Seminar in European Economics

Midterm

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1. European integration has been a gradual process, evolving over time towards greater depth and broader integration.

   a) Which can be considered the main stages of this integration process and what motivated the evolution between stages?

(10%) The European project starts as a peace project, with the goal to rebuild Europe and ensure higher levels of development and prosperity, in the follow-up of WW II. In 1952, the ECSC would be the first supranational European organization to regulate industrial production of coal and steel in 6 countries and make war not only *unthinkable*, but *materially impossible*.

(20%) In 1957, the Treaty of Rome would set the foundations for the EEC and Euratom. The six nations would propose the progressive reduction of customs duties towards establishing a free trade area and customs union in Europe. The European project saw in free trade and free movements of capital and labor (4 freedoms) a way to promote greater productivity (through competition, specialization), comparative advantages and economies of scale, better allocation of resources and a higher level of wellbeing. The single market would be further consolidated with the Single Act in 1986 and the project would attract new members with successive enlargements since 1973.

(10%) In 1992, the Treaty of Maastricht sought to move towards further integration, setting the stage for the EMU and the accession to the euro in 1999, moving from a period of euro pessimism to euro optimism. A greater similarity of economic structures contributes to the greater synchrony of business cycles, facilitating policy coordination and minimizing the emergency of countries' vulnerabilities attributed to large asymmetric shocks.

b) How did the institutional setup and the decision-making process change in view of this greater integration?

Different European institutions were created since the establishment of the ESCC:

(5%) The European Commission is responsible for the legislative initiative, implementing decisions (executive body) and upholding the EU treaties.

(10%) The European Parliament is directly elected by EU citizens. Together with the Council of the EU, 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). The Parliament also elects the President of the Commission.

(5%) The Council of the EU 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; concludes agreements between the EU and other countries or international organizations; and adopts the annual EU budget - with the Parliament.

Decision-making also evolved from unanimous decisions that would need all countries in Council to engage in agreements, to more flexible rules of procedure:

1) (10%) 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 (more democratic legitimacy to proposals, and a better consensus between federalist and intergovernmental views);
2) (10%) replacing unanimous decisions with qualified majority allowed for the possibility for enhanced cooperation in different areas by majorities of member states, without single countries vetoing further European integration.

c) How do you assess these changes in terms of the balance of power between federalist and intergovernmental institutions in the EU?

(10%) 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.

(10%) 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.

2. The euro area sovereign debt crisis highlighted fragilities in the institutional architecture of the EU.

    a) What were the main drivers of the sovereign debt crisis?

(30%) The policies implemented towards price stability, in the process leading to the adoption of the euro, allowed a reduction of risk premia and interest rates in many EU countries. This, together with greater financial liberalization, stimulated borrowing from abroad leading to higher consumption, investment and current account deficits. This stimulus was particularly high in peripheral countries, where interest rates were initially higher. Loose fiscal policies also contributed to the overall indebtedness of the countries.

As, given structural features of these economies, credit flows did not result in increased productivity or competitiveness, the high level of indebtedness was soon perceived as unsustainable once international investors became more aware of risks. The international financial crisis provided the trigger to this change in market sentiment leading to a sudden stop in capital flows to more heavily indebted countries.

    b) Why were euro area countries particularly vulnerable to current account problems, compared to countries outside a monetary union?

(35%) The high level of trade and financial integration in a monetary union can make countries particularly prone to persistent and high current account deficits – as explained above, the convergence of interest rates in the run up to the euro was an important determinant of credit growth, allowing the financing of current account deficits.

However, the scope to correct for a current account imbalance is more limited in a monetary union as the country lacks autonomous monetary and exchange rate policies. Even though expenditure reducing policies can be implemented in order to correct for the deficit, these usually entail greater costs than currency devaluation.

In addition, the inability of the Stability and Growth Pact to promote greater fiscal discipline and the lack of common crisis resolution mechanisms also contributed to countries' vulnerabilities.

    c) What elements were missing from the euro area and EU institutional setup that would have facilitated a resolution of this crisis? Please explain.

(35%) A more efficient Stability and Growth Pact, with enforceable rules to promote fiscal discipline, would allow fiscal policy a more stabilizing role in times of crisis.

A central bank with a clearer mandate to act as a lender of last resort could also contribute to minimize credit risk and improve market sentiment.

An automatic fiscal transfer mechanism to provide assistance to more financially distressed countries would also facilitate the resolution of a crisis.

In addition, greater surveillance of countries' imbalances and structural weaknesses and mechanisms allowing for their correction could also help prevent the build-up of vulnerabilities.