Seminar in European Economics

Exam Correction Topics - S1 24-25

1. **The architecture and institutional setup of the European Union have evolved in different dimensions and with different purposes.**

   a) **What have been the objectives of the EU enlargements?**

- Promote peace and stability in Europe by integrating countries into a cooperative framework.
- Strengthen democracy, rule of law, and human rights in candidate countries. Reunite Eastern and Western Europe, addressing historical divisions and post-Cold War challenges, and supporting transitions to democracy.
- Create a larger single market to boost trade, economic growth, and investment opportunities.
- Encourage economic modernization and reduce regional disparities through EU support and funds.
- Extend the EU's political and economic influence while promoting European values globally. Strengthen regional security and address cross-border issues like migration and organized crime.

   b) **What were the objectives of the baking union, and to what extent were they achieved?**

- Objectives of the banking union:
  - One objective was to reduce financial fragmentation, ensuring financial stability and reducing systemic risks, by centralizing banking supervision and resolution mechanisms to ensure uniform application of rules across the eurozone and improve coordination.
  - The second objective was to break the Sovereign-Bank feedback loop, by decoupling banks' financial health from the fiscal health of their home countries to prevent crises in one from triggering crises in the other.
- Achievements of the banking union:
  - The establishment of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) has created a more centralized and cohesive framework for oversight and crisis management. However, the lack of a fully implemented European Deposit Insurance Scheme (EDIS) leaves the Banking Union incomplete.
  - The SSM centralized the oversight of major banks, ensuring consistent standards and reducing risks. The SRM has improved the framework for managing bank failures, but the bank-sovereign link persists in some cases, especially in countries with high public debt and strong bank exposure to domestic sovereign bonds.

- While many objectives have been partially achieved, the lack of a fully realized EDIS and persistent bank-sovereign links highlight the need for further reforms to complete the Banking Union and fully meet its goals.

c) What was the underlying rationale for the co-decision procedure, which is applied to most EU legislation?

- The rationale for the co-decision procedure can be understood through the lens of the ongoing debate between federalism and intergovernmentalism in the European Union. This debate revolves around the balance of power between supranational EU institutions and member states, shaping the procedure's structure and purpose.
- Federalists advocate for a stronger role for supranational institutions to ensure the EU functions as a unified polity. The co-decision procedure aligns with federalist ideals by empowering the European Parliament (EP), the directly elected body representing EU citizens. By giving the EP equal legislative power with the Council of the EU, the procedure reflects a move toward supranationalism, enhancing democratic legitimacy and citizen representation in law-making. It reduces the dominance of member states in EU governance, distributing authority more evenly across EU institutions.
- Intergovernmentalists emphasize the sovereignty of member states and the primacy of intergovernmental decision-making. The co-decision procedure accommodates this by maintaining a central role for the Council of the EU, where member states' governments are directly represented. The Council's equal legislative role ensures that member states retain significant influence over EU legislation, safeguarding their interests and sovereignty. It ensures that no legislation can pass without the agreement of both the Council (member states) and the EP, reflecting the intergovernmental priority of protecting national preferences.
- The co-decision procedure embodies a compromise between these two perspectives, reflecting the hybrid nature of the EU as both a supranational and intergovernmental entity. It ensures that decisions require the consent of both the supranational (EP) and intergovernmental (Council) bodies, promoting broader legitimacy and accountability. The process encourages negotiation and consensus, balancing federalist aspirations for integration with intergovernmentalist concerns about state sovereignty.

2. **Current account crisis and sudden stops in external financing are very problematic events, especially for countries that are part of a monetary union.**

   a) **Why did a sudden stop in external financing occurred in some euro area countries after 2010?**

- The 2008 global financial crisis exposed vulnerabilities in financial systems worldwide. While the immediate impact was mitigated by fiscal and monetary interventions, the resulting economic slowdown strained public finances in many euro area countries. Investors became increasingly risk-averse, reevaluating the creditworthiness of countries with high debt levels or weak economic fundamentals.
- Prior to 2010, several euro area countries, such as Greece, Portugal, and Spain, had run persistent current account deficits. These deficits indicated reliance on external financing to fund imports and consumption, making these economies dependent on foreign capital. When confidence in these countries' ability to meet their financial obligations waned, capital flows reversed.
- After 2010, sovereign debt levels in countries like Greece, Ireland, and Portugal became unsustainable, leading to fears of default. Rating agencies downgraded these countries' credit ratings, making it costlier and riskier for them to borrow internationally.
- Eurozone countries share a common currency but lack centralized fiscal policies or mechanisms to address asymmetric shocks effectively. This meant that countries with weaker economies and less competitive exports faced greater difficulty recovering from crises. Unlike countries with their own currencies, euro area members could not devalue their currency to regain competitiveness, exacerbating their vulnerabilities.
- The crisis in one country (notably Greece) created fears of contagion across the euro area. This led to a generalized withdrawal of capital from other peripheral economies perceived to be at risk, such as Spain and Italy.

   b) **How did the loop between sovereign debt risk and banks aggravated the crisis and risked financial stability?**

- Many banks in eurozone countries held large amounts of government bonds. As sovereign debt risks increased due to rising concerns over default, the value of these bonds dropped, leading to significant losses for banks.
- The losses on sovereign bonds weakened banks' capital positions. This diminished their ability to lend and worsened the economic downturn, creating a vicious cycle where weaker banks led to further economic stagnation.

- As banks faced mounting losses, their ability to purchase or hold more government debt was reduced. This created a feedback loop, where the financial instability in the banking sector increased the likelihood of sovereign default, and the sovereign debt crisis worsened the banks' solvency issues.
- Fear of contagion spread across the financial system, as markets feared that banks' exposure to risky sovereign debt would lead to broader financial instability. This led to a drying up of liquidity, as banks became reluctant to lend to each other or to other sectors of the economy.
- In response to failing banks, governments often had to provide bailouts, increasing public debt. This further exacerbated sovereign debt risks, continuing the loop of financial instability and deepening the overall crisis.

c) How did affected countries rebalanced their economies and what is the role of structural reforms in these adjustment processes?

- Austerity Measures: To reduce public debt and meet the fiscal targets set by EU/IMF bailout programs, affected countries implemented austerity measures, including cuts in government spending, tax increases, and reductions in public sector wages. Their social and economic costs were significant in the short term.
- Privatizations: As part of the bailout conditions, some countries were required to privatize state-owned enterprises to raise capital and reduce the role of the state in the economy. This also aimed to improve efficiency.
- Labor Market Reforms: To improve competitiveness and reduce labor costs, countries enacted labor market reforms, such as making it easier to hire and fire workers, reducing wage rigidity, and reforming pension systems.
- Product Market Reforms: Structural changes aimed at enhancing market efficiency included deregulation, liberalizing key industries (e.g., energy, transport, and telecommunications), and reducing barriers to entry for businesses.

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3. **In the euro area monetary and fiscal policies are managed independently and this poses challenges to achieve economic goals.**

   a) **What is the mission of the Eurosystem and what have been the main monetary policy tools used?**

- The Eurosystem is composed of the European Central Bank (ECB) and the national central banks (NCBs) of the euro area countries. It is responsible for the monetary policy of the euro area and its mission is:
  - Price Stability: The primary goal is to keep inflation rates close to, but below, 2% over the medium term, ensuring that the value of the euro remains stable and preserving the purchasing power of consumers.
  - Support Economic Policy: While price stability is the primary objective, the Eurosystem also supports the general economic policies of the European Union, aiming to contribute to economic growth, high employment, and balanced economic development.
- Main Monetary Policy Tools Used by the Eurosystem:
  - Interest Rates: The ECB uses interest rates as its main tool to influence economic activity and inflation (main refinancing operations, deposit facility rate, marginal lending facility).
  - Non-Conventional Monetary Policies: The buying and selling of government securities in the open market to regulate the money supply.
  - Conventional Monetary Policies Open Market Operations: The buying and selling of securities in secondary markets to manage liquidity (asset purchases, quantitative easing, long-term refinancing operations).
  - Forward Guidance: This involves the ECB providing signals to the markets about its future policy intentions, such as future interest rates, to influence expectations and economic behavior. It helps provide clarity on the ECB's policy stance.

   b) **What are the pros and cons of having fiscal policy conditioning monetary policy decisions (fiscal dominance)? Is this the situation in the euro area?**

- Fiscal dominance refers to a situation where fiscal has a significant influence on monetary policy decisions:
  - Pros of fiscal dominance: support for government financing needs; reduced borrowing costs for governments; room for counter-cyclical fiscal policy.
  - Cons of fiscal dominance: inflationary pressures; loss of central bank independence; reduced monetary policy effectiveness; debt sustainability.
- Fiscal dominance in the euro area:

- In general, fiscal dominance is not fully present in the euro area due to the ECB's independent monetary policy and the separation of fiscal and monetary powers.
- The ECB is independent and focused primarily on maintaining price stability and conducting monetary policy. Fiscal policy decisions are not supposed to directly influence ECB decisions. This separation aims to prevent fiscal dominance and ensures that the ECB is not pressured into keeping interest rates low to finance government debt.
- However, there have been periods, particularly during financial crises, where fiscal policies have been closely linked with ECB actions. For example, during the sovereign debt crisis, the ECB's monetary policy supported government debt markets, but this was more a reaction to extreme economic circumstances rather than a situation of direct fiscal dominance.

c) Why are fiscal rules important in a monetary union and how have they performed in the EU?

- Fiscal rules are crucial in a monetary union because they help to ensure:
  - Fiscal discipline – set limits on budget deficits and public debt, preventing individual member states from excessively increasing debt and deficits that could destabilize the currency union or create risks for other members
  - Avoid spillover effects – for example, excessive government borrowing in one country could raise borrowing costs for other countries or lead to inflationary pressures
  - Prevent the need for bailouts – avoiding situations like the ones of the sovereign debt crisis
- In the EU, the Stability and Growth Pact (SGP) and other fiscal frameworks have been the main mechanisms for enforcing fiscal discipline:
  - The SGP sets limits on the budget deficit (3% of GDP) and public debt (60% of GDP) for EU member states. It was designed to ensure fiscal responsibility and maintain stability in the euro area.
  - However, the pact has faced challenges of lack of enforcement (rules have often not been enforced consistently), flexibility issues (during times of economic downturn higher deficits could be necessary), and weak sanctions (these have rarely been applied or have been ineffective).
  - After the crisis, fiscal rules were tightened and complemented by new frameworks, aimed at strengthening fiscal surveillance and improving enforcement (Six-Pack, Two-Pack, European Semester, Macroeconomic Imbalance Procedure). However, enforcement remains a challenge.

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4. International trade of goods, services and energy are key elements for the prosperity of the EU.

a) Why are energy imports relevant in the EU and how have they changed in the last three years?

- Energy imports are vital for the European Union (EU) due to its limited domestic energy resources, making it reliant on external suppliers to meet its energy needs. In 2021, the EU imported large shares of gas, oil and coal from Russia, with energy representing more than half of EU total imports from Russia.
- Over the past three years, the EU's energy import patterns have undergone significant changes. Imports of natural gas in gaseous state decreased in volume but much more in value as prices decreased, while the imports of liquified natural gas increased both in value and volume. Imports of coal increased in value, while volume fluctuated strongly.
- These shifts reflect the EU's efforts to diversify energy sources and reduce dependence on specific suppliers, particularly in light of geopolitical tensions and the need for energy security.

b) Why are EU State aid and competition regulations important to trade and the functioning of the single market?

- State aid refers to government assistance or subsidies given to companies that could distort competition by providing them with an unfair advantage. The EU has strict State aid rules to prevent governments from using public funds to favor domestic businesses, which could undermine competition across the Single Market.
- The EU's competition rules prohibit anti-competitive practices like price-fixing, market-sharing agreements, and abuse of dominant positions. This ensures that businesses across the EU compete fairly, which leads to lower prices, better quality, and more innovation for consumers.
- EU State aid and competition regulations are foundational to ensuring that the Single Market functions smoothly, fairly, and efficiently. These regulations promote fair competition, prevent market distortions, encourage innovation, and facilitate cross-border trade, ultimately contributing to a stronger and more integrated European economy.

c) What are the consequences of higher tariffs involving China and USA to EU firms and what are possible response strategies?

- Consequences of higher tariffs between China and the USA on EU firms:
  - EU firms reliant on Chinese or US imports may face higher production costs due to increased tariffs on raw materials or intermediate goods. Higher tariffs can lead to delays and inefficiencies in global supply chains.
  - EU firms may become less competitive in the Chinese and US markets due to retaliatory tariffs or higher costs for consumers in those countries. Reduced demand for EU exports to China and the USA could harm key industries like automotive, agriculture, and machinery.
  - Ongoing trade tensions can create volatility, making it difficult for EU firms to plan long-term investments and strategies. Decreased business confidence due to market instability may harm overall EU economic growth.
- Possible response strategies for EU firms:
  - Source inputs from regions other than China and the USA to reduce reliance on tariffs and mitigate supply chain disruptions. Consider nearshoring production to regions like Eastern Europe or Africa.
  - Invest in innovation to offer unique or higher-value products that can justify higher prices due to tariffs. Differentiate products to remain competitive despite rising production costs.
  - Look for alternative markets in regions like Southeast Asia, Latin America, and Africa to reduce dependence on China and the USA. Leverage regional trade agreements to access new opportunities with lower tariffs. EU firms could benefit from trade diversion if higher tariffs make Chinese or US products more expensive, creating opportunities in other regions like Southeast Asia or Africa.