The Economics of European Integration

RICHARD BALDWIN and CHARLES WYPLOSZ
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Book review by TOMISLAV GLOBAN
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In the infancy of societies, the chiefs of state shape its institutions; later the institutions shape the chiefs of state.

Baron de Montesquieu

To write a book that deals with the economics of European integration is in itself a very ungrateful job, due to the constantly changing and fast-growing nature of the topic. But when the book is being written in the midst of the greatest economic and political crisis in the European Union's and the eurozone's history, the job becomes increasingly difficult in many ways. The changes that the EU has undergone in recent years have altered the very foundation of European integration and the principles upon which it has been built. Authors who deal with this topic therefore face a difficult dilemma. On the one hand, in order comprehensively to examine the causes and analyse the consequences of current events, from both a scientific and an educational aspect, the authors must approach them with a certain time lag. Otherwise, they run the risk that events will in the very near future refute the conclusions they have made. On the other hand, since the current events profoundly interfere with basic assumptions and "pillars" upon which the process of European economic integration stands, any book that ignores them will be outside the context of the time we live in, while its value and applicability will be significantly diminished.

The fourth edition of the book *The Economics of European Integration*, published in 2012, authored by Richard Baldwin and Charles Wyplosz, reconciles the two aforementioned problems in an exceptional way, despite the difficulties encountered by the authors during the book writing process. Just as the 2008 global financial crisis disrupted the authors in writing the third edition of this book (published in 2009), so the eurozone sovereign debt crisis and the uncertainty over the future of European Monetary and Economic Union (EMU), which has followed, significantly hampered the writing of the book's fourth edition. The book went to print in late 2011, at a time when many economists predicted not only a dramatic change in the structure of the eurozone, but also its disintegration. However, Baldwin and Wyplosz skilfully deal with the issue of uncertainty about future events. They have considerably changed chapters that dealt with macroeconomic theory in the third edition in order to put more emphasis on issues that have arisen as a result of the crisis – e.g. the functioning of global financial markets, the problem of banking sector regulation in the EMU and the role of the U.S. subprime market in the evolution of the crisis. In addition, the authors have provided a completely new chapter entirely devoted to the sovereign debt crisis in the eurozone. In it, the short- and long-term implications of eurozone leaders' decisions in resolving the debt crisis are analysed in detail, the fundamental institutional and political weaknesses upon which the eurozone is based are emphasized and several possible outcomes of the current situation are discussed, with the appropriate argumentation for each scenario offered.

As an additional step forward in improving the quality of the book, I would rate the fact that the authors removed the section covering the fundamentals of macroeconomic models (for example, the IS-LM and AS-AD model), given that they are taught at the beginning of every undergraduate study of economics. Since the book is primarily intended for senior undergraduates, the assumption that the target audience will manage these models well seems reasonable so their repetition would have been unnecessary and uneconomical. On the other hand, by doing so, the authors made room for the very important new chapter dealing with the eurozone crisis without making the book longer than it already is.

The book consists of 19 chapters grouped into five thematic sections. Since an understanding of the functioning and importance of European economic integration requires much more than a mere knowledge of economics, the first section deals with issues of the historical context of the European Union, its institutions, legislation and decision-making systems through three introductory chapters. The retrospective concerning the creation of the EU can be useful even to students who are familiar with the historical facts, as it gives a clear insight into the political and economic logic behind the founding of the Union. The authors point out that the original idea guiding the creation of the European Union was not an economic union, but rather cooperation between countries in order to prevent future conflicts of catastrophic proportions on European soil, as exemplified by the First and Second World War. Also, the authors show how disagreements on the required degree of sovereignty of member states, which are still very topical, especially in the light of the British announcement of a possible EU exit, were present in the very beginning of the European Union.

Making the interactive content available online is standard for most recent textbooks, and the book does not disappoint in this respect. For instance, by following website links one can listen to the original speech by Winston Churchill from Zurich in 1946 in which the British prime minister calls for creation of a "United States of Europe", or a speech by Charles de Gaulle in 1963 in which he expresses the famous non to the membership of the United Kingdom in the European Community. The novelty of the fourth edition is that it analyses the changes brought about by the Lisbon Treaty, which entered into force in late 2009. In this respect, I find particular interest in the way in which the authors link game theory with the decision-making system in the EU institutions defined by the Lisbon Treaty. This is essential for understanding the changes that are currently taking place in this area, i.e. the tendency of jurisdiction and sovereignty to be transferred from the national to the supranational level. On the other hand, one could complain that the book almost completely ignores the prospect of further enlargement of the EU, although Croatia became a new member state in 2013.

The remaining four thematic sections can be grouped into microeconomic (second and third sections) and macroeconomic (fourth and fifth sections) views of Euro-

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pean integration. In both cases, the authors first introduce the basic micro/macroeconomic tools for understanding the theoretical foundations of economic integration in general, and then extensively examine the micro/macroeconomic policies implemented by the European Union.

Through five chapters, the second section provides methods for the microeconomic analysis of economic integration. Using basic microeconomic tools, the authors explain the economic logic behind the key concepts of the European Union and their effects on economic entities inside and outside the integration, e.g. customs policy, preferential trade liberalization or economies of scale. Emphasis is put on the effects of European economic integration on economic growth in member states in the medium and long run, linking some empirical case studies of EU countries with the theory of neoclassical and endogenous growth. The second section ends with the microeconomics of the labour market, in order to explain the impact of migration and social transfers on (un)employment, wages and growth rates within the economic integration.

The third section deals with specific microeconomic policies implemented by the European Union. The economic logic and the facts necessary for the understanding of the Common Agricultural Policy (CAP) are extensively analysed, especially in light of its impact on international trade and the reforms that will follow in the 2014-2020 budget framework. EU regional policy and the location effects of economic activity are explained by the neoclassical Heckscher-Ohlin theory and the theory of the so-called new economic geography, thereby effectively explaining the empirical finding that despite greater economic cohesion among EU countries, economic integration and EU regional policy lead to greater centralization and regional disparities within countries – a fact rarely mentioned by the media. Unfortunately, the authors dedicated very little space to the role of the structural funds and other EU programs in achieving the objectives of cohesion and regional development, while the pre-accession funds and their importance in preparing candidate countries for EU membership are not even mentioned, which I would consider one of the book's rare deficiencies.

Furthermore, the third section deals with the competition and state aid policy in the EU. From an educational perspective, it is commendable that the authors do not choose an approach in which they only describe the characteristics of the Union's policy, but rather they explain the economic logic behind the fight against anti-competitive behaviour of economic agents, which is corroborated by a number of case studies. The section concludes with an analysis of EU trade policy, which enjoys considerably less public attention than the CAP and regional policy, but is, as Baldwin and Wyplosz point out, probably the only foreign policy of the EU which is consistently efficient and has made the EU the largest and most important participant in the world trade.

Using a similar principle to the one used to examine microeconomic aspects of economic integration in the second section, the fourth section describes the basic macroeconomic principles and tools needed to understand the economic and monetary integration, through three chapters. The authors examine a variety of topics, ranging from theoretical assumptions and the implications of interest rate parity, purchasing power parity and the "impossible trinity" in order to explain the choice of the exchange rate regime, to a comprehensive historical review of European monetary integration, starting from the gold standard and Bretton Woods to the creation of the European Monetary System and the introduction of the euro. The fourth section concludes with a chapter on optimum currency areas (OCA). I regard this as the key chapter for an understanding of what follows in the fifth section, and from a teaching point of view, the best analysis of the fulfilment of OCA criteria by the eurozone, or lack of it, that I have come across. The authors very intuitively explain why each of the six economic and political criteria has been included in the OCA theory and what the potential consequences are if one or more of them are not met. They make it clear to readers that the theory does not offer a clear cut answer to the question of whether a particular area is also the optimum currency area, but rather gives us a tool to assess the costs and benefits of forming or joining a monetary union. Baldwin's and Wyplosz's analysis of fulfilment of the OCA criteria by the eurozone is a great introduction to the last, fifth, section of the book.

The fifth section begins with a chapter that analyses the main features of the eurozone's monetary policy. Again, in a very intuitive way the authors explain how each of the five convergence criteria set out in the Maastricht Treaty contribute to the achievement of the main objective of the European Central Bank (ECB) – maintaining price stability. Along with an explanation of how the Eurosystem and its instruments for implementing monetary policy function, the chapter provides the analysis of the EMU's success in achieving the goals set during its first decade of existence, until the onset of the global financial crisis. This is followed by a chapter concerning fiscal policy and the Stability and Growth Pact, which was designed as an insurance policy to sanction fiscally undisciplined countries and thus maintain the stability of the eurozone. Baldwin and Wyplosz skilfully manage to explain the inherent flaws of the Pact, present since its inception and coming to the fore in full glory a decade later, and which are a direct result of failures to meet some of the OCA criteria. The authors could be criticized for not devoting more attention to the reform of the Pact in 2005, which considerably relaxed the required level of fiscal discipline, increased moral hazard and directly contributed to the emergence of the sovereign debt crisis in the eurozone. Moreover, the authors do not address the issue of the growing democratic deficit in the eurozone, which is reflected in the growing supranational jurisdiction of the European Commission and the Council of the EU in dictating national fiscal policies. Because these bodies do not have to bear the consequences of their policies, resistance to stronger fiscal coordination at the EU level tends to be generated. Since the book was published in 2012, it does not include the recent agreement of the member states regarding the implementation of a new, perhaps crucial fiscal pact (Fiscal Compact), which significantly redefines the level of fiscal sovereignty of member countries. This is the topic to which I assume the authors will certainly pay a lot of attention in any subsequent edition.

In the chapter on financial markets the authors emphasize the deficiencies of the eurozone in terms of regulation and prudential supervision of financial institutions that directly contributed to the spread of the financial crisis in the United States in 2007 and 2008 and the efforts that are being undertaken in order to implement regulation at the supranational level. The section concludes with the chapter already mentioned on the crisis in the eurozone, its causes, consequences and potential outcomes and discusses possible long-term solutions that should prevent its recurrence.

To conclude, the book *The Economics of European Integration* in its fourth edition represents an improvement over the already successful and very popular third edition. In an intuitive and accessible way it gives the reader an insight into the facts, theories and controversies that are the driving force of rapid and constant changes within the European Union. Focusing on the latest developments in the eurozone, the book provides extra value which makes it worth obtaining a new edition. By combining the economic with historical, political and legal approaches Baldwin and Wyplosz have produced a comprehensive work that is accessible to a wider circle of readers and that makes it easier to understand the complicated process of European economic integration. The writing is not particularly challenging to read, it does not require advanced mathematic or econometric skills, but requires a knowledge of the basics of economics, microeconomics and macroeconomics. In any case, for anyone interested in the economic issues of the European Union and European economic integration, this book is an excellent starting point.