Nova School of Business and Economics

João Amador

Rita Bessone Basto

Pedro Freitas

European Economy Seminar

Final Exam

June 2020

Notes:

- Students are asked to **answer three questions**, out of the four available, and they all have a similar grade.
- **Maximum of 600 words per question, including a), b) and c)**
- You must submit the exam until 9 p.m. However, note it was conceived to be written in 2 hours.
- **You should submit a PDF file with your answers under "Exam submission" on the assessment section of the moodle webpage.**
- **When submitting the PDF file, if you are asked to accept the Turnitin End User Licence Agreement, you MUST do it.**
- The PDF file name should contain your name and student id
- Students should reflect before start writing in order to provide straight to the point answers.

1) **Fiscal packages implemented by several countries in order to minimize the effects of the current pandemic crisis will contribute to a significant increase in public debt ratios.**

   a) How will these increases in public debt ratios affect economic recovery after the crisis?

Higher debt limits the ability to run further fiscal deficits and increase exposure to risk, notably through financial markets. The high public debt has spillover effects on the financing conditions of firms, hurting investment, innovation and exports.
In a context where households are Ricardian, this may limit private consumption.

   b) Can the reaction of financial markets compromise debt sustainability in the euro area? Justify.

On the one hand, a recession coupled with high debt increases the likelihood of looming spread for financing in external markets and even sudden-stops. However, the problem is not specific to Portugal and the very accommodative stance of the monetary policy may reduce the probability of higher public debt yields.

   c) Is there a rationale for a common EU-level policy intervention to minimize the impact of the pandemic crisis and speed up economic recovery?

      Yes, since this is a common shock, with no moral hazard issues involved, common action will facilitate the financing effort (at lower cost), especially for more fragile economies. Moreover, the interconnections between European economies (and banks) are very large.

2) **The utilization of teleworking, as a way to deal with social distancing imposed by the ongoing pandemic crisis, has contributed to speed up the transition to a digital economy.**

   a) What are the economic costs of this transition? Please explain.

Some firms will have their business model permanently damaged, leading to permanent drop in output and job destruction. If this effect is strong, there is potential social disruption. Policy action to save these firms may constitute a waste of scarce resources. Going forward these costs will more than compensated by new firms operating in the new sectors/services/products.

b) What are the foreseeable consequences of the digital transition for international trade and for the functioning of the labour market?

More trade in services, further customization of goods traded (embodying more services). Lower utilization of labour in production (more automation).
As for the labour market, there are consequences in terms of the skill needed, with an impact on wages for different types of workers.

c) What are the difficulties involved in measuring productivity in a context of teleworking and digital transformation?

Information on hours worked is mandatory. Taking into account the role of home production and the value of imputed rents is also necessary. As for the capital stock, measuring the internet connections, computers and intangibles in general is even more important than in the past.

3) The intervention of the ECB in the course of the 2010 sovereign debt crisis was decisive to contain financial markets' turmoil.

a) How is the ECB contributing to minimize the effects of the current pandemic crisis?

The ECB has been buying assets in secondary markets (Pandemic Emergency Purchase Programme), thus massively increasing liquidity available for firms and households. In addition, pre-existing purchase programmes (Asset Purchase Programme) continue. The deposit facility rate remained unaltered. Moreover, the intervention contributes to stabilize the yields on government bonds.

b) Given the starting point and the current circumstances, what are the drawbacks of this intervention?

The drawbacks are associated with the exhaustion of monetary policy tools. The enormous expansion of the balance sheet of the central bank introduces risks to its overall solvency. In addition, there is the risk of sustaining in the market inefficient, thus firms hurting GDP growth, to potentially aggravate public debt and to increase the likelihood of asset bubbles in general. Inflationary risks are also present.

c) Would a scenario of inflationary risks affect the stance of monetary policy? Is such a scenario likely?

In a context of inflationary pressures the ECB would not be able to justify present decisions. The price stability objective is dominant in the ECB mandate. High inflation rates would also put the burden of the adjustment on savers. Nevertheless, inflation expectations remain very low and a likely serious results after the pandemic crisis make it unlikely that inflation surges.

4) Oil prices play a key role in global economic developments and also in the EU, but there is some heterogeneity across countries.

a) Which have been the main drivers of changes in oil prices?

The drivers are changes in demand, associated with the business cycle and long-term growth patterns, scarcity of this non-renewable resource, and supply associated with producers' decisions and installed capacity.

b) Why is the impact of changes in oil prices heterogeneous across EU countries?

Because they have different oil dependency ratios (different endowments) and different oil intensities. Tax policies on oil are different across countries.

c) In the context of the current pandemic crisis, how have oil prices evolved and what are the consequences of such changes?

Lower demand associated with the drop in activity linked with the pandemic crisis. Higher supply due to the production war between oil producers. There is strong supply production installed, notably in the US. This will dampen inflationary pressures. Whether this will investment in renewables is an issue to be seen.