Final Exam – Basic solution guidelines

1) In the last ten years the European monetary policy has been very active, especially if compared with the initial decade of the monetary union.
a) What is the mandate of the ECB and how would you compare this institution with the other main EU institutions?
b) How has ECB monetary policy evolved since the 2008 international financial and economic crisis? What were the goals that it wanted to achieve?
c) Which new tasks, besides monetary policy, were attributed to the ECB after the crisis and what is the objective?

a) 30%

The ECB is the institution responsible for the implementation of monetary policy in the euro area, with the primary goal of maintaining price stability. The Treaty and its statutes provide the ECB with independence, necessary to the pursuit of its objective.

Compared to the other institutions, the ECB can be differentiated by the exclusivity of its main function (monetary policy) and the greater degree of independence.

In fact, other EU institutions (e.g. EU Commission, European Parliament, and Council) are responsible for a wider range of policies, but none has complete authority on the approval of decisions (the Commission does not decide and the European Parliament and Council share decision-making responsibilities in the Ordinary Legislative Procedure – co-decision procedure).

b) 35%

The aftermath of the international financial crises was characterized by severe financial turbulence and pressures in money markets, which seriously undermined the functioning of the transmission mechanisms of monetary policy. This prompted the ECB to intervene with extraordinary measures, both in terms of reducing policy rates to levels that are unprecedented, and in terms of unconventional policy measures aimed at providing liquidity to markets and at improving the bank lending channel. The unconventional liquidity measures (e.g. extended maturity of refinancing operations, expansion of eligible collateral for monetary policy operations, allocation of liquidity at fixed rate and in greater quantities, outright monetary transactions) were required due to the limited room provided by the very low policy rates.

c) 35%

The ECB has been attributed supervisory tasks, in the context of the Single Supervisory Mechanism (SSM) of the Banking Union.

The need for a banking union emerged more clearly after the sovereign debt crisis. The greater uncertainty caused by the financial crisis and the related change in market sentiment affected severely more vulnerable countries, which were penalised with higher sovereign risk premiums. The correlation between bank and sovereign risk implied that these costs were extended to the banking sector. In addition, it also became clear that in a monetary union, problems caused by close links between public sector finances and the banking sector can easily spill over national borders and cause financial distress in other EU countries. The Banking Union, with its burden-sharing mechanisms (Single Resolution Mechanism and a single deposit insurance scheme – not yet concluded) and a common regulatory and supervisory framework (SSM) was created as a solution to decouple bank and sovereign risk and to improve financial integration in the euro area.

2) It is widely acknowledged that the fiscal policy is an important stabilization tool in any economy but is has proven to be difficult to manage it in the EU.
a) What is currently the setup for the management of fiscal policy for EU member-countries?
b) What have been the problems and which fiscal challenges presently remain?
c) Why has the supervision of macroeconomic imbalances in the EU countries enlarged beyond the fiscal aggregates?

a) 30%
In the EU there is no common fiscal policy, but a framework, the Stability and Growth Pact (SGP), ensuring coordination and discipline with respect to fiscal policy. The SGP includes a Preventive Arm, which sets the rules and medium term goals that bind countries towards sound fiscal policies and a Corrective Arm aimed at ensuring that Member States adopt appropriate policy responses to correct excessive deficits, by implementing the Excessive Deficit Procedure (EDP).

b) 35%
The main problem with fiscal policy has been the non-compliance with the rules of the SGP. This led to excessive budgetary deficits and high levels of public debt which, together with other weaknesses, made countries vulnerable to the risk of a sudden stop in the aftermath of the financial crisis. The fact that euro area countries do not have an autonomous monetary policy and that there are no automatic fiscal transfers within the euro area limits policy responses and accentuates this risk.
In order to overcome these problems extensive reforms have recently been made with respect to fiscal policy, aimed at strengthening the enforceability of the SGP and the monitoring of fiscal policies. In addition, a mechanism was created in order to provide financial assistance to euro area countries with financial difficulties (European Stability Mechanism).
However, it is still soon to assess the efficacy of these reforms (i.e. whether the ‘new’ SGP is in fact more enforceable; whether the ESM is not prone to moral hazard problems).

c) 35%
It was not only high levels of public debt that made countries vulnerable to the risk of a sudden stop in the aftermath of the crisis, but private indebtedness also mattered. The high degree of financial integration in the euro area can easily lead to unsustainable debt levels. This observation led to the awareness that the monitoring and supervision of macroeconomic imbalances in the EU should be enlarged beyond fiscal variables – large and persistence current account deficits, highlighting competiveness weaknesses, are particularly relevant.
This monitoring is since 2011 performed under the Macroeconomic Imbalance Procedure (MIP), which aims to identify and prevent the emergence of macroeconomic imbalances that could adversely affect economic stability. This monitoring can be enhanced when a country is found to have an excessive imbalance and can imply the imposition of sanctions.

3) *Competition in the goods and services markets has always been an important element in EU legislation but, more recently, concerns over the creation of a friendly business environment within the context of a broad structural reform agenda have greatly increased.*
a) Why is market competition important in the EU and what are its guidelines?
b) Why structural reform is considered a true priority nowadays?
c) Are there special concerns regarding the functioning of EU energy markets? Please explain.

a) 40%
The EU is rooted on free trade of goods and services. In this context, the existence of market power, mostly if backed by state aid to firms, distorts comparative advantages and the fair distribution of gains across member countries. In addition, competition promotes innovation and the correct allocation of resources in the economy. The guidelines for competition policy in EU (as well as in individual countries) are the approval of mergers and acquisitions and surveillance to identify cartels and other abuses of dominant position. Moreover, large operations (with EU relevance) are decided by DG-Comp, while, through the principle of subsidiarity, smaller cases are dealt by national competition authorities. Competition rules are part of the EU legislation since the Treaty of Rome.

b) 30%
In the medium and long run the structural reform agenda is the only sustainable driver for economic growth. Only through efficient labor and product markets, competition and good institutions does the long run supply curve expand. In the current juncture the classic macroeconomic policies are mostly exhausted. Monetary policy has reached the zero lower bound for interest rates and the future creation of additional liquidity poses high risks of speculative asset bubbles. The fiscal policy is constrained by high public debt levels. The adoption of strong expansionary stance in classic expenditure policies risks reigniting macroeconomic imbalances. Therefore, for short-run purposes structural reform is the alternative available. This has been acknowledged by many governments and international economic policy institutions.

c) 30%
Energy markets are key for the economy and present a large number of challenges and distortions. Primary energy sources are not abundant in the EU, i.e., there is significant energy dependence in many economies. Therefore, energy security is a major concern that requires diversification of suppliers and integration of energy infrastructures in the EU. Moreover, the efficient utilization of energy to produce output is another challenge in EU economies, i.e., improve energy efficiency. The investment in the development of renewable energy sources is also a way forward, despite problems regarding the reliability of their supply. Finally, there are distortions associated with the excessive market power of many energy producers and the existence of public subsidies and guarantees. The creation of the energy union, including the transnational energy connections, is the main goal of the EU in this area.

4) The removal of obstacles to international trade of goods and services, capital movements and labour mobility has been reinforced since the Treaty of Rome.
a) Which of these three dimensions has advanced the furthest? Please explain.
b) How are trade and capital flows interconnected in today's globalized world?
c) Why is international labour mobility both an important and a contentious issue in the EU?

a) 30%
The trade of goods and services is the dimension that has advanced the furthest in the EU. The creation of the customs union in the 50s, the European Single Market and the monetary union progressively removed barriers and transaction costs. The freedom of capital movement is part of the single market but the sovereign debt crisis has shown that there is still fragmentation of financial markets across the EU as interest rates differed substantially and the markets signaled a country-specific risk. The movement of workers across the EU countries is still limited by specific professional regulations, as well as cultural and language barriers.

b) 40%
The circulation of capital is closely linked with the trade of goods and services. Firstly, trade of goods involves use of trade finance tools (e.g. commercial credit). Secondly, trade flows sometimes leads to temporary imbalances that imply the financing of countries in deficit by those in surplus. This has been clear in the euro area in the run up to the 2008 and 2011 crisis. Finally, several drivers of growth in trade match those fueling the increase in capital flows, notably, technological progress and lower political barriers. The foreign investments that take place in the context of the GVCs are also proof of a relation between both elements.

c) 30%
Labor mobility is important issue in the EU because it offers a way of adjusting imbalances in the euro area. In the event of asymmetric shocks, workers could move from high unemployment regions/countries to low unemployment ones, thus mitigating the effort that would have to be made in terms of real wage adjustments. This is an important feature in a monetary union. Nevertheless, this is a contentious issue because there are distortions related with unemployment subsidies, productivity and wage bargaining that make it attractive for some workers to migrate even is unemployment rates are high in destination countries. Finally, cultural barriers also make it difficult for the mobility of workers in the EU to resemble that observed in the US.