European Monetary Union

Teaching Note

This case explores the economic integration of Europe and the workings of the European Union as of mid-March, 1999 when the Commission resigned because of corruption. In particular, it examines (1) the political structure of the EU under the Treaty of Rome and subsequent amendments; the Single Europe Act of 1985 and its effects on product markets, capital markets, and labor markets; and the Maastricht Treaty of 1991 and subsequent monetary union. Its supplement – **European Monetary Union: Honeywell Europe** (HBS No. 799-151) – explores a large corporation's structural adjustment to integration.

Conceptually, the case shows the inter-relatedness of markets and difficulty of achieving real integration. In particular, it considers the connections between monetary policy, fiscal policy, tax policy, and social policies. Globalization, as seen from a detailed exploration of Europe, turns out to be an immensely complicated and slow-moving process. Because Europe is far ahead of North America or Asia in this process, and yet still far from integrated, it reveals how (relatively) little progress has actually occurred in the globalization process.

Teaching questions:

1. Why are the Europeans so intent on economic integration?
2. How has the Single Europe Act worked? Is there much left to do?
3. Does Monetary Union make sense, in your view? What are the implications for members of the EU, with regards to diverse business cycles, growth rates, unemployment rates, labor policies, and social values?
4. What are the implications of European integration for firms like Honeywell? Has Honeywell moved too fast? Is it doing enough?
5. What problems do you foresee for Europe during the next few years?

This note was prepared by Richard H. K. Vietor for the sole purpose of aiding classroom instructors in the use of European Monetary Union, HBS No. 799-131. It provides analysis and questions that are intended to present alternative approaches to deepening students' comprehension of business issues and energizing classroom discussion.

Analysis:

The first six pages of the case review the integrative rules and institutions of the EU since the Treaty of Rome (1956). The EU (with revisions in the Treaty of Amsterdam in 1997) consists of four institutions – the European Commission, the Council of Ministers, the European Parliament, and the Court of Justice. Each has jurisdictional authority described in the case. The Commission, with authority over trade, origination of directives, and the budget has been the most powerful bureaucracy – 14,000 highly paid, well-educated bureaucrats. Of late, the other three institutions have all gained power. The Council, representing member-states political institutions, controls the final shape of directives. The EP, the so-called "democratic deficit," has recently gained more responsibility. Since 1997, it has co-decision making powers with the Council, power to accept or reject the budget, and power to turn out the Commission by a vote of no confidence. This, in fact, would have happened in March 1999, had not the Commission resigned. The Court of Justice has authority to settle disputes over the implementation of Commission directives. In the past few years, it has levied large fines on countries that fail to implement directives properly.

The case goes on to describe the Single Europe Act. In 1985, Europeans were suffering from slow growth, high inflation, high unemployment and a lack of competitiveness relative to both Japan and the USA. The Single Europe Act was designed to foster market integration, providing European companies with the market scale necessary to attain lower costs, to integrate and to compete more evenly with Japanese and American firms.

The Single Europe Act was intended to foster the free movements of people, goods and services. By 1992, the Commission was to propose nearly 300 directives, removing border controls, standardizing 100,000 different regulations, reducing public procurement and ownership to alleviate uncompetitive bidding, to harmonize differences in value-added taxes, and to integrate markets for services – particularly financial services.

The Maastricht Treaty, initialized in 1991, was designed to foster currency union by 1997 or 1999. Eleven countries eventually approved Maastricht by referenda. The Treaty required locking currencies together around a band that varied by plus or minus 2.25%, and achieving convergence criteria discussed on page 6. It also established a European Monetary Institute that would become a European Central Bank with integration, in Frankfurt.

Although the convergence was ruined German Reunification (and resulting high interest rates and strong DM), a wider band was established in 1995, with a new target of 1999. In 1997, eleven countries worked hard to lower deficits and interest rates, achieving the convergence necessary by May 1998. Monetary union ensued January 1, 1999. A schedule on page 6 describes the remaining steps necessary to achieve full integration by July 1, 2002.

Pages seven through twelve describe the efforts and accomplishments of Europeans towards integrating product markets, capital markets, and labor markets over the past thirteen years (1986-1999).

In **product markets**, border controls have been largely eliminated. People and goods move relatively freely across the 15 EU nations. The restriction on Japanese autos (imposed in mid-1991 to keep Japanese market penetration below 16%) is scheduled to expire at the end of this year. Moreover, there are still selective barriers to Japanese electronics and high tariffs on food.

Standardization, through mutual recognition, has made significant progress. Chart 7 shows that about half the difficult sectors have been standardized. Chart 6 indicates that telecommunications, public procurement, intellectual property, and social policies are the areas where the biggest gaps in harmonization remain.

Differences in value-added taxes have been somewhat reduced, from 37% to narrower bands, but still have a long way to go.

Exhibits 10-12, on price dispersion, suggest that Europe still has a long ways to go on product-market integration. While the coefficient of variation for the GDP has dropped from 20% to about 16%, many sectors still have dispersed prices of 8% to 32%. Autos, an especially important sector, are still priced according to local competition and what producers think they can get.

Exhibits 9a and 9b do indicate an increase in merger activity across this more integrated market, but mergers remains relatively small (as a portion of GDP) and largely within countries rather than across the EU or internationally. The text mentions that after 1997, however, extra-EU merger activity has been picking up.

The text mentions that smaller business, retail and distribution have only just begun the process of integrating. Most smaller firms, and most retail brands, are still local.

Capital markets have made much greater progress in the integrative process. Exhibit 13 shows that the EC has fostered an immense amount of deregulation – most of which has been taken up by most countries. Exhibits 14 a-d show that prices and costs of some financial products are dropping as a result. But Exhibit 8b indicates again that most bank mergers are intra-country; relatively few are inter-European or extra-European. The text suggests that wholesale markets and product markets where globalization (such as bonds) is dominated, have integrated first. Retail banking, equity and venture capital markets are beginning to merge and modernize, but still have a long ways to go (e.g., before catching up with the USA).

Labor markets are the least integrated, by far. The case suggests that while there has been some reform in a few countries (Netherlands, Denmark and the UK), in most of Europe – especially France, Germany and Italy – these markets remained highly regulated and inflexible. Marginal taxes on employed labor are high (exhibit 15b), benefits are incredibly large (exhibit 17), minimum wages are high, and hours worked (exhibit 18) incredibly low (relative to the USA). As a result, unemployment (exhibit 15a) is high – not withstanding healthy economic growth the past three years.

Currency union beginning in January 1999 is the next phase of European integration. Since the adoption of the euro for business transactions, some government transactions, and increasingly for payroll, savings and even checking accounts, the value of the euro has fallen about 11%. This only makes Europe more competitive with the United States, increasing exports and dampening imports. The EU countries lowered interest rates just before the end of 1998, and then the ECB lowered interest rates another .5% in March.

At issue here is the integration of macroeconomic policy. What does monetary union mean? It surely has helped reduce inflation, as exhibit 3 suggests, and probably interest rates (exhibit 4) as well. But monetary union means that a central bank, in Frankfurt, makes the major decisions in monetary policy, based on a charter of keeping inflation below 2%. It is no longer related at all to economic growth. That is, if an individual country (such as Ireland) is overheating, the ECB does not raise interest rates. If an individual country (such as Italy) is stagnating, the ECB does not lower interest rates.

And because EU-11 countries have given up national monetary policies, they have substantially constrained their ability to have independent fiscal policies. That is, if a country wishes to increase its deficit (and 3% is the ceiling in the Stability & Growth Act), it must issue more debt. It can not print its own currency. Rather, it must sell debt in euros – up to whatever point its credit rating is lowered, and its debt costs rise.

Along with these macro limits on monetary and fiscal policy, countries need accept limits on the social-spending component of fiscal policy. Since this portion of fiscal expenditures amounts to as much as 30% of GDP, the macro-constraints on fiscal policy effectively impose constraints on this sort of spending.

What does all this mean (in the recent past, the present, and the near-term future) for firms? An integrated market should foster greater competition. Therefore, it should necessitate lower prices and lower costs, and eventually, rationalization of industries. To be competitive, this means changes in most firm's strategies.

Honeywell is a good example. A $2.1 billion subsidiary of a $9 billion American firm, Honeywell Europe had costs (and prices) nearly forty percent above it's American counterpart. It was organized regionally; each country had a sales and service organization. Manufacturing, of too many models with technological variations according to national taste or regulation, was conducted at 17 locations. Both the upstream and downstream elements of its value chain were expensive.

The case supplement describes Bill Hjerpe's intention to cut costs and increase margins. He starts by forcing suppliers to reduce costs, by reducing the variation of models ("stinkers") by 10 percent, and by reorganizing the firm by strategic business units. Is this the right direction? Is it enough? Is the timing right? Does the firm need to merge with someone? There is just enough here to get participants to see the consequences for firms.

The last element of the case is tied to Exhibit 21. This exhibit shows the real GDP growth, adjusted for purchasing power parity, over the past 28 years for EU-countries, Japan and the USA. It shows (1) Portugal and Greece not catching up, (2) Germany adjusting (in 1990), and (3) the USA pulling away. This exhibit offers an opportunity to get an overview of European integration. Is it likely to lead to (1) uplifting Portugal and Greece, and (2) catching up with the USA? Why or why not, and when?

There are other questions that can be asked – about the EU's budget (and agricultural barriers) (exhibit 20), about future fiscal responsibility (exhibit 19), about the eventual integration of three or thirteen other eastern European countries (exhibit 1), about assumption of defense responsibilities from NATO, and about immigration.

Teaching Plan

My plan for teaching this case generally follows the five parts of analysis above. It starts by examining the problems that led to the Single Europe Act and looks at how the EU works. Then it examines 13 years of integration in three markets -- product, capital, and labor. Next, it considers the costs and benefits of monetary union. Then it considers the fact of integration from the perspective of the firm. And finally, it speculates about the future of European growth.

Q. Why are Europeans doing this – economic integration and monetary union?

Q. How does the EU work? What are the four parts?

Problems?		EU works?	
GDP, Unemp, Inf.		**Commission**	**Council**
Objectives?		Propose, trade	approve
Scale? Competitiveness?		Budget	amend
			Reject
Other?		**EP**	**Court**
		Adopt budget	decisions
		No-confidence	penalties

Q. Over the past 13 years, what kind of progress have they made integrating markets?

Product mkts?	Capital mkts?	Labor mkts?	Barriers?
Border controls	mergers	part-tim	VAT?
Standardization	costs & prices	some lower taxes	pensions?
Procurement	retail slow	replacement?	Subsidies?
Prices	insurance slow	35 hrs?	
Rationalization		hours worked?	

Q. Autos, a done deal? Q. Pharmaceuticals? Q. Telecom? Q. Food?

Q. Cross-border mergers? Costs up or down? Insurance?

Q. US Comparison?

Q. What about procurement? Subsidies? VAT?

Q. When do you think this will be completed?

Q. <u>Do you think currency union will be a good thing? Why? Why not?</u>

	EMU Good?	EMU Not Good?	Firms/Honeywell
Monetary pol?	Inflation down	no counter-cyclical	
Fiscal Policy?	Common deficits	no Keynes (S&G Act?)	
Tax Policy?	Common taxes?	No autonomy	
Social Plans?	Can't have separate programs	Culture?	

Q. What will be the effects of ECB monetary policy?

Q. What effects on fiscal policy?

(Does the Stability & Growth Act make sense?)

Q. <u>What does market integration and currency union mean for firms?</u>

Q. <u>What do you make of Honeywell's strategy?</u>

Q. Is first moving bad, here?

Q. Will there really be no downward price pressure?

Q. How does firm handle globalization (given regional cultures)?

Q. <u>Look at Exhibit 21 – EU has fallen behind USA since 1980; will these integrative efforts catch it up?</u>