‘Seminal contributions to the political economy of European integration: what have we learnt?’
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Comment on Paul de Grauwe: What have we learnt about monetary integration since the Maastricht Treaty?

WALTRAUD SCHELKLE
w.schelkle@lse.ac.uk

The paper by Paul De Grauwe is exemplary for all his work on monetary integration: his presentation extremely clear, fathomable for economists and non-economists alike; his analysis relevant not only to an academic audience but to ‘concerned citizens’ as well as policymakers; the author characteristically modest and polite but also relentlessly probing the professions’ understanding of theory and policy.

In my comment, I will take up all these elements.

- I will, first, give a more appropriate account of Paul’s contribution to our understanding of monetary integration than his characteristic modesty allows him to do.
- Then I will take up what his extremely clear analysis of the role that Mundell I played in the mainstream view of EMU implied. My argument is, in short, that OCA theory never made much sense as an economic theory. But it served as a very effective conceptualisation of the political economy of reform that was driving monetary integration.
- This finally leads me to a brief, and I’m afraid dismal, reflection on the role of academic policy advice in European integration. After all, this *Seminal contributions* series is also an attempt to reflect on academia’s own blind spots and failures instead of engaging in the ever popular criticism of EU policymakers. In short, I will argue that one of the dilemmas of European integration is that policymaking has to rely so much on academic advice; but if it would not rely on it, there would be little other political feedback.

Let me start with an appraisal of Paul De Grauwe’s work on monetary integration. I think his work, not only on EMU, had and has the potential to give us a very clear idea on what are the relevant issues to consider while OCA theory is of more limited help in that respect.

As early as 1975, he published an article on ‘Conditions for Monetary Integration – A Geometrical Interpretation’ (Weltwirtschaftliches Archiv). He argues within a Philips Curve framework that convergence on governments’ preferences regarding the inflation-unemployment trade-off is the crucial condition for monetary integration. We have become a bit more sceptical since then about governments’ ability to choose their own or

a jointly preferred combination of economic woes. But the essential point of Paul's 1975 article stood the test of time, namely that a specific kind of political integration must go along with monetary integration, namely the formation of a consensus on the importance of price stability. This basic idea was 25 years later one of the key ingredients in Kathleen McNamara's explanation for why the monetary union took off: the 'Currency of ideas' was a hard currency. This early argument of De Grauwe (1975) about the need for simultaneous political integration also links up with his diagnosis as regards the two fundamental flaws of the existing EMU: lack of a central budget and lack of an effective policy coordination framework, ie political integration in the economically tangible way.

Another important insight – and criticism of OCA theory – is implied by another strand of Paul's work, namely exchange rate theory. For some time, he used chaos theory to explain the erratic exchange rate behaviour that basically no microfounded theory of exchange rates can explain. Such theories must inadvertently test a joint hypothesis: that the underlying theory of what determines exchange rates fundamentally is correct and that people understand it and act upon that theory (ie. have rational expectations in the sense of economic theory). On his website[1], I saw just the announcement of a new book that tries to apply insights from behavioural finance, ie a theory based on bounded rationality, to exchange rate markets. Be it chaos or psychology, the important point here is that such conceptualisations of the exchange rate imply that OCA theory got the costs on the wrong side of the balance sheet. For most countries, it is not a cost of losing the exchange rate as an adjustment mechanism but a benefit of eliminating a source of asymmetric shocks. For most countries, the exchange rate does not provide a degree of freedom but uses up a degree of freedom in their economic policy since they have to stabilise this asset price. Mundell II is a step forward in that respect although I think its underlying diagnosis that free capital movements have brought about that sea change that makes Mundell I no longer applicable is trivialising the issue. Paul's explorations in the exchange rate as a fundamentally unpredictable price is, I think, a much more plausible rationale for currency unification.

Let me sum up the first point: it is not only the textbook author since 1992 that has greatly contributed to our understanding of monetary integration but so has the early Paul De Grauwe (on political integration) and the other side of Paul De Grauwe (working on rather complex exchange rate theories). I now come to my second point which you can see as a point of disagreement, but I tend to think of it as a defense of the more radical Paul against the mild-mannered Paul. The criticism he outlined of traditional OCA theory, Mundell I, implies nothing less than that it is defunct as an economic theory.

We already talked about the fact that it got the loss of the exchange rate on the wrong side of the balance sheet. And that that is more fundamental than the Mundell II critique which implies it is just historical circumstances, globalisation etc, that makes Mundell I

[1] http://www.econ.kuleuven.ac.be/ew/academic/intecon/degrauwe/

no longer applicable. Because it requires us to grasp that currency areas are not equal and that it is always weak and strong currencies that will merge; not that they are similar but that they are dissimilar makes them want to merge.

But there is worse to come. We cannot even infer from the theory that it can still be framed in terms of cost-benefit analysis once we consider losing the exchange rate as a benefit for all except the anchor currency. For principal reasons that do not depend on the empirical validity of the Rose effect only, the OCA criteria are endogenous. Thus, the currency area may be optimising or worsening in the very process of forming a monetary union. In technical language, that means that our textbook theory of monetary integration is fundamentally susceptible to the Lucas critique and that is pretty damning for an economic theory. In other words, the entire cost-benefit framework becomes rather fuzzy, to put it mildly.

So why has OCA theory been revitalised in the run-up to EMU? Paul gave the answer in his elegant presentation of the three conditions for monetary union. The theory could be interpreted as calling for more *flexibility* of commodity and labour markets, to make up for the lack of *symmetry* and/or *integration*. This interpretation turns OCA theory upside down: a monetary union like EMU does not have to be an optimal currency area ex ante but we must implement reforms that make it an OCA. This political use of OCA theory exploits the endogeneity of the criteria to the full. A political reform agenda was behind the renaissance of OCA theory. Never mind that this theory does not say anything about that or what kind of structural reforms you need. To me, the underlying political economy of reform agenda can also explain why the architects of EMU did not follow OCA theory coherently. In fact, the Stability and Growth Pact (SGP) directly contradicts one of the criteria, namely the need for a common budget or tightly coordinated fiscal policy that is able to stabilise the member states. The analogy is pretty obvious: Introduce monetary union so that the case for flexibilisation becomes irresistible. Implement a fiscal framework for the monetary union that does not provide stabilising transfers but puts additional pressure on national budget consolidation, calling for retrenchment and cutbacks in public expenditure.

Dani Rodrik has called this the ‘Back against the wall’ hypothesis in the political economy of reform, ie you use one measure as a stick to enforce other (reform) measures. The lever that pushes national polities against the wall can be a common monetary policy pursuing a rather rigid inflation target or fiscal austerity. It conveys the message that things can’t go on as they always have and that therefore structural reforms are imperative.

This strategy has experienced its Waterloo with the demise of the original SGP – but that’s for another seminar. This brings me, however, to my third part. The basic conceptualisation of European monetary integration with the help of OCA is of a technocratic nature. It was used by policymakers to argue TINA: ‘we can o longer

devalue, so labour market parties now have full and sole responsibility for the outcome of their wage bargains'; 'we no longer have the discretion to lower interest rates, so markets must respond flexibly to changing market conditions' etc. But my criticism here is not for the policymakers who like to push through certain reforms – that's what we elect them for. I blame the academic advisors that give such legitimate political strategies the seal of scientific truth, as if flexibility of labour markets were a quality of social physics, universal and operational like the elasticity of rubber. The architecture of EMU resulted from a curious attempt at social revolution from above, of technocrats trying to liberalise, of planners going for economic laissez faire.

This makes us acutely aware of a well-known, fundamental problem of the EU: its 'democratic deficit' makes EU policymakers get advice predominantly from lobbies and academic policy advisors. This must substitute (imperfectly) for the failings of national parliaments and the lack of debate about EU decisions among the wider public. I don't see that that will change in the foreseeable future but therefore it is only welcome that academics spell out the complexities and ambiguities of policymaking rather than lend their reputation to back up TINA strategies. So should Paul De Grauwe accept part of the blame for the professions' failure to give clear advice on 'whether a monetary union in Europe was a good idea' as he just did, criticising his textbook edition of 1992? Again I find myself defending the earlier Paul. He should trust his instincts as someone who is not only a brilliant scholar but also an astute politician: economics can't tell you all, it can lay out the choices involved and that's a lot. But these choices are ultimately political. Beware of economists who pretend otherwise. We are lucky that Paul De Grauwe who has taught us all the theory and policy of monetary union is not one of them.