

European Economy Seminar

Correction topics

Resit Exam

17th June 2019

- 1) Fiscal policy is key for macroeconomic developments and it has played an important role before, during and after the euro crisis.
 - a) How has fiscal policy contributed to trigger and intensify the sovereign debt crisis in the euro area?
 - b) Which reforms were adopted in the EU budgetary surveillance system to avoid similar problems in the future?
 - c) How do you assess the existing rules and the stability of EU public finances in the near future?

- a) Fiscal policy contributed because: There were initial fragilities linked with fiscal balances and public debt. Moreover the bank risk sovereign debt loop fed speculation and pressured fiscal balances and banks solvency. Finally, the fiscal multipliers were small making it harder to bring fiscal balances without strong deterioration in GDP
- b) Reforms include the macroeconomic imbalances procedure, new public expenditure and structural fiscal adjustment rules, in the context of the two pack and six pack.
- c) Present situation is still fragile due to high debt levels in some countries and interest rates should eventually increase. Moreover, the new set of rules is still strongly dependent on political discretionary decisions, limiting its enforcement credibility.

2) The world trade is under pressure due to strong protectionist tensions between the US and China.

- a) Are protectionist tensions between US and China likely to affect the EU economy? Why?
- b) What have been the drivers of international trade growth and are they likely to continue?
- c) Which policies would you suggest to European countries in order to improve their external performance?

- a) The existence of Global Value Chains implies that parts and components from many different locations are embodied in production. Therefore, impacts on China-US trade will disturb these complex relationships. Moreover, the financial flows and the overall macroeconomic situation are also affected by this situation and repercussion effects are likely to occur. These effects are nowadays stronger than before. Finally, the outcome of the China-US trade war may follow up towards new trade deals (upgraded or downgraded) by these economies with the EU.
- b) The drivers have been strong technological progress (likely to continue) and lower political and trade barriers (unlikely to continue). Further drivers have been FDI flows and portfolio investment.
- c) External performance is related with flexibility and innovation. For this outcome a skilled labour force is key. This should be the priority for EU countries. Moreover, EU countries should consistently pursue a broad structural reform agenda.

3) The Portuguese economy underwent a current account crisis in recent years which ultimately resulted in an economic and financial assistance program.

- a) Please briefly describe the vulnerabilities and the events which led to the crisis.
- b) Please describe the main pillars of the economic and financial assistance program and any links between them.
- c) In your view, was the economic and financial assistance program successful in achieving its aims? Make reference to economic indicators in your answer.

- a) The Portuguese economy was vulnerable due to high debt levels and sizeable external and fiscal deficits. Moreover, although exports were improving, the overall competitiveness of the economy was quite

limited. This followed from the absence of reform after EMU accession and inadequate adjustment to its low inflation regime.

- b) The pillars were actions on fiscal balances, improve solvency of the banking system and promote structural reform in a wide set of areas (competition, housing, labour market, energy, judicial, education, transports, regulated professions). There are obvious linkages because some fiscal actions make it harder to adopt structural reform (tension between raising revenue and implementing some reforms). Moreover, broad labour market and competition reforms are strongly interlinked.
- c) The program was successful in the sense that fiscal and external imbalances were strongly reduced, though it has not laid down the conditions for stronger potential output growth. Moreover, a better framing of the reform process would have been useful.

4) The Banking Union stands as one of the major reforms to be undertaken after the sovereign debt crisis in the euro area.

- a) Please describe the events that occurred in the euro area which the Banking Union is meant to prevent in the future.
- b) What are the main pillars of the Banking Union and what is their individual purpose?
- c) What is the current state of completion of the Banking Union?
 - a) The sovereign debt crisis in the euro area and the sharp drop in confidence and financial fragmentation in the euro area had strong impacts in the overall economy and risked the continuation of the euro area.
 - b) The pillars are the Single Supervisory Mechanism (SSM) (for banks with systemic size), the single resolution board and fund (to settle banks with solvency problems without compromising the system), as well as a European deposit insurance system (guaranteeing deposits up to a certain amount)
 - c) At present the SSM is in place but the other two pillars are incomplete. Although there is a general agreement amongst countries on the need to implement, the calendar of implementation is long and vague, notably because there are different views regarding priority to reducing existing risk levels (turn banks more robust) vs increasing previously risk sharing (as a way to turn banks more robust later).