Economics of European Integration

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Problem Set 10

References: BW (6.ed) The Economics of European Integration Ch. 14 & 16

Exercise 1: The history of European monetary integration

a. Consider once again the logic of the impossible trinity. Explain why, once monetary policy autonomy is given up, a monetary union is nothing more than a fixed exchange rate regime.

b. Explain Hume's Mechanism and how it applies within the concept of the impossible trinity.

c. Why/how does it apply to the internal working of a monetary union?

Exercise 2: The European monetary union

a. The Maastricht Treaty specified that the main task of the Eurosystem is to deliver "price stability". Explain.

b. To ensure price stability within the Eurosystem, the central banks main tool is to set the interest rate accordingly. The Eurosystem has developed a detailed strategy in doing so. Explain.

c. Consider a central bank that cares only about price stability. Use the IS-MP-IRP framework under a flexible exchange rate regime to see what happens when inflation is rising.