Nova School of Business and Economics

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# European Economy Seminar

## Final Exam

12th June 2018

**Notes:**

- Students are asked to **answer three questions**, out of the four available, and they all have a similar grade.
- Total time for the exam is 2 hours.
- Answers should be contained in the space given.
- Students should reflect before start writing in order to provide straight to the point answers.
- Keep this pack of pages together.

**Name:** ______________________________

**Number:** _______

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1) The enlargement towards the western Balkans and the deepening of the monetary union are competing objectives in the EU.

a) In conceptual terms, what are the benefits and costs of EU enlargements for existing and new members?
b) What are the key objectives to achieve through the deepening of the monetary union?
c) Why are the enlargement and the deepening of the monetary union objectives difficult to articulate?

*a) For new member, and also for existing ones, the main benefit of EU enlargement is the participation in a larger area of economic integration, with free trade and free movements of capital and labour. Free trade can promote greater productivity due to the higher competition, specialization in sectors of greater comparative advantage, and benefiting from economies of scale. In addition, it allows for a wider diversity of consumption goods. Greater integration of capital and labour markets allows for a better allocation of resources across countries.*

*Given that new EU member are often less advanced economies with greater structural weaknesses, they are likely to become net beneficiaries of EU cohesion funds. This benefit of new members, however, imposes a cost on existing members.*

*Furthermore, greater competitiveness may be a challenge for countries where firms are not sufficiently efficient to compete in international markets. This is likely to be a greater cost for new members. Moreover, new members are likely to incur transition costs in adapting their economic structures and institutions in order to participate in common EU policies.*

*In addition, a greater number of countries will complicate the EU decision-making process and make common policies more difficult to manage.*

*b) The key objective to achieve through the deepening of the monetary union is the greater integration and convergence among its members and greater macroeconomic stability. This can only be achieved through greater monitoring of countries' imbalances and vulnerabilities, greater enforcement and coordination of fiscal discipline and some degree of burden-sharing (fiscal transfers) among countries.*

*Since the sovereign debt crisis some reforms have been introduced in that direction (the Macroeconomic Imbalances Procedures and the European semester; the fiscal compact, the European Stability Mechanism). However, to a great extent, their efficacy remains to be tested.*

*c) The deepening of the monetary union is facilitated with a greater cohesion among EU members. 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.*

*By contrast, enlargement contributes to the greater heterogeneity of the EU, thereby making the well-functioning of the monetary union more difficult.*

*Furthermore, the need for burden sharing mechanisms – a particularly critical issue – becomes more relevant with lower cohesion in the monetary union. This is likely to trigger resistance to the establishment of such mechanisms.*

2) Fiscal and monetary policies are important in the present EU debates and important challenges lie ahead.

a) What are currently the main challenges to the EU budgetary approach and to its fiscal supervision mechanisms targeted at Member-countries?
b) What are currently the challenges faced by the ECB's monetary policy?
c) How do you assess the interplay between fiscal and monetary policies in a monetary union?

a) *The EU budgetary approach is characterized by a relatively small common EU budget and by different fiscal policies among Member-countries. The Stability and Growth Pact is the main fiscal supervision mechanism to coordinate and impose fiscal discipline among EU-members.*
*The main challenges regarding this framework is the difficulty in providing sufficient enforcement power to the Stability and Growth Pact and the inadequacy of the EU budget to allow for a significant degree of burden-sharing, as needed for the smooth functioning of EU common policies.*

*b) The main challenges of the ECB are to ensure the effectiveness of the monetary policy in providing stimulus to economic activity and, simultaneously, avoid that the gradual exiting from current policies causes deflation and undermines financial stability in heavily indebted countries.*
*The ECB has been implementing monetary policy with very low interest rates. This close proximity to the lower-bound implied the introduction of a wide range of unconventional monetary policy measures in order to provide a stimulus to economic activity and avoid deflation. These massive liquidity injections caused a significant expansion of central banks' balance sheets and cannot be sustained over time. In addition, very low interest rates can exacerbate risks in the financial sector through search-for-yield behaviours.*
*Therefore it is important to devise an exit strategy from existing policies. However, raising the interest rates too soon may risk deflation and harm financial stability in heavily indebted countries (as a higher interest rate contributes to increase debt service costs, which may undermine repayment capacity).*

*c) Fiscal and monetary policy can interplay in several ways and this interplay is more relevant in a monetary union.*
*Expansionary fiscal policy in some countries may undermine the monetary policy's goal of inflation, thereby creating pressure to increase the common monetary policy rate – and creating an externality to countries with more disciplined fiscal policies.*
*Also, a high level of public debt is more problematic in a monetary union, given the impossibility of printing money to avoid sovereign default.*
*In addition, given the impossibility to devalue the currency for countries in a monetary union, fiscal policy is the main stabilization policy to respond to an adverse asymmetric shock at the national level.*

3) Developments in the labour market and migration have strong social consequences and have a potential impact on convergence between countries. Therefore, they should be at the core of EU policy-makers' concerns.

a) What is the role of labour markets a monetary union and explain why there is a potential impact on convergence?

The existence of labour mobility, i.e., the integration of labour markets, is a necessary condition for an optimal currency area. When an asymmetric shock takes place the higher unemployment in the negatively affected country/region is mitigated by the movement of workers towards the expanding regions. Therefore, there is a smoothing of economic cycles, which makes it easier for the central bank to manage monetary policy. In addition, the adjustment to economic shocks does not entirely operate though (difficult) wage changes.

In structural terms, labour mobility would promote a convergence of wages across countries, thus contributing to real convergence. However, if fast growing areas are positively affected by the dynamics of labour inflows (positive agglomeration effects) the movement of workers continues out of the poorer region leading to a desertification. In this case there is economic divergence. Although labour mobility is enshrined in the Treaties, the EU is quite distant (in practice) from the paradigm of cross-country labour mobility.

b) What are the challenges posed by globalization and Global Value Chains to the European labour markets?

The GVCs imply the fragmentation of the production chain along different stages (tasks). The initial and final tasks of production generate the largest part of total value added, thus translating into higher wages. Therefore, the intermediate steps of production have been delocalized towards developing economies, reducing wages and total employment in these tasks in the EU. Therefore, GVCs contribute to raise inequality and dam age social cohesion.

Moreover, globalization also leads to (facilitates) stronger inflows of workers, notably from non-EU countries. In this context, there is pressure regarding low skilled jobs, which adds to the tension emerging from GVCs, thus fueling populist rhetoric.

c) How do you assess proposals for a common EU unemployment and minimum wage policies?

The proposal for a common unemployment subsidy is a part of an agenda directed at creating automatic transfers between EU countries, which should act as automatic stabilizers. However, this component of fiscal federalism must be

complemented with common taxation. In any case, finding a common understanding for implementation across EU countries seems very difficult.
The minimum wage introduces a distortion in labour markets because prices (wages) cannot fully adjust. The imposition of common minimum wages would be unfeasible in terms of competitiveness, given the prevailing wage heterogeneity in the EU.

4) International trade has been changing its nature along the last decades it is now driving policy debates inside and outside the EU.

a) Why is trade policy totally centralized at the EU level?

The EEC (now EU) was created as a customs union. Therefore, by definition, there is a common trade policy versus third countries, making it necessary that it is centrally managed. In a free trade zone, members can retain autonomy in trade policy, but face the burden of controlling the origin of all products imported, even if entering from another member of the agreement.

b) How does the EU economy positions in current paradigm of international trade and production and how has this changed since the mid-20th century?

Nowadays, the EU countries are well integrated in global value chains (GVCs). Actually, there are strong intra EU GVCs, integrating Western and Central and Eastern countries. Nevertheless, as a whole, when compared with first decades of the 20$^{th}$ century the EU posts a not so important role in the world trade and the world economy. The rise of China and other developing economies has transferred power away from the economic powers that developed in the pre-GVC era.
On average, the EU occupies the initial and final stages of the value chain, i.e., it is not specialized in simple parts and components that require low skills and compete on the basis of low prices.

c) What are the challenges that lay ahead regarding economic globalization and how should they be addressed?

There are several challenges. The rise in inequality emerging from lower wages (and jobs) for workers in the intermediate stages of production, asks for further redistribution in order to maintain support for international trade as a source of gains. In addition, the stronger interdependence between countries that results from this new paradigm asks for coordinated responses to shocks. Furthermore; challenges associated with pollution and climate change need to be addressed with the correct economic tools (e.g. green taxes, CO2 markets). Moreover, the strong technological progress that is expected to continue asks for flexibility and innovation in the economies, which base on further human capital.