Improved 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 go to redistribution between different groups, regions, or countries. European integration does not take place in isolation. In concluding the first part of the course, we discuss the challenges of migration, globalization, automation, and offshoring of production to low-wage countries. We relate these findings to the outcome of the Brexit referendum, the resistance against migration and free movement, and the rise of populist and nationalistic parties in Europe.

The second part deals with monetary integration and adopting the single currency—or the EURO—following the Maastricht Treaty in 1992.

The single currency can be viewed as a natural step in the integration process to enhance economic efficiency further and increase growth in Europe. But the decision to adopt the single currency can also be viewed as a political 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 strongly impacted the EURO zone and strengthened rising skepticism against the European project. To understand why the EURO crisis 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 central bank with behavioral rules substituting for a common fiscal backstop and discuss the drawbacks of such a system.

We look at 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 of the 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 the EURO crisis.

We end with a discussion of the future of the EURO and the EU and suggestions to reform and revive the European integration project. Finally, we will also discuss how the present COVID19 has contributed to necessary reforms in the EU, where the new recovery fund NG-EU may be the start of a new EU-wide fiscal policy financed by common borrowing.

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 **leading EU institutions** and the **historical evolution** of the EU institutions.
- Explain how **Europe has gained from integration** using economic theory (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 the Southern European** countries and relate them to the EURO project.
- Discuss reasons for and consequences of **Brexit**
- **Discuss how the EU and its member countries have handled the COVID19 crises and how this may shape the EU in the future.**

Practical Information

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Lectures: Mondays, 09.00-11.45
Room: 975a (Swedish Program Classroom)
Visit hours: Mondays, 11.45 (after lectures)

Prerequisites: One course in macroeconomics, one course 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).

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, Harald James and Jan-Pierre Landau. Princeton University Press, 2016.

Course Outline: preliminary!

2/9: Room 133	Lecture 1: Overview of European integration and European Institutions. (BW 1-3) .
9/9: Room 348	Lecture 2: Gains and losses from Trade in The Ricardian model, (F/T 2) . The Eastern Enlargement. <i>Problem set #1 handed out.</i>
16/9: Room 133	Lecture 3: Gains and losses from trade in the Specific-Factors Model (F/T 3) . <i>Problem set #2 handed out.</i>
23/9: Room 348	Lecture 4: (F/T 6 and B/W 6) . Trade with increasing returns to scale and imperfect competition. The gravity model with applications.

30/9: Room 348	Lecture 5: (F/T 7, BW 7). Offshoring of Goods and Services. Globalization, Digitalization and Inequality.
7/10: Room 133	<u>Mid-term-exam.</u> (Material: FT 2-FT3, BW 1-3, F/T 6 and F/T 7)
14/10: Room 348	Lecture 6: Import Tariffs and trade policy (FT 8). The UK, Brexit and the CAP. <i>Problem set #3 handed out.</i>
21/10: Room 320	Lecture 7: Labor market integration and migration. Growth effects of European Integration B/W 7 . <i>Problem set #4 handed out.</i>
11/11: Room 328	Lecture 8: European Monetary integration. “The impossible trinity” (BW 13-14) <i>Optional problem sets handed out</i>
18/11: Room 133	Lecture 9: European Monetary integration The EURO and optimum currency areas. Swedish crises. (BW 13-16, BHL 1-2)
TBA (zoom or other day)	Lecture 10: Maastricht Treaty and the EURO, Financial markets. The EURO zone in crises. (BHL 5-8, 10)
2/12	Lecture 11: Future of European Economic Integration. (BW 16-19, BHL 1, 5-8, 10).
9/12	<u>Final exam.</u> (only material covered after midterm)