# Seminar in European Economics

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1. The COVID-19 pandemics has been a challenge to the world economy and also to the European Union.

   a) What are the main differences between the current crisis and the great recession of 2008/2009 and the follow up sovereign debt crisis in the euro area?

   **The great recession of 2008/2009 had its origins in a financial shock in the US sub-prime credit market and in the euro area, following an effort to recover based on expansionary monetary and fiscal policies, this later triggered a sovereign debt crisis. This crisis found the Euro Area with deep differences between its members and large macroeconomic imbalances in several of them. Productivity differentials across countries led to imbalances in external accounts. Despite the euro area showed a balanced trade balance with the rest of the world, within the monetary union, some countries built up large trade deficits along the years and, consequently, significant external debt levels. These countries were at a more vulnerable position during the financial crisis and were quickly perceived as risky countries by investors, leading to an overshoot of the interest rate on their public debt and a more difficult access to financial markets (a sudden-stop in external financing). In that sense this was an asymmetric shock within the euro area, i.e. with some countries being more affected than others.**

   **Conversely, the Covid crisis is much more symmetric since it is a common exogenous shock across different countries. The spread of the Covid-19 lead to widespread lockdowns causing a sudden decrease in production and consumption and the collapse of world trade. These lead to a fall both in demand and supply, though with differences across sectors. The crisis was particularly hard on sectors like tourism, and more favorable for others like communications and technologies.**

   **The policy answers to both the crisis were very different. During the last financial crisis and the ensuing sovereign debt crisis, the euro area was not equipped with the tools need to face a sovereign debt crisis. There was not a common fiscal instrument that could correct such imbalances, which mean that at the peak of the increase on the risk premium on public bonds, the monetary authorities engaged in a set of**

**unconventional monetary policy following the "whatever is takes" statement. The covid crisis hit the euro are at a moment when the room for further monetary policy is partially constrained, due to very low interest rates, meaning that there was a drive to intensify the utilization of the fiscal policy.**

b) Why has the pandemics required strong action from fiscal and monetary policy at the European level? How has it materialized?

**As mentioned in the previous question, the room for further monetary policy was partially constrained during the zero-lower bound environment inherited form the last financial crises. Despite the more limited effectiveness of the monetary policy the ECB engaged on:**

1. **Pandemic Emergency Purchase Program (PEPP), which started with €750bn and it has increased to €1000bn**

2. **No ceiling on the amount of public debt the ECB can buy**

3. **The ECB engaged in program the Corporate Sector Purchase Program (CSPP) and eased the collateral demands on banks to refinance their debt close to the central bank**

4. **On the banking supervision side, the liquidity requirements were softened to allow an extra buffer to be used in new credit to the economy. Less demanding rules related to credit concession**

5. **No demand to additional reserves for credits whose risk increased or for those whose payment time was rescheduled, or moratoriums were applied**

**All these policies aim to provide as much liquidity as needed to the markets, calming down possible increases in risk premia. However, in the medium and long-run this may come at a cost of the increase of non-performing loans and the creation of credit bubbles.**

**Thus, fiscal policy became even more relevant. In that sense many countries have been engaging in:**

**1. Increase in health care expenditure**

**2. Extension of unemployment subsidy or extra support to short-term contract workers**

**3. Temporary and partial layoff**

**4. Direct subsidies, postponement of tax payments, loans, collateral on credits and moratoriums**

**Additionally, common European answers have been put forward, namely through instruments like:**

**1. "temporary Support to mitigate Unemployment Risks in an Emergency" (SURE), under which loans can be given to the member states to leverage the employment support – total amount: 100 Billion. Guarantees from the European Investment Bank (25 Billion) to new loans and direct loans of 200 Billion to small and average firms**

**2. European Stability Mechanism – up to 2% of the GDP – to help finance direct costs of the Covid 19, such as health expenditures**

**3. €750 billion Next Generation EU recovery funds**

c) What are the EU institutions that have an intergovernmental and a federalist nature?

**From the very beginning, the process of EU integration is a combination of two divergent approaches – federalism an intergovernmentalism – which is then ultimately reflected in the nature of EU institutions.**

**In fact, as a result of their membership of the EU, member states decided to transfer some powers to EU institutions. Thus, in specified policy areas, these independent institutions can take supranational binding decisions. In this context, we may argue that the European Parliament (EP), the European Commission (EC) and the European Central Bank (ECB) share a federalist nature. Indeed, the EP is directly elected by EU citizens and 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 and also elects the President of the Commission. The Commission has also a federalist nature. It is a supranational institution of the EU responsible for proposing legislation (legislative initiative), implementing decisions (executive body), upholding the EU treaties and managing the day-to-day business of the EU. In addition, the European Central Bank (ECB), as the central bank of 19 different countries, is an independent EU institution in charge of the Eurozone's monetary policy.**

**Differently, both the European Council (EC) and the Council of the EU (Council) have an intergovernmentalism nature. The EC, composed by member states' head of state and government, defines the EU's overall political direction and priorities. It sets the EU's policy agenda, which identifies issues of concern and actions to take. The Council, composed by government ministers according to the policy area being discussed, adopts EU laws and the annual budget (together with the EP) and coordinates EU countries' policies. In both the EC and the Council, the dominant feature is a stronger component of intergovernmental cooperation where each representative defends its national interest.**

d) Has this crisis turned the EU more intergovernmental or federalist?

**Governments have been asked to engage in expansionary fiscal policy to contain the economic consequences of the pandemic on economic activity and employment. Since this shock – contrary to the previous financial crisis – is a more symmetric one, affecting all countries equally, there has been a push from the European institutions for a common fiscal approach. This led to a European recovery plan composed both by grants and loans designed to provide financing channels to the economy and act in a counter-cyclical way. These new programs are to be financed, for the first-time, trough mutualized EU debt, showing that countries are willing to share part of the risk for a common fiscal solution to the current pandemic. The main pillar of this response is the EU recovery fund (Next Generation EU), amounting to a total of €750bn. Even acknowledging that this facility required a unanimous approval at the Council level (reflecting EU's intergovernmental side), one may argue that this crisis has turned the EU more federalist. Indeed, not only countries were willing to share risk through mutualized debt, but also the European Commission played a central role in the negotiation. On the other hand, the ECB also played a key role, taking significant measures (such as the PEPP) to mitigate the impact of the coronavirus pandemic on the euro area economy.**

**Notwithstanding, despite such measures pointing out towards a federalist response, it is still too soon to grasp whether the COVID-19 crisis will boost integration and initiate a path towards greater federalism in the long-term. Indeed, past experiences show that crises may be accompanied by pessimism. Therefore, the success of EU's coordinated economic response, as well as a successful management of the health crisis (e.g., through a smoother vaccination process) are fundamental features to prevent an increasing negative sentiment towards EU integration.**