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European Economy Seminar

Final Exam

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Notes:

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

Name: ______________________________

Number: ____________________________

1) The war in Ukraine has reignited the discussion about future enlargements of the EU.

a) How has the size of the EU evolved since its inception, and what were the leading causes behind Brexit?

On 25 March 1957, Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany, signed the Treaty of Rome, creating the European Economic Community (EEC). There were more enlargements, with the UK, Ireland, and Denmark joining in 1973, Greece (1981), Portugal and Spain (1986), and Austria, Finland, and Sweden (1995). The largest enlargement happened in 2004 with 10 Eastern European countries joining. This was followed by 2 more enlargements in Eastern Europe: 2007 and 2013, with Croatia.

There were several reasons for the Brexit to take place, but most were related to the loss of sovereignty associated with belonging to the EU. The UK which wasn't one of the founding members of the EEC, always had a particular relationship with the rest of the union. It initially endorsed another type of trade agreement (EFTA) which didn't imply such a large loss of sovereignty. It also never adopted the euro and was resistant to the adoption of many of the common European rules. Misperception bout the magnitude of gains from trade, about net financial transfers with the EU and the illusion of deciding autonomously in a globalized world, together with non-economic objectives, led the UK public opinion to favor Brexit.

b) What are the benefits and costs of enlargements, both from EU and new member-states perspectives?

For the new members, entrance means access to a large open market with free circulation of goods, services, labour, and capital. It also means the access to European funds, namely for countries and regions whose development levels are below the ones of the EU. On the counterpart, it means the adoption of common policies, loss of sovereignty, and the need for higher productivity to be able to compete in the common market.
To the union, the enlargements mean a larger and stronger market. However, the incorporation of a more diverse poll of countries is particularly challenging in terms of the decision process mechanism and the voting of new rules. Having a highly diverse set of members is also challenging in terms of finding policies suitable to everyone and raising funds to promote cohesion.

c) What are the other institutional challenges for the EU to address?

Several institutional challenges remain within the EU. The first challenge regards the completion of the banking union, namely the second and third pillars of the single resolution mechanism and the deposit insurance scheme. The second institutional challenge relates to the reform of the stability and growth pact. After the 2010 sovereign debt crisis, although the six-pack and the two-pack and the consequent adoption of the macroeconomic imbalance mechanism and the European semester gave some contribution, weaknesses remain. During the recent pandemic crisis, a great part of these rules was put on hold, casting doubts on their efficiency in a crisis. Finally, the enlargements of the recent decades and the change in treaties triggered reforms in voting rules and in the operation of the decision process. Nevertheless, the decision time in the EU is still long, jeopardizing the efficiency of the common economic policies.

2) Recent events brought energy to the forefront of the economic debate in the EU and the world.

a) What are the macroeconomic impacts of much higher energy prices for a prolonged period?

The energy prices will have cascade effects on overall price levels, given how reliant most goods and services are on oil, gas, and transportation. Higher inflation, combined with no capacity to depreciate the currency in a monetary union, will decrease the price competitiveness in external markets of some countries, especially those producing low value-added goods. Furthermore, it is quite likely that wages won't go up as much as inflation, thus decreasing real wages and leading to a loss of purchasing power. Overall, this can be seen as a negative supply shock, pushing inflation up and GDP down.
However, the increase in energy prices might have a slight positive effect as it will likely increase the urgency to transition to renewable sources of energy.

b) How do the recent energy price developments impact the stance of the monetary policy followed in recent years?

Since the sovereign debt crisis, the ECB has been following an expansionary monetary policy: extremely low-interest rates combined with massive injections of liquidity into the system. This led to a large accumulation of debt, both private and public. Furthermore, during the pandemic, there was an extremely large amount of debt issuance, with the ECB increasing the buying of sovereign debt, and there were moratoriums put in place.

The higher inflation demands a reversion of this expansionary policy, namely, to preserve the credibility of the central banker. This implies that interest rates will need to go up if the ECB wants to curb inflation. The higher interest rates can pose possible impacts on the solvability of the debt issued under a low-interest-rate environment. This will likely increase the number of NPLs and strain public finances. Therefore, a contractionary monetary policy is weighed against financial instability.

c) How does the above affect the governments' fiscal position?

A scenario of inflation brings several positive and negative impacts to the fiscal balance. On the one hand, the increase in inflation increases the nominal tax collection by the government and decreases the nominal debt/GDP ratio, also due to the denominator effect. On the other hand, the increase in inflation will likely reverse the recent expansionary monetary policy causing an increase in the interest rates. Within the Euro Area, some countries present large stocks of both public and private debt, worsened by the large support packages put in place during the COVID pandemic. The increase in interest rates and the consequent raise in the costs of debt can bring additional financial stress to families and governments. Additionally, the inflationary pressures hit the most vulnerable families, which may raise the need for additional social support from the governments.

3) The COVID19 pandemics and the Russian invasion of Ukraine were significant shocks with a substantial impact on international trade.

a) Why have the recent shocks created severe disruptions in the supply chain of specific goods?

The existence of a global value chain (i.e. where different stages in the production and consumption of materials and products of value take place in different parts of the world) implies a global supply chain engaged in the movement of those materials and products on a global basis.
During the pandemic, several production facilities had to close due to infections (or fear of infections). Given that GVC implies extreme specialization, that meant that some products completely stopped being produced (microchips in Taiwan being a common example). In general, COVID19 was responsible for a strong contraction of the supply of many of the goods and services embedded in global value chains, which slowed or halted the production processes. A follow up effect is the congestion of ports and delays in ocean shipping.
This scenario was substantially worsened by the war in Ukraine, which besides increasing the price of oil worldwide, also stopped the production of certain products in the region (cereals being a major one and which is already having

cascading effects). Additionally, the war demanded finding alternative routes for the transport of several goods, which increase transportation costs even further.

b) Is the shift towards more internal production the right way to minimize these problems and increase welfare?

The increase in protectionism wastes the potential gains from comparative advantages and it is likely to increase costs and bring inefficiencies to the economies.
Thus, a maximization of welfare as a result of the redirection to internal production of goods in which there was no previous revealed comparative advantage it is not expected. Although, the shift towards internal production might minimize shocks coming from supply chain disruptions, it does not necessarily reduce risk.

c) Have the pandemics and the war affected the international trade of services, and what are the prospects regarding this segment of international trade going forward?

The pandemic was a common shock across countries but not a common shock across sectors. Within the services sector, while tourism and hospitality were negatively affected, others such as telecommunications saw their demand increase during the lockdowns. Additionally, the pandemic and now the war affected the stability of the global value chains, an impact amplified by the increase in energy prices. However, services sectors like tourism are strongly rebalancing, an increase also in the telecommunications industry, leveraged by the recent technological developments and the more intensive use of teleworking and tradable services. Finally, goods progressively embody more services (e.g. customization of goods). Although this is not really captured in services trade statistics, it is a very relevant trend.

4) The monetary union is the most advanced segment of the EU integration project, and its expansion is an objective.

a) What are the requirements for countries' accession to the monetary union, and are they sufficient and adequately designed?

To ascend to the monetary union, countries need to experience nominal convergence in the years prior. This implies having an inflation rate and interest rate close to the best performers in the EMU. Moreover, the countries would need to have a stable exchange rate.

Countries also need to comply with the rules in the Excessive Deficit Procedure, namely, they need to have fiscal deficits below 3% of GDP and public debt below 60% of GDP.

While important, these criteria don't reflect convergence in real terms, namely productivity, something that was revealed problematic as the sovereign debt crisis showed it. Some of the countries joining the EMU in 1999 were not competitive at that exchange rate and they quickly started accumulating large current account deficits and macroeconomic imbalances.

Moreover, it would be useful that countries post a stable macro situation for some years before actual accession in order to guarantee that potential shocks emerging from a shift towards nominal stability are absorbed.

b) What are the possible economic responses for a country in a monetary union which suffers from macroeconomic imbalances?

Being part of a monetary union implies a loss of monetary sovereignty. While some macroprudential policies can still be applied, countries can't use the full monetary policy as they would otherwise.

In this case, the adjustment must come from the domestic demand, namely through a contractionary fiscal policy and wage reduction. Lower real wages improve competitiveness in the short term, automatically improving the current account balance. Although undesirable in the long run, strong investment reductions tend to occur, also conducting to lower imports. However, short-run recessionary effects usually accompany this type of policy.

However, in the long run, counties need to implement structural reforms that improve the supply-side, namely in terms of human capital and labor productivity improvements.

c) Why is fiscal discipline necessary in a monetary union?

Under a monetary union, there is one single monetary policy for a set of different regions or countries. For this reason, it is key to promote the synchronization of the different economic cycles. If countries engage in divergent fiscal policies, this will likely lead to different CA positions and consequently different levels of debt accumulation. These different levels of indebtedness may be transmitted to higher levels of risk premia causing financial fragmentation, as in the last sovereign debt crisis. These imbalances jeopardize the ability to manage the monetary policy and break the traditional channels of monetary transmission.