Seminar in European Economics

Midterm

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1. The institutional architecture and the decision process in the European Union is complex and combines federalist and intergovernmental elements.

a) What are the main roles of the European Commission, the Council of the European Union and the European Parliament in the EU architecture?
b) How has the balance of power been changing between these institutions? Does it reflect reinforced federalism or intergovernmentalism?
c) What are the advantages and disadvantages of the co-decision procedure?

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a) The European Commission is an institution of the European Union responsible for proposing legislation (legislative initiative), implementing decisions (executive body), upholding the EU treaties and managing the day-to-day business of the EU.

The European Parliament (EP) is directly elected by EU citizens. Together with the Council of the European Union, it exercises the legislative function of the EU, including control over the EU budget. The EP also has the role of supervising EU institutions (can dismiss the commission by adopting a motion of censure). The Parliament also elects the President of the Commission.

The Council of the European Union is the main decision-making body of the EU. It adopts EU laws (together with the EP, based on proposals from the Commission); coordinates EU countries' policies; develops the EU's foreign and security policy, based on European Council guidelines; concludes agreements between the EU and other countries or international organisations; and adopts the annual EU budget - jointly with the European Parliament.

b) Recent institutional reforms have changed the balance of powers towards greater federalism.

Over time, there was an increase in the number of acts adopted through the co-decision procedure which, since the Treaty of Lisbon, became the ordinary decision-making process of the EU. This is the decision-making process in which the EP has greater power, thus reinforcing the power of a federalist institution.

Furthermore, the changes over time concerning the voting rules in the Council (from unanimity to qualified majority) are also illustrative of greater federalism: with unanimity every country has veto power, whereas with a qualified majority voting countries are bound to accept proposals voted by the majority despite their disagreement. Recent reforms concerning the definition of the qualified majority (aimed at limiting the possibility of a coalition formed by a few countries with veto power) also contributed to this trend towards federalism.

In addition, the EP can now also elect the President of the Commission.

C) The co-decision procedure is a decision making process, whereby a draft proposal made by the Commission requires the approval of the Council and the EP to be adopted.

<u>Main advantages:</u>

- The fact that the approval of both the Council and the EP is needed for the legislation to be adopted ensures a consensus between federalist and intergovernmental views.
- In addition the EP participation confers democratic legitimacy to the proposal.
- The process involves significant efforts in order to ensure that a consensus is reached (several readings and interactions between institutions, possibility of amendments, redrafting of the proposal by the Commission in order to take into account amendments; the intervention of a Conciliatory Committee in order to search for a compromise).

<u>Main disadvantages</u>:

- The number of interactions described above can make the process very complex and lengthy, contributing to delay decisions.
- Even though recent reforms in the voting rules of the Council have reduced this likelihood, there is still the possibility of a relatively small number of countries to veto the decision.

2. The sudden-stop in external financing in some Southern European countries was one of the dimensions of the sovereign debt crisis in the euro area.

a) What factors led to the current account deficits in these euro area countries?
b) To what extent are current account crisis more serious if countries participate in a monetary union?
c) In your view, how could these problems be minimized? Please explain.

a) One of the benefits from joining a monetary union with a credible central bank which is committed to maintaining price stability is that domestic agents can obtain lower interest rates when borrowing from abroad. This stems from the fact that, since investors believe that debt and interest cannot be devalued through to high inflation or acute currency depreciation, they are willing to lend at lower premia. These advantages accrued to a number of European countries during the convergence period leading up to the creation of the euro area and afterwards. This led to a period of high credit growth, fueled from borrowing from other euro area countries, which eventually generated current account deficits for peripheral member-states

The willingness of core countries to lend is explained by their high stock of savings, which maps into an elevated capital stock. Economic theory predicts that return rates on capital are lower in countries with larger capital stocks and vice-versa. During the 1990s, with the gradual removal of capital controls and the attenuation of financial regulation in low savings countries like Portugal, Greece, Ireland and Spain, credit flowed in large quantities from the core of the EMU.

This was further intensified by the expectation of high income growth in peripheral countries, which should follow from real convergence as capital increased and productivity improved. This resulted in an expansion of private consumption and investment through borrowing from abroad, generating low savings rates and a widening of current account deficits. Additionally, governments chose to increase spending in the expectation of further savings from dropping interest rates on government debt.

Due to structural features of these economies, credit flows did not result in increased productivity or competitiveness. This was due, for example, to inefficiencies in the financial sector, often the recipient of these funds, which channeled them to sectors with low productivity growth and which produced non-tradable goods, such as the construction sector.

b) A country participating in a monetary union is not able to conduct an autonomous monetary policy. This implies that, if it is subject to an asymmetric shock, it cannot improve its competitiveness via a decline of the nominal exchange rate, or smooth the recession through an interest rate reduction, spurring consumption and investment.

In the euro area, this issue is amplified by the lack of a common fiscal policy. This implies that there are no automatic transfers in the event of a government deficit and the absence of a backstop on the debt of each of the member-states. This creates country-specific default risk, which increases the likelihood and severity of current account crises.

This issue is further amplified by absence of a lender of last resort for euro countries. Under an autonomous monetary policy regime, that role would fall to the central bank, which could buy government debt in the event that yields started to rise and thus reduce a country's bankruptcy risk. In the euro area however, national central banks are barred from monetary financing and the Eurosystem does not have an explicit mandate to act as a lender of last resort. In the event of financial stress in debt markets, investors were uncertain whether the Eurosystem would prevent a member-state from defaulting, which raised the risk that investors would stop lending.

The absence of a backstop for government debt in either of these forms created incentives for banks and sovereigns to become correlated: first, it led governments to lean on domestic financial institutions in order to obtain financing; second, it exposed governments who were attempting to bailout domestic banks to changes in debt market sentiment, due to their exposure to non-performing loans.

c) One way to minimize these issues is to address the vulnerabilities in the architecture of the European Monetary Union, such as the lack of a common fiscal policy and of a lender of last resort for euro area members.

A common fiscal policy could take the form of a transfer mechanism between euro area countries, acting as a stabilizer for GDP growth and curbing country idiosyncratic risks. Alternatively, there could be a single euro area budget and the issuance of common debt, which could eliminate country specific risk. In the absence of these, the powers of the European institutions could be reinforced in the area of fiscal surveillance, such that the issue of public finance soundness would no longer be an issue in the risk assessment of investors. This would, however, not solve the issues that arose in Ireland and Spain, where there existed sound public finances but where government assistance was required in order to maintain financial stability.

The existence of a lender of last resort would reduce uncertainty in sovereign debt markets, both through its role as a backstop in times of financial stress and in case a euro area member becomes insolvent and there is a danger of contagion. With respect to the former, the ECB could have this role as part of its mandate, removing the uncertainty of whether or not member states are able to roll-over their debts in the short-term. With respect to the latter, a mechanism that could provide financial assistance to euro area countries in financial difficulties would minimize the risk of default and avoid larger GDP losses. In fact, this is the role of the European Stability Mechanism, which can provide loans to euro area countries in distress, conditional to their adherence to reform programs aimed at reducing macroeconomic imbalances.