European Economy Seminar – Exam 17th January 2018

<u>Basic solution guidelines (please note that in the exam, additional development on each topic was warranted)</u>

1) *The latest economic and financial crisis triggered a strong debate about the need for institutional reform in the EU, which has led to several changes. These latest reforms accelerated a process that had started before the crisis.*

a) Which have been the trends regarding the EU voting procedure and the democratic legitimacy of European institutions?
b) Which institutional changes took place to address banking and financial risks in the EU?
c) Does the democratic legitimacy of the EU institutions interconnects with the reduction of banking and financial risks? Please explain why.

a) Reforms in the EU voting procedure started well before the crisis and have been materialized into a gradual reduction of the voting majority required to pass a decision in the Council (from unanimity to a smaller qualified majority). The aim is to prevent a minority of large countries to veto the decision-making process, thereby reducing differences in countries' relative power.

Furthermore, these reforms also consisted into enlarging the areas where the decision-making process follows the co-decision procedure (EU ordinary legislative procedure), implying greater decision-making power to the European Parliament, an institution with more democratic legitimacy, as its members are directly elected by the people.

b) One of the most important reforms in order to address banking and financial risks in the EU, implying significant institutional changes, consists in the creation of the Banking Union. It consists of a Single Supervisory Mechanism, a Single Resolution Mechanism and a European Deposit Insurance Scheme. The Banking Union, aims at disentangling the link between sovereign and banking risks and, thereby, contributing to mitigate financial risks in the EU.

The major institutional change consists in transferring to the ECB, through the Single Supervisory Mechanism, the responsibility over supervision and regulation of the banking sector of the euro area.

c) The transfer of national sovereignty over regulation and supervision to a supranational authority can reduce democratic legitimacy as a supranational authority has, in general, less democratic legitimacy than an elected government. However, the degree of accountability and responsibility of the institution also matters for democratic legitimacy. A supranational authority can have democratic legitimacy if it represent the interests of EU citizens and is accountable and responsible for its actions. The fact that the banking union is still uncompleted undermines both democratic legitimacy and effectiveness in reducing banking and financial risks. The sovereign-bank risk nexus can only be reduced with the creation on a resolution and deposit guarantee funds – as if the costs related to a bank failure remain national, the risk of the sovereign affects the banking sector. The fact that the ECB cannot be made accountable for a failure in supervision (as costs are borne by national) undermines its legitimacy.

The willingness of governments to transfer competencies over the two other pillars of the Banking Union is key to the reduction of banking and financial risks. Since this willingness by governments depends on the support of its citizens (conferring democratic legitimacy to the Banking Union) democratic legitimacy can interconnect with the reduction of banking and financial risks.

2) The European sovereign debt crisis brought renewed attention to the theory of Optimal Currency Areas.

a) What characterizes an Optimal Currency Area?

b) How do countries in a monetary union adjust in case of a very negative shock affecting its external competitiveness?

c) What are the limitations of the nominal convergence criteria for accession to the monetary union established in the Maastricht treaty?

a) An optimal currency area is an area in which it is optimal to have a single currency. This occurs because the gains resulting from the single currency (e.g. the elimination of exchange rate risk) are greater than the costs due to the loss of an autonomous monetary and exchange rate policy as a mechanism of adjustment to negative idiosyncratic shocks. The greater the likelihood of common rather than idiosyncratic shocks, and the greater the efficiency of other adjustment mechanisms, the more likely is a country to benefit from being in a currency union. Several factors can contribute to this: labour and capital mobility; the flexibility of labour and goods market; the diversity of productive structures; a mechanism of fiscal transfers.

b) The lack of a national currency precludes the possibility of a currency devaluation, which would be the most obvious way to restore external competitiveness following a negative shock. As such the country has to resort to other ways to change the relative prices between domestic and foreign goods. This could be achieved through restricted fiscal or incomes policies, aimed at reducing wages and domestic prices. The more flexible is the labour market the easier would be to implement those measures. Reforms aimed at improving productivity and market flexibility would also restore competitiveness in the long run, but would take more time.

c) Maastricht criteria are aimed at ensuring nominal convergence and fiscal discipline. However, these criteria fail to include the conditions to achieve real convergence. In fact, most of the factors, referred to above, that characterize an Optimal Currency Area are missing.
Furthermore nominal criteria which have to be observed at a specific point in time are relatively easy to achieve with restricted policies which, if not sustained over time, can give rise to future imbalances.

Relying merely on nominal criteria over a short term is not sufficient to ensure the well-functioning of the monetary union and can give rise to future problems. The reduction of interest rates as a result of deflationary policies that most countries pursued in order to join the monetary union, were and incentive to indebtedness and to the accumulation of future macroeconomic imbalances.

3) Structural reform is often referred as the solution to boost productivity in EU countries that struggle with macroeconomic imbalances.

a) *Why structural reform is repeatedly pointed out as major driver for the correction of macroeconomic imbalances?*
b) *Are there linkages between different structural reforms? Please justify and provide some examples.*
c) *Should structural reform in the EU base on the equalization of economic legislation across countries? Please explain your view.*

a) The adjustment of macroeconomic imbalances (deficits) can be addressed using classical expenditure reducing (contraction of investment, consumption and public expenditure) or expenditure switching policies (depreciating to prompt higher exports and lower imports). The former policies lead to a contraction of demand, recession and unemployment, while the latter policies are simply not available in a monetary union. Therefore, the supply-side approach emerges as a convenient solution, and it materializes in the adoption of structural reforms. In addition, common EU stabilization policies are not available either. In fact, structural reforms can deliver long term economic growth and not just short-term stabilization.

b) Structural reforms form a complex and form an intricate network, i.e., there are many linkages between them. For example, the judicial system is key to assure property rights, which are themselves basic for the good functioning of the housing market and attract FDI. In addition, the competition in the goods market and the bargaining power of workers is related. Higher market power by firms leads to rents (profits) that workers can explore, thus maintaining distortions in the labour market. Therefore, there are complementarities in reforms, and the sequencing and the timing of reforms is key.

c) In some areas it is important that legislation is fully comparable across EU countries. This is the case of competition or regulation regarding the financial system and its safeguard mechanisms (e.g. banking union). Nevertheless, is some areas there are country specificities that should be accommodated, notably regarding production processes.

4) The face of international trade has been transformed by the emergence of global value chains (GVCs) as the paradigm for the production of goods and services.

a) What are global value chains and how do they impact in our understanding of the economy?
b) Do global value chains explain the rise of a protectionist ideas in some advanced economies? How would you assess this rhetoric?
c) What is the mutual effect between Brexit and GVCs?

a) Global value chains correspond to a production paradigm where stages of production are split along different geographical locations and each one of them there is creation of value added. The fragmentation of the production chain can be organized in different ways but it still relies on exploring comparative advantages at the detailed product level. This reality increases the interdependence between economies and the propagation of shocks. Moreover, there has been a reallocation of tasks across countries.

b) Yes, tasks in the intermediate segment of the global value chain, where value added is smaller, have been directed towards emerging economies where wages are comparatively smaller. Therefore, unemployment emerged in these segments in the advanced economies, also increasing inequality inside these countries. This has been fertile ground for the protectionist rhetoric, which forgets that trade is not a zero-sum game. In this context, proper redistribution policies should be put in place.

c) The Brexit will insert new trade and legal barriers that disturb the functioning of existing GVCs. Therefore, there will be costs both for the European firms (which will have to adapt and potentially redirect production and sales) and also for the UK (who will find out its firms cannot stay out of these chains and remain competitive).