Exam questions

1. **Inflation became one of the central concerns of policymakers in the EU and around the world.**

a) What have been the drivers of inflation and the monetary policy responses?

There were three main drivers:

- The accumulated savings during the pandemic and increased demand followed the lifting of restrictions.
- Lockdowns and supply disruptions in several goods led to the breakdown of global value chains during and after the pandemic.
- The burst in food prices and, especially, in energy prices because of the conflict in Ukraine. The rise in energy prices had a cascading effect on overall price levels, given how reliant most goods and services are on oil, gas, and transportation.

From the aftermath of the sovereign debt crisis in the euro area until mid-2022–monetary policy took a strongly expansionary stance. Since then, the ECB has embarked on a contractionary monetary policy: the reference interest rates have increased, and there was a break in liquidity creation through non-conventional methods.

b) What are the trade-offs of the Euro-system’s monetary policy in the current situation?

Since the sovereign debt crisis and until mid-2022, the monetary policy was anchored in very low interest rates and the use of unconventional monetary policies. The prolonged use of expansionary policies, combined with an expansionary fiscal policy during the pandemic, led to the accumulation of public debt sustained under a low-interest-rate environment.

The higher inflation demanded reversing this expansionary policy to preserve the central bank's credibility. Interest rates had to go up if the ECB wanted to curb inflation.

However, higher interest rates can impact the solvability of the debt issued under a low-interest-rate environment. The interest rate increase puts the government, firms, and families under financial pressure, which could trigger relevant losses in bank portfolios and fuel a new financial crisis. Therefore, a contractionary monetary policy is weighed against financial instability.

c) What has been the role of European and country-level fiscal policies in this context?

European:

The increase in the aggregate demand from implementing the RRF is likely to sustain high inflation rates. However, some common approaches have been taken by European institutions to curb the rise in inflation, mainly on energy prices: gas price cap and diversifying gas imports.

Country-level:

A scenario of inflation brings positive and negative impacts to the fiscal balance. The increase in inflation raises the nominal tax collection and decreases the nominal debt/GDP ratio. On the other hand, the increase in interest rates implies a rise in debt servicing costs, which requires some financial prudence. Most governments have been implementing targeted measures to help the most vulnerable families, as these were the hardest hit by inflation. These have included cash transfers, lowering VAT on essential items, and lowering energy costs.

2. **The conflict in Ukraine is a reminder of the massive costs of war and how economic integration is a contributor to peace and stability.**

a) Why have the enlargements brought both more stability and difficulties to the EU?

Enlargements are an opportunity to build a larger economic bloc under a common market with harmonized common policies based on the four main freedoms: labor, capital, goods, and services. The higher level of trade integration leads to an increase in welfare, higher competitiveness, and productivity and then to higher economic growth. The enlargements are also a way to deepen the integration in the European global value chain networks.

However, the enlargements also mean a more diverse union. This diversity is, in the first place, an economic challenge since a higher volume of funds may be needed to guarantee convergence across different member countries. It may also mean great difficulties in ensuring compliance with common fiscal rules. A higher diversity of countries can also lead to a lengthier decision process, given the larger number of perspectives to be incorporated in the union's final decisions.

b) How is the EU institutional architecture designed to reach compromise and integrate different views?

The present architecture of the Union tries to balance the need for a fast decision process and the need to incorporate different visions within the union. Thus, on the proposals drawn by the Commission, the Council of the European Union and the European Parliament engage in a co-decision process. During this process, the proposals are improved to incorporate the view of the two institutional bodies, allowing for a balanced view from a more federalist body (like parliament) and a more intergovernmental body (like the council).

To guarantee that the decisions do not linger, the union has moved from a unanimity voting system to a majority voting. However, a small group of countries can still block the decision-making.

The need for compromise in European decisions is clear in aspects like the scoreboard o the macroeconomic imbalances procedure and fiscal surveillance, where the diverse set of rules and variables satisfies the need to accommodate countries with different fiscal policies.

c) What were the arguments put forward by Brexit supporters? How do you assess them?

Brexit was based on the UK's previous reluctance to be part of the EU. Previously the country had preferred other types of trade agreements, demanded compensation for losses on lost Commonwealth trade, and never wanted to be part of the monetary union.

The Brexit arguments can then be grouped into three main topics. 1. Trade and compliance with common European policies; 2. The need to contribute to the European budget, particularly the fear of contributing to the bailouts during the sovereign debt crisis; 3. The will to decrease the free movement of labor, mainly migration flows.

Regarding the first argument, being out of the common market hit the export of British producers due to the lower integration in global markets and global value chains and payment of tariffs to sell in the Single Market. Moreover, exporters still have to comply with other rules not negotiated by the UK government. Regarding the second point, some sectors that were net beneficiaries of European funds (like education and science) have been particularly affected. Finally, regarding the control of migration, this lower level of integration has also led to shortages in particular segments of the labour market, and illegal immigration continued. Overall, immigration has been a growth driver in the UK that has been diminished.

Some of the consequences of Brexit have been clear during the recent inflation spike, which was particularly acute for the British economy.

3. **The macroeconomic supervision in the EU and structural recommendations are undergoing a revision process.**

a) What is the rationale for the existence of fiscal rules in the EU, and how have they performed? Please explain.

The different levels of interaction among fiscal and monetary policies and the fact that there are several fiscal authorities in the monetary union and only one monetary policy creates a rationale for setting a framework for fiscal policy coordination. Indeed, the lack of fiscal coordination can undermine the monetary policy goal of price stability. For instance, expansionary fiscal policy in some countries may undermine the monetary policy's goal of price stability, thereby creating pressure to increase the common monetary policy rate. In addition, given the impossibility of currency devaluation, fiscal policy is the main stabilization policy to respond to an adverse asymmetric shock at the national level. Also, the lack of fiscal discipline and lack of a clear framework for crisis management makes it difficult to prevent contagion, affecting sovereign risk and countries' risk premiums. Such market fragmentation, associated with increased volatility in financial markets, may also affect monetary policy transmission, making it challenging to target policies to improve financing conditions in more vulnerable countries.

In this context, the Stability and Growth Pact (SGP) was established with the single currency to ensure sound public finances. However, as shown during the sovereign debt crisis, its existence did not prevent the emergence of severe and recurring fiscal imbalances in some Member States. The rules were therefore reformed through the "Six Pack" and the "Two Pack," as well as by the "Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union" (TSCG). Although the above-renewed framework has not yet been sufficiently tested, it does not seem to have a robust enforcement mechanism, thus maintaining initial fragilities. Furthermore, the EU's fiscal rules were lifted to face the current pandemic crisis, remaining temporarily suspended considering recent events (e.g., the war in Ukraine).

b) Why does the Macroeconomic Imbalances Procedure incorporate imbalances beyond the fiscal dimension?

The Macroeconomic Imbalances Procedure (MIP) aims to identify, prevent and address the surge of potentially harmful macroeconomic imbalances that could adversely affect economic stability in a particular EU country, the euro area, or the EU as a whole. The MIP covers a broad range of macroeconomic imbalances beyond the fiscal dimension, including issues related to external imbalances and competitiveness, internal imbalances, and employment indicators. This comprehensive approach ensures that policymakers know the various economic risks and vulnerabilities and can take appropriate measures to address them.

The MIP is designed to detect economic imbalances that could lead to a crisis before they become too severe. By identifying imbalances at an early stage, policymakers can take corrective action before they become materialized in an economic and financial crisis. The MIP was created as the response of the European Union to the failure of the Stability Growth Pack and the surge of macroeconomic imbalances, notably in the current account, that fueled the sudden stop in external financing during the sovereign debt crisis.

c) Why are structural reforms in EU countries so difficult to design and implement?

In the medium and long run, the structural reform agenda is the only sustainable driver for economic growth. The long-run supply curve expands only through efficient labor and product markets, competition, and good institutions. However, structural reforms may take more work to design and implement. They often interact in complex ways and involve changing long-standing policies, institutions, and practices, which may result in strong resistance to reform efforts. Additionally, structural reforms often require coordinated action across different levels of government and multiple policy domains. At the EU level, member-states are deeply integrated, which can also make it challenging to implement structural reforms that need to be coordinated with other countries. Coordination problems can thus arise when different countries have different priorities or incentives or when there needs to be more institutional mechanisms to facilitate cooperation and collaboration. Also, structural reforms often involve short-term costs and long-term benefits. Policymakers may be reluctant to undertake reforms requiring immediate sacrifices, particularly if they face political pressures to deliver short-term results.

Despite these challenges, EU decision-makers work to accelerate structural reform in member countries and other supply-side aspects while increasing the screening and enforcement of fiscal rules and the broad correction of macroeconomic imbalances. In parallel, the creation of EU-wide risk-sharing mechanisms is warranted (e.g., Banking Union, fiscal federalism).

4. **Free trade and competition are key pillars of the EU single market, which completed 30 years of existence.**

a) Why are free trade and competition important and complementary elements in the EU integration process?

Trade is a fundamental element of the EU integration process, as it has been a key driver of economic growth, job creation, and market expansion. By creating a single market and removing trade barriers, the EU has allowed businesses to benefit from economies of scale and expanded market opportunities, contributing to increased trade volumes. Trade has also played a significant role in strengthening the competitiveness of EU businesses. Competition encourages firms' efficiency, leading to a broader choice of products and services for consumers at higher quality and lower prices, thereby contributing to higher welfare. By encouraging firms to produce better products, competition also drives firms to be more innovative in their product concept, design, production, etc.

In this context, trade openness exposes firms to external competition. Suppose this competition is not fair due to the greater capacity of some countries to provide state aid and protect national firms. This may lead to trade distortions and imbalances, preventing countries from fully benefitting from free trade. As such, competition rules aim to ensure a level playing field among firms, which is therefore critical for the well-functioning of the single market.

b) What are the main features of the EU trade and competition policies?

The main goal of the EU's trade policy is to increase trading opportunities for European companies by removing trade barriers such as tariffs, quotas, and other non-tariff barriers and guaranteeing fair competition in a single market. Trade policies also feature trade agreements with non-EU counties to open new markets for EU companies, trade regulation to protect EU producers from unfair competition, and EU membership in the WTO, which sets international trade rules. The Commission plays a central role in trade negotiations and implementation, while member states collectively shape EU trade policy.

Complementary EU competition policy aims to prevent distortions in competition and ensure a level playing field for firms in the single market. It is based on a set of rules and enforcement powers to ensure the achievement of its objectives. The policy covers four key areas (i) Antitrust & cartels: preventing agreements that restrict competition, including price-fixing and other abuses by firms who hold a dominant market position; (ii) Market liberalisation: aiming at introducing competition in previously monopolistic sectors such as energy supply, retail banking, postal services, mobile telecommunications, and air transport; (iii) State aid control: analysis of state aid measures to ensure that they do not distort the level of competition in the single market; (iv) Merger control: investigation of mergers and take-overs between firms which could result in dominant market positions. The Commission is the main body responsible for ensuring the correct application of competition rules and has wide-ranging inspection and enforcement powers. The Commission has also put forward measures to improve the right of consumers and businesses to get damage compensation when they are victims of anti-competitive conduct.

c) How have trade and competition evolved at the global level in the past decade?

The last few decades have been marked by higher economic integration, driven by a deeper financial integration. The deregulation of the financial markets, coupled with technological progress and the lowering of administrative barriers, allowed investors to choose from a wider set of places and investment opportunities to diversify their risk. This leads to the rise of Foreign Direct Investment (FDI) flows worldwide and the outflow of capital from Western to emerging economies, leading to deeper economic integration between different blocs. The establishment of Global Value Chains (GVCs) was only possible because FDI flows supported required investments. The last decade was also marked by a continued increased importance of Asian countries in world trade, most notably China. These changes also challenged the competitiveness of traditional Western economies, contributing to higher levels of inequality, namely due to the movement of low value-added activities from high wages to locations with lower unit labour costs. These consequences also help to explain the rise of protectionist tensions (e.g., between the US and China).

The last few years were also marked by a pandemic and the beginning of a war in Europe. First, the COVID-19 pandemic was responsible for a strong contraction of the supply of many goods and services embedded in GVCs, which slowed or halted the production processes. A follow-up effect is the congestion of ports and delays in ocean shipping. This scenario was substantially worsened by the war in Ukraine, which besides increasing the price of gas and oil worldwide, also stopped the production of certain products in the region (cereals being a major one and already having cascading effects). Additionally, the war demanded finding alternative routes for transporting several goods, which increased transportation costs even further.