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Chapter 1

History

The Economics of European Integration, Sixth Edition

Early Post War Period: climate for radical change

Europe has experienced horrifying wars and was in ruins after WWII:

- Mainly as an effect of governmental failures
- Pictures show London in late 1940 (left) and Dresden in 1945 (right)

Figure 1.1 London Hospital in late 1940 and Dresden 1945

Early Post War Period: climate for radical change

- During the Second World War, millions of people died.
- The war also caused enormous economic damage.

Table 1.1 Death and destruction in the Second World War

	Death toll	The economic setback: pre-war year when GDP equalled that of 1945
Austria	525,000	1886
Belgium	82,750	1924
Denmark	4,250	1936
Finland	79,000	1938
France	505,750	1891
Germany	6,363,000	1908
Italy	355,500	1909
Netherlands	250,000	1912
Norway	10,250	1937
Sweden	0	(a)
Switzerland	0	(a)
UK	325,000	(a)

(a) GDP grew during the Second World War.

Source: GDP data from Crafts and Toniolo (1996), p. 4; death toll from https://en.wikipedia.org/wiki/World_War_II_casualties

The prime question in 1945

Prime concern: ‘How can Europe avoid another war?’

- What caused the war? - Three schools of thought were in evidence
  - blame Germany;
  - blame capitalism;
  - blame nationalism.

- These answers implied 3 very different solutions
  - ‘Neuter’ Germany to avoid any future aggression;
  - adopt communism;
  - pursue European integration.

→ European integration ultimately prevailed, but this was far from clear in the late 1940s.

Emergence of a divided Europe

The economic, political and military situation in Europe after WWII.

- Germany was divided into the US, UK, French, and Soviet zones.
- The Soviet Union led communism spread in East Europe quite aggressively.
- America and Britain rejected the Soviet vision and this confrontation lead to the 'Cold War'. The division ruled European realities for a half century.
- The US, UK, and French zones merged in 1947/8.
- 'Berlin Blockade' and 'Berlin air bridge' in 1948.
- The Federal Republic of Germany established in 1949.

→ The merger of the French, US and UK zones was a defining moment in Europe and a precursor of European integration.

First steps in European integration

Marshall Plan (1948)

- The USA offered financial assistance if countries agreed on a joint programme for economic reconstruction.
- Marshall Plan aid amounted to $12 billion, with half of this going to the UK, France and West Germany.
- The Organisation for European Economic Cooperation (OEEC) administered this aid and prompted trade liberalization:
  - The OEEC (which in 1961 became the OECD) started in 1948 with 13 western members of today's EU plus Norway, Iceland, Switzerland and Turkey.
  - It advanced European integration.
- The European Payment Union (EPU) facilitated payments and fostered trade liberalization.

→ New view: trade liberalization could be pro-growth and pro-industrialization.

The drive for deeper European integration

The OEEC was an economic success boosting income,

- but would it prevent another war between France and Germany?
- The OEEC and EPU produced booming imports and exports, and rising incomes.
- But some OEEC members felt that European integration would have to be much deeper to make a new war unthinkable.
- The problem was that European nations disagreed sharply on how European integration should move beyond the OEEC and EPU.
- Fundamental disagreement about the depth of European integration.
- The debate over whether we need ‘more Europe’ or ‘less Europe’ has been going on since the 1950s until today.

Two strands of European integration

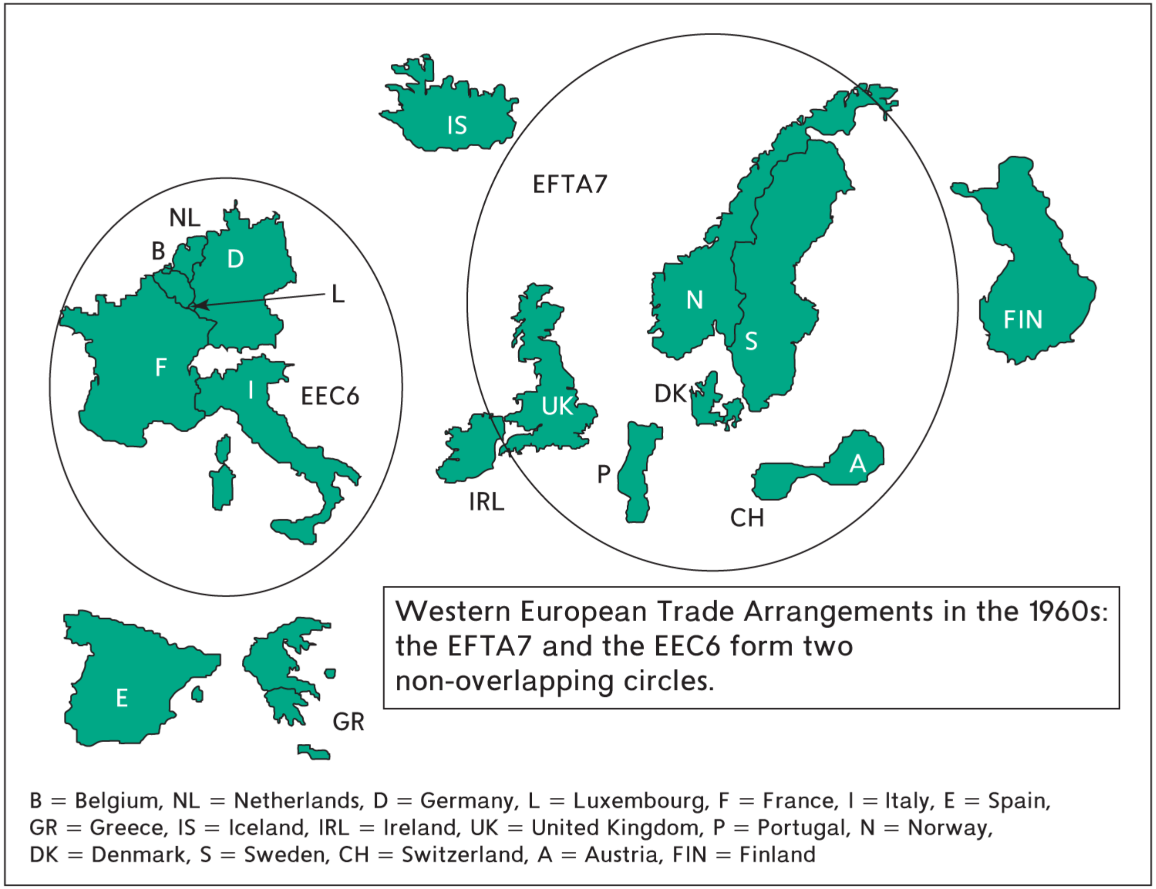
Federalism vs Intergovernmentalism

- The two concepts display the disagreement about the depth of European integration. They describe the trade-off between European integration and national sovereignty.
- Intergovernmentalism: nations retain all sovereignty with only international cooperation
  - OEEC (1948), Council of Europe (1949), Court of Human Rights (1950), and EFTA (1960).
- Federalism: supranational institutions
  - ECSC (1951): Belgium, France, Germany, Italy, Netherlands, and Luxembourg (the 'Six') place their coal and steel sectors under the control of a supranational authority (Schuman Plan);
  - EEC (1957): riding on the success of the ECSC, the 'Six' committed to form a customs union, promise free labour mobility, capital market integration, free trade in services, and a range of common policies;
  - but also failures: EDC and EPC.

Two non-overlapping circles

Situation by the late 1960s: European countries either joined the EEC or the EFTA with economic discrimination between the two groups:

Figure 1.4 A Europe of two non-overlapping circles



Source: Baldwin (1994)

Evolution to two concentric circles: domino effect I

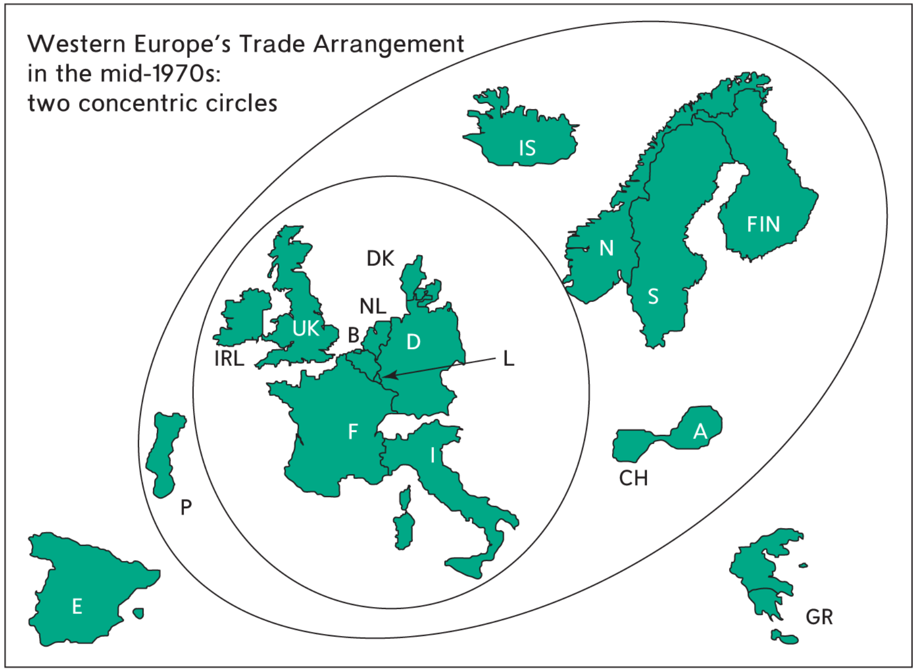
- Falling trade barriers <u>within</u> the EEC and <u>within</u> EFTA (but not between) led to discrimination.
- The GDP (i.e., potential market size) of the EEC was much larger than that of EFTA (and EEC incomes were growing twice as fast).
- Thus, the EEC club was far more attractive to exporters and this led to new political pressure for EFTA nations to join the EEC.
- The UK applied for membership in 1961 and Denmark, Ireland, and Norway also followed, as they would otherwise face even stronger discrimination with the UK joining EEC.
- Other EFTA nations did not apply because of political reasons such as neutrality (Switzerland), lack of democracy (Portugal) or relative independence from EEC market (Iceland).
- Charles De Gaulle stopped UK membership twice. Denmark, Ireland, and the UK joined in 1973 while Norwegians said no in a referendum.

Evolution to two concentric circles: domino effect I

Firms based in the remaining EFTA states would suffer a disadvantage (trade diversion effects):

- EFTA industries pushed their governments to address this situation;
- Resulted in a set of bilateral free trade agreements (FTAs) between each remaining EFTA nation and the EEC.

Figure 1.5 A Europe of two concentric circles



Note: See Figure 1.4 for abbreviations and source.

Euro-pessimism, 1973-1986

- Political shocks:
  - ‘Luxembourg Compromise’ + enlargement = decision-making jam;
  - unanimity was the typical rule in EEC decision-making procedures: the insistence on consensus radically reduced the EEC’s ability to make decisions.
- Economic shocks:
  - Bretton Woods falls apart, 1971-1973;
  - EEC failed to establish monetary union (Werner Plan was put on hold);
  - 1973 and 1979 oil price shocks with stagflation;
  - introduction of ‘technical barriers to trade’ as substitute for tariffs brought back trade frictions.
- However, also some bright spots:
  - democracy in Spain, Portugal and Greece lead to their accession;
  - EMS set up in 1978 works well;
  - Budget Treaties (1970 and 1975) and direct election of EU Parliament (1979).

Deeper circles: Single Market Programme

The Single European Market (SMP) was a powerful boost to European economic integration:

- Jacques Delors launched completion of the internal market;
- The Single European Act (SEA, 1987) aimed to create 'an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured' (i.e., the **four freedoms** already promised by the Treaty of Rome);
- It also implemented important institutional changes: majority voting instead on unanimity on issues related to the Single European Market;
- This change in voting procedures unleashed a massive wave of TBT liberalization and gave a big boost to further trade integration;
- 'Investment diversion' effect (on top 'trade diversion' effect already by customs union).

Single Market Programme

Basic elements of the Single Market Programme (SMP):

- Goods trade liberalization
  - streamlining or elimination of border formalities;
  - harmonization of VAT rates within wide bands;
  - liberalization of government procurement;
  - harmonization and mutual recognition of technical standards in production, packaging, and marketing.
- Factor trade liberalization
  - removal of all capital controls;
  - liberalization of cross-border market-entry policies, including mutual recognition of approval by national regulatory agencies.
- Increasing cross-border supply chains as a result.

Deeper circles: ‘Domino effect part II’

Deeper integration in EC12 strengthened the ‘force for inclusion’ in remaining EFTA nations.

New ‘forces for inclusion’ lead to a further domino effect (part II):

- European Economic Area (EEA) initiative (1989) to extend single market to EFTA nations.
- Membership applications by all EFTA nations except Iceland and Liechtenstein:
  - Norwegian rejected (again) membership in a referendum;
  - Switzerland only adopted a EEA-like bilateral deal with EU.
- The fourth enlargement (1995) adds Austria, Finland, Sweden, and leads to the EC15.

Communism's spectacular collapse

- Division of Europe was cemented by the Berlin Wall (1961).
- By the 1980s, West's economic system provided a far better way of life and living standards diverged.
- Up to 1980s, Soviets thwarted reform efforts but inadequacy of Soviet system forced changes in USSR:
  - timid pro-market reforms (perestroika);
  - openness (glasnost).
- End of 1990: independence of Estonia, Latvia, and Lithuania.
- End of 1991, the USSR itself breaks up.
- Former Soviet Republics becoming independent nations or merging with Russia.

Velvet revolutions in CEECs

- Pro-democracy forces in the central and eastern European countries (CEECs) had been repeatedly put down by military force hereto but found little resistance from Moscow in the late 1980s:
- June 1989: Polish labour movement 'Solidarity' forced free parliamentary elections and communists lost. Moscow accepted new Polish government.
- Moscow's hands-off approach to the Polish election triggered a chain of events:
  - Hungary opened its border with Austria and many East Germans moved to West Germany via Hungary and Austria;
  - mass protests in East Germany; Wall falls 9th November 1989;
  - end of 1989: democracy in Poland, Hungary, Czechoslovakia;
  - end of 1990: German re-unification.
- The Cold War ended without a shot and with it, the military division of Europe ends.

The Maastricht Treaty

The collapse of the Soviet-bloc landscape started a chain of events that massively changed the EU:

- On the success of the Single Market, Delors proposes 2nd radical increase in European economic integration: monetary union.
- **Maastricht Treaty** signed 1992 committed EU countries to achieve monetary union by 1999, and a single currency to put into circulation by 2002.
- Further elements:
  - EU citizenship;
  - strengthened EU cooperation in non-economic areas (justice, defense etc.);
  - strengthened the power of the European Parliament;
  - introduced the 'Social Chapter'.
- Ratification difficulties:
  - Britain opted out of common currency;
  - Danish voters rejected the Treaty and reversed their choice only once Denmark opted out of common currency.

Reuniting East and West Europe

CEEC announced that their goal was to join the EU:

- At first, no promise of eventual membership was made.
- but ‘Europe Agreements’ were introduced: free trade agreements with promises of deeper integration and some aid.
- In 1993, the EU sets the Copenhagen criteria for accession of CEECs:
  - political stability of institutions that guarantee democracy, the rule of law, human rights, and respect for and protection of minorities;
  - a functioning market economy capable of dealing with the competitive pressure and market forces within the Union;
  - acceptance of the Community ‘acquis’ (EU law in its entirety) and the ability to take on the obligations of membership.
- Copenhagen summit (2002) says CEEC nations plus Cyprus and Malta join in 2004 (5th enlargement).

Preparing for eastern enlargement

- Envisaged enlargement required EU to reform its institutions.
- The EU's institutions, earlier designed for six members and were straining to work with fifteen, had to change if they were to continue to work with a dozen new members.
- The process was politically painful for the existing EU members since almost every change helped some EU15 nations but hurt others.
- Basic dilemma: while there was a shared understanding of the institutional challenges, there was little agreement on the solutions.
- Four attempts at reform over a 16-year period:
  - Amsterdam Treaty, 1997;
  - Nice treaty, 2000;
  - Constitutional Treaty, 2004;
  - Lisbon Treaty, 2007.

Amsterdam Treaty (1997)

The Amsterdam Treaty is best thought of as a tidying up of the Maastricht Treaty, but failed to agree main reforms set out:

- It did tie up the Maastricht Treaty in the following areas:
  - more social policy;
  - parliament powers modestly boosted;
  - flexible integration, 'closer cooperation introduced'.
- But no agreement on
  - Reform of Commission;
  - Reform of Council voting rules;
  - on list of areas to move to 'Qualified Majority Voting' (QMV).
- The 'Amsterdam leftovers' would be addressed by a future Treaty.

Nice Treaty (2000)

EU leaders met in Nice in December 2000 to wrap up a new treaty that was supposed to deal with the Amsterdam leftovers:

- Not successful.
- The critical Amsterdam leftover issues – the size and composition of the Commission, extension of majority voting in the Council of Ministers, and reform of Council voting rules – were not fully solved.
- The Nice Treaty experienced some trouble with ratification, but far less than the Maastricht Treaty.
  - Irish voters initially rejected the Treaty. After some concessions were granted to Ireland, Irish voters accepted the Treaty.

Constitutional Treaty (2000 – 2004)

One year after Nice Treaty, EU leaders adopt the 'Laeken Declaration' and set up the 'Convention on the Future of Europe' to outline a new Treaty.

- In light of the difficult Nice Summit, the Laeken Council also decided on a novel working method: The European Convention.
- The Convention decided to write a 'Constitution', which was signed in Rome in 2004.
- France and Netherlands rejected the Constitutional Treaty in referendums in 2005 and EU leaders suspend the ratification process.
- In reaction, EU leaders declared a 'period of reflection'.

Lisbon Treaty (2007)

- Under the German EU Presidency, EU leaders declared the Constitutional Treaty to be dead and agreed on the basic outlines of its replacement: the Reform Treaty, also known as the Lisbon Treaty (2007).
- Much of the Constitutional Treaty is taken up in the Lisbon Treaty but ‘rephrased’:
  - all the grandiloquent language and gestures to supranationalism were dropped;
  - all references to symbols of statehood were eliminated;
  - the word ‘constitution’ was banished.
- Goal was to avoid referendums without changing the substance. But Irish Constitution required a referendum: Irish voters initially rejected the Treaty, reversing their vote after some concessions.
- The Lisbon Treaty came into effect in December 2009 and represents the status quo → key features are addressed at length chapters 2+3.

Eurozone Crisis

European Monetary Union seemed to work during the ‘Great Moderation’:

- Interest rate convergence caused by EMU formation (sign of confidence).
- But this confidence turned out to be misplaced and sharp divergence was triggered by the crisis.

The Lehman’s bankruptcy in September 2008 witnessed the formation of the biggest and fastest-moving snowball effect that the world has ever seen, turning the world into a deep recession which hit the Euro area hard.

Eurozone Crisis

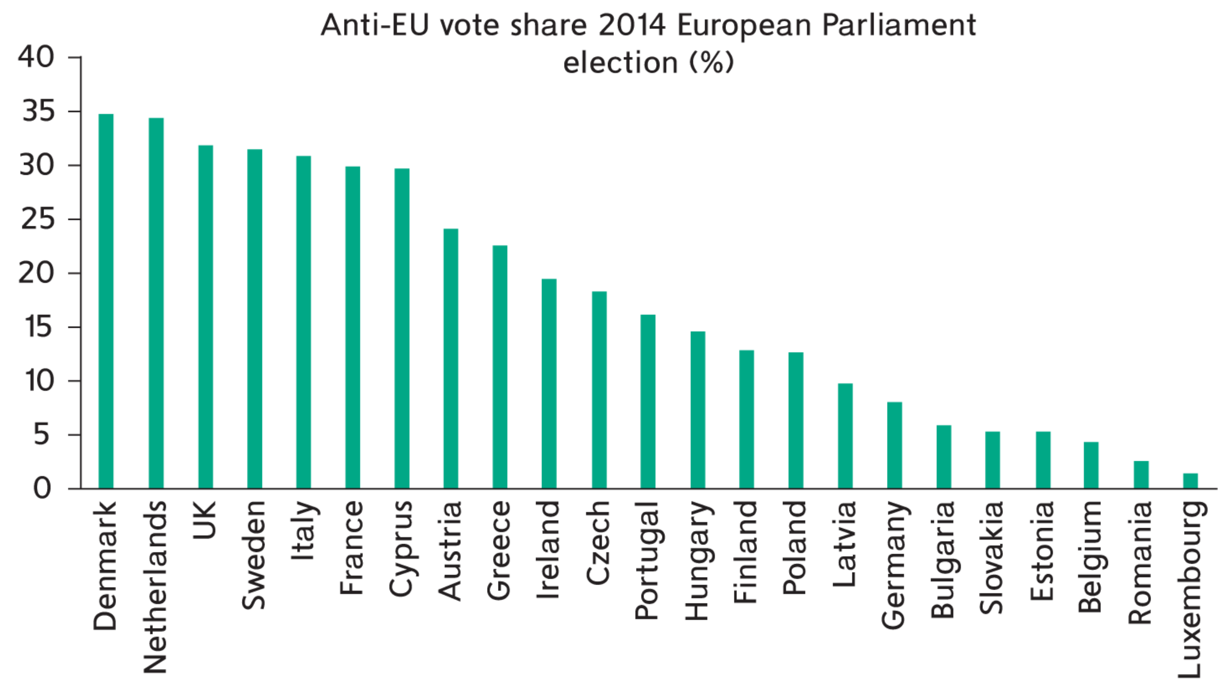
- Emergency loans and packages:
  - Greece (May 2010);
  - Ireland (February 2012);
  - Portugal (May 2011);
  - Spanish banks (July 2012) and
  - Cyprus (May 2013).

- Massive institutional reforms were introduced along with transferring sovereignty to the Eurozone level and new rules, such as
  - Balanced budget rules;
  - Six Pack;
  - European Stability Mechanism;
  - European Banking Union.

The rise of Euroscepticism

- Something like the Euro-pessimism of the 1970s has returned, but with a big difference: it is about whether it should be stopped or even reversed.
- Anti-European populistic political parties are winning large vote shares in elections by calling for the break-up of the Eurozone.

Figure 1.7 Anti-EU parties' vote shares in 2014



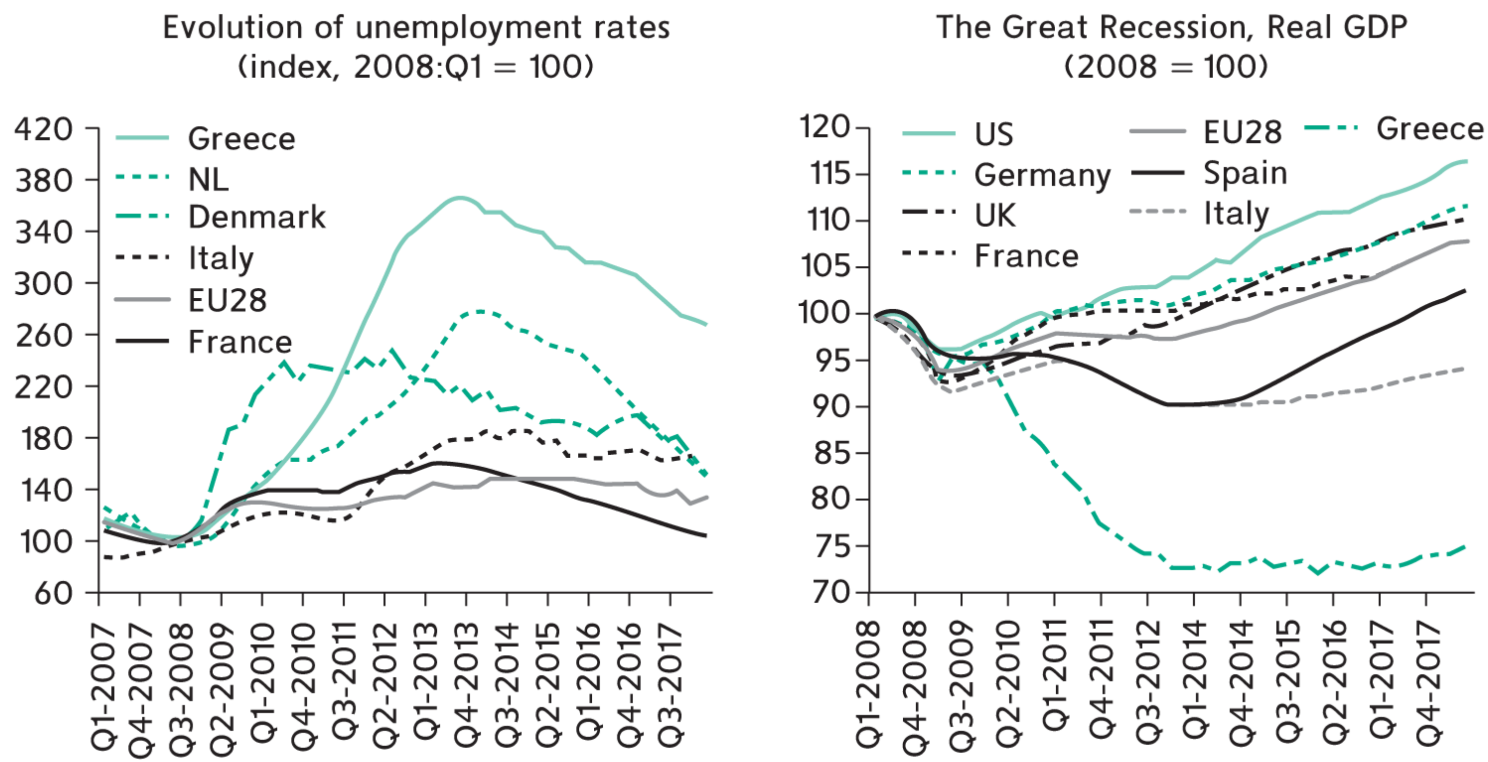
Note: The share was zero for Croatia, Lithuania, Malta, Slovenia and Spain.

Source: Based on data from Figure 1 of Emanuele et al. (2016).

The causes of Euroscepticism (I)

Economic hardship that started with the Global and Eurozone crises

Figure 1.8 Lingering unemployment and slow recovery during the Great Recessions



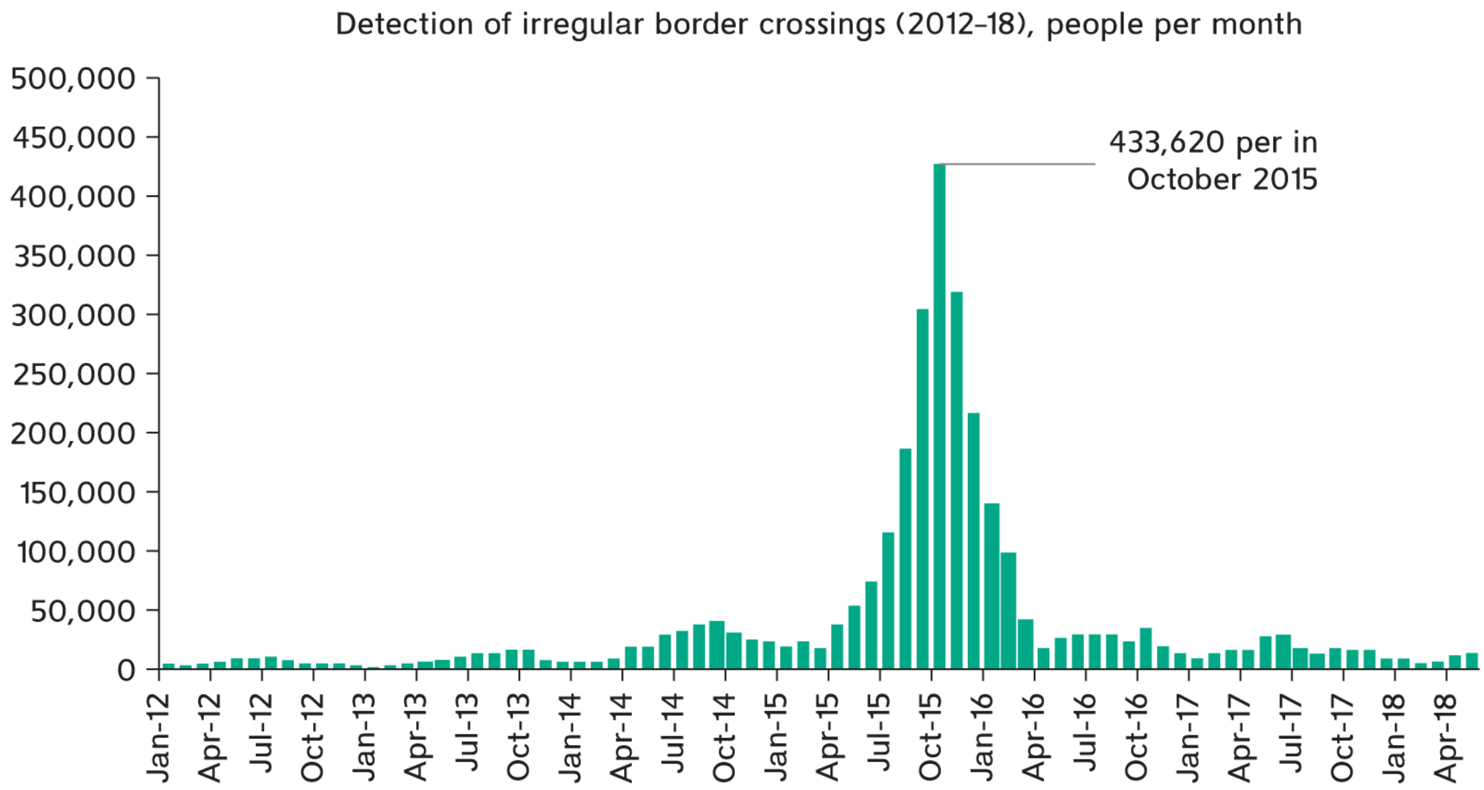
Source: Author's elaboration of data downloaded from OECD.org; unemployment figures are for unemployment of all people over 15 years old.

Note: Real GDP figures are for the nation, not per person. You can update these figures by visiting www.oecd.org.

The causes of Euroscepticism (II)

The migration shock

Figure 1.9 The 2015–16 migration crisis



Source: Author created using publicly available data.

Brexit (2016 – 2019)

- In June 2016 the UK population voted to leave the EU.
- The outcome of final vote was tight and largely unexpected:
  - About 52 % of voters choose the 'Leave' option, while about 48 % chose the 'Remain' option.
- Article 50 of the Lisbon Treaty (technically known as the Treaty on European Union) states that members can leave the EU.
  - Article 50 states that the exit happens when the withdrawal agreement enters into force, or two years after the process is triggered.
  - UK triggered the process on 29 March 2017 and this set in motion a negotiation for a 'withdrawal agreement'.
  - There is, however, a legal loophole that allows the negotiations to stretch longer than two years, but this would require all 27 other members of the EU to agree to the extension.

Lecturers are advised to update on Brexit, since no final agreement on 'the Deal' in UK parliament has reached in UK parliament by February 2019 when these slides were prepared.