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Correction topics

1) The European sovereign debt crisis highlighted the need for a greater surveillance of macroeconomic imbalances and vulnerabilities in the European Union.

a) Please describe the framework for the monitoring and surveillance of macroeconomic imbalances in the European Union.
b) Which institutions are involved in that exercise and what are their respective roles?
c) Is this framework likely to be effective in preventing the emergence of major imbalances in the future?

a) *The framework for the monitoring and surveillance of macroeconomic imbalances in the European Union is defined by the macroeconomic imbalance procedure (MIP), which aims to identify, prevent and address the emergence of potentially harmful macroeconomic imbalances that could adversely affect economic stability in a particular EU country, the euro area, or the EU as a whole. Macroeconomic imbalances are monitored as part of the EU's annual cycle of economic monitoring and guidance (the European Semester).*
In addition, imbalances in fiscal accounts are monitored within the context of the Stability and Growth Pact
b) *The main institutions involved in the MIP are the European Commission and the Council. The European Commission's role is to analyze the economies of all EU countries (alert mechanism report) and identify those whose situation requires deeper analysis in order to detect any macroeconomic imbalances and assess their severity (in-depth review). The European Commission may recommend that the Council requires countries the submission of a corrective action plan detailing measures to address their imbalances and a time frame for their execution.*
c) *Although the framework has not yet been sufficiently tested, it does not seem to have a strong enforcement mechanism.*
The emergence of macroeconomic imbalances in many countries prior to the crisis was not due to lack of monitoring or identification of those imbalances, but to the fact that these vulnerabilities were underestimated and that little action was taken to address them.

2) Over the recent years monetary policy has been maintaining very low interest rates.

a) Why have interest rates been persistently low?

b) What constrains do very low interest rates imply for the implementation of monetary policy?

c) Given these limitations, which measures have been implemented by the ECB to provide a monetary stimulus to the economy?

a) *Interest rates have been low even before the crisis. The credibility of monetary policies and low inflation targets enabled central banks to keep inflation low without raising interest rates, despite the significant expansion of credit. In addition, globalization and the possibility of importing goods at lower prices from emerging markets may also help explaining the low inflation rate.*
Since the international financial crisis central banks have decreased interest rates even further in an attempt to stimulate economic activity.

b) *Low interest rates imply a proximity to the lower bound, beyond which the expansion of monetary policy can no longer be effective. This is so because agents would be reluctant to deposit money in the banking system at a very negative interest rate.*
In addition low interest rates may also undermine financial stability and, thereby, affect the transmission mechanism of monetary policy. In fact, low interest rates are frequently associated with risk behaviour (search-for-yield phenomena) and may affect banks' profitability through lower interest rate margins – as banks have more difficulty in transmitting lower rates to depositors.

c) *Given these limitations, the ECB had to resort to a new 'unconventional' approach to expand its monetary stance. This approach relied less on adjusting its main refinancing rate, and more on* directly influencing *the whole spectrum of interest rates in the economy that are relevant for private sector financing conditions. These measures consisted in large assets purchase programmes of private and public sector securities, in an expansion of the list of assets eligible for monetary policy operations; in longer-term refinancing operations, etc. These measures allowed the ECB to provide liquidity in a larger scale, at longer maturities and against a wider range of collateral.*

3) The recent wave of financial globalization has been characterized by a significant increase in the volume of capital flows at the world level and by a greater predominance of foreign direct investment in the composition of capital flows.

a) What explains the greater predominance of foreign direct investment?

b) What are the main advantages and disadvantages associated with financial liberalization?

c) How can countries better reap the benefits of financial liberalization?

a) International capital flows have increased for several reasons. Technological progress and lower administrative barriers make it easier to invest on foreign markets. In addition, the implementation of a fragmented production process (global value chains) requires substantial FDI, which is also part of capital flows. Moreover, the existence of global foreign account imbalances prompts capital flows from surplus to deficit countries.

b) On the one hand, capital flows offer an opportunity to diversify risk and make it possible for countries to access finance for productive investment, thus promoting growth. On the other hand, strong capital flows risk creating speculative bubbles (overvaluation of asset process), who's burst leads to the fast propagation of shocks across countries.

c) Countries should put in place capable financial supervision systems (including macro prudential policies) and maintain a stable macroeconomic situation (reduced imbalances). Moreover, the creation of conditions for productive investment projects to emerge, instead of those associated with economic rents, is key. This involves adequate regulation of product and labour markets.

4) The Portuguese current account balance improved significantly since the signing of the Financial Assistance Programme with the IMF and the European Union institutions.

a) What factors led to the prior deterioration of the current account deficit?

b) Why can gross exports be a misleading indicator of the contribution of exports to the reduction of the external imbalance?

c) What reforms would contribute most to increase the competitiveness of the Portuguese economy?

a) The decrease in interest rates prior to the EMU accession boosted consumption and investment, thus increasing imports. However, also due to adverse shocks on the patterns of comparative advantages (China in the WTO and Central and Eastern European Countries in the EU), export performance was poor. Moreover, fiscal policy was expansionary, adding to the external financing needs. Overall, prior to the crisis Portugal was facing a severe shortage of savings to finance investment, leading to current account deficits that generate a deterioration of the external investment position.

b) Since there is an increasing import content on exports (due to global value chains) it is preferable to assess the true domestic value added embodied in exports instead of its gross value.

c) Many reforms can be mentioned. To increase the quantity and quality of inputs (capital and labour) is basic. This means promoting a healthy demography and further human capital, as well as more productive investment. In addition, the correct functioning of the labour market and competition also support the competitiveness of the Portuguese economy.