<u>**Seminar in European Economics**</u>

Resit Correction Topics - S1 24-25

1. **The mobility of capital is one of the four freedoms of the EU single market, which interacts with the functioning of the financial system.**

a) **Does mobility of capital guarantee similar interest rates across euro area countries? And across non-euro area EU countries?**

- Conceptually, capital mobility responds to interest rate differentials, expected changes in the exchange rates amongst countries involved, risk and other economic variables, such as potential output growth.
- Mobility of capital does not guarantee similar interest rates across euro area countries. While capital moves freely within the EU and exchange rates among members are fixed, interest rates still vary due to factors like national economic conditions, notably indebtedness and risk. These local factors can lead to different borrowing costs despite the mobility of capital.
- During the sovereign debt crisis in the euro area, although there was a unified monetary policy, local factors affected interest rates, leading to a capital outflow from southern European countries – the so-called fragmentation of the monetary policy between core and periphery countries.
- For non-euro area EU countries, interest rates depend on both the ECB and the national central bank. Moreover, there are changes in the expected exchange rates. This can lead to interest rate differences compared to the eurozone.

b) **Which benefits and risks arise from the integration of the banking system in the euro area?**

- Benefits:
    - Increased financial stability: The integration of the banking system in the euro area enhances financial stability by reducing exchange rate risk and enabling better risk-sharing across member states. It helps banks to grow, diversify their portfolios and manage shocks more effectively.
    - More efficient capital allocation: With an integrated banking market, capital can flow more freely, enabling better allocation of resources and investment opportunities across the region. This can lead to increased economic growth and more competitive financial markets.
    - Reduced transaction costs: The integration of the banking system eliminates exchange rate risks and costs associated with cross-border transactions, making it easier and cheaper for businesses and consumers to operate across the euro area.
- Risks:
    - Systemic risk: The integration of banking systems can lead to the spread of financial instability across the euro area. A banking crisis in one country

could quickly affect others, as interconnectedness increases the potential for contagion.

  - Loss of national control: Countries in the euro area no longer have full control over their monetary and banking policies. This can limit their ability to respond to specific national banking crises or economic challenges.
  - Moral hazard: With an integrated banking system, some countries might be less cautious about fiscal discipline, relying on the EU to handle crises, which can create a moral hazard. This can lead to excessive risk-taking by banks in weaker economies.

c) Given European global competitivity concerns, why are EU policymakers engaged in the creation of a capital markets union, which facilitates access to non-banking finance to most firms?

- Diversification of funding sources: EU policymakers are focused on creating a Capital Markets Union (CMU) to reduce dependency on bank financing and provide firms, especially small and medium-sized enterprises (SMEs), with access to alternative funding sources. This diversification can help businesses weather financial challenges and promote growth.
- Boosting economic growth and innovation: By facilitating access to non-banking finance, the CMU aims to foster innovation and economic growth, as highlighted in the recent Drahi report. It allows firms to tap into global capital markets, attracting investment and supporting entrepreneurial activities, which is crucial for competitiveness in a global economy. In parallel, the savings generated in the EU would be tapped into internal investment instead of being applied abroad.
- Enhancing global competitiveness: The CMU is designed to strengthen the EU's global position by making it easier for firms to raise capital, attract foreign investment, and compete internationally. This move aims to reduce reliance on the US and Asian financial markets, enhancing the EU's role in global finance.
- Improving market efficiency and integration: By creating a single capital market across the EU, the CMU can improve market liquidity, reduce transaction costs, and enhance the efficiency of capital allocation. This helps firms gain better access to finance, contributing to a more resilient and competitive European economy.

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2. **The mobility of workers in the EU single market is formally established, but its implementation and the management of external migration flows are important challenges.**

a) **What are the economic pros and cons of labor mobility inside the EU?**

- Economic Pros of Labor Mobility:
  - Smoothening of asymmetric shocks: Labor mobility allows labor to flow from regions where unemployment is high to regions where unemployment is low. This allows for the smoothening of asymmetric shocks, which cannot be addressed with monetary policy in a currency area.
  - Increased labor market efficiency: Labor mobility allows workers to move where their skills are in demand, filling gaps in the workforce. This leads to a better match between supply and demand for labor, enhancing productivity and economic growth.
  - Higher wages and better job opportunities: Workers can benefit from moving to areas with better economic conditions or higher wages. This improves individual income levels and can reduce regional disparities in the EU.
  - Innovation and knowledge transfer: The movement of workers between countries fosters the exchange of skills, ideas, and innovation. This helps to enhance productivity and can lead to greater economic development across the EU.
- Economic Cons of Labor Mobility:
  - Brain drain in certain regions: Some EU countries, especially those with weaker economies, may face the loss of highly skilled workers as they migrate to higher-paying countries. This can lead to labor shortages and hinder long-term economic development in the sending countries.
  - Population shifts: Receiving countries will experience stronger activity due to consumption and investment from newcomers, while the reverse happens in the other countries. This may increase the core-periphery gap.
  - Social and fiscal pressures: In receiving countries, high levels of labor migration can place pressure on public services, housing, and social welfare systems. This could create tension or strain on local infrastructure.

b) **What drives strong migration flows into the EU?**

- Economic opportunities: One of the main drivers of migration into the EU is the pursuit of better economic opportunities. Many migrants are attracted by the prospect of higher wages, better job prospects, and overall improved living standards compared to their home countries. This is amplified by the strong ageing of the EU population.

- Political stability and safety: Conflicts, war, and political instability in certain regions, such as in parts of Africa, the Middle East, and Eastern Europe, lead people to seek refuge in the EU. The EU offers a safer environment with more stable political systems and stronger rule of law.
- Better social services and welfare systems: The EU is known for its strong social safety nets, including access to healthcare, education, and social benefits. These services attract migrants, particularly from countries with weaker social systems or higher poverty rates.
- Educational opportunities: Many migrants, particularly students and skilled workers, are drawn to the EU for its high-quality education and training systems. The EU offers a wide range of academic and professional development opportunities that appeal to people seeking to improve their skills and future prospects.

c) What are the economic pros and cons of migration into the EU?

- Economic Pros of Migration into the EU:
  - Labor force growth: Migration helps increase the labor supply, particularly in sectors with skill shortages, such as healthcare, agriculture, and technology. This supports economic growth and helps maintain the workforce in aging populations across many EU countries.
  - Increased innovation and entrepreneurship: Migrants often bring new skills, ideas, and perspectives, which can foster innovation and entrepreneurship. Many migrants start businesses, contributing to job creation and boosting the economy.
  - Fiscal contributions: Migrants contribute to the EU's economy through taxes and social security payments, often providing more than they take in terms of public services. This helps sustain public finances and supports welfare systems, especially in countries with declining native populations.
- Economic Cons of Migration into the EU:
  - Pressure on public services and infrastructure: High migration flows can strain public services like healthcare, education, and housing, especially in regions where resources are already stretched. This can lead to increased public spending and potentially lower service quality.
  - Wage competition: In certain sectors, an influx of migrants willing to accept lower wages can drive down wages for low-skilled workers in receiving countries. This may lead to tensions between migrant and native workers and contribute to income inequality.
  - Integration challenges: The economic benefits of migration can be undermined if migrants face difficulties integrating into the labor market or

society, such as language barriers or discrimination. Poor integration can result in higher unemployment among migrants and reduced economic contributions.

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3. **Positive GDP and productivity developments are the goals of economic authorities.**

a) **Why does heterogeneity across firms' productivity and size pose a challenge to EU policymakers?**

- Uneven economic growth: Heterogeneity in firm productivity and size means that some firms grow rapidly, while others lag behind. This uneven development can lead to disparities in income, economic growth, and employment across EU regions, making it harder for policymakers to implement uniform policies that benefit all firms equally. This is particularly striking in the case of monetary policy, which cannot respond to differences in economic conditions across EU regions,
- Inefficient resource allocation: When productivity varies significantly across firms, it indicates that resources may not be allocated efficiently. Larger or more productive firms may have better access to capital and markets, while smaller or less productive firms may struggle. This can limit overall economic growth and productivity improvements.
- Barriers to competition: Small, less productive firms may struggle to compete with larger, more productive ones, leading to market concentration and reduced competition. This can hinder innovation and productivity growth in the broader economy, as dominant firms may not have the same incentives to innovate.
- Policy challenges: Policymakers face difficulties in creating policies that can address the diverse needs of firms of different sizes and productivity levels. While large, productive firms may benefit from one set of policies (e.g., support for innovation), smaller firms may require different forms of support (e.g., access to finance or easier regulatory conditions). Balancing these needs can be complex.

b) **Why are poor productivity developments particularly concerning to a country in the monetary union?**

- Current account imbalances: Poor productivity developments can lead to persistent current account imbalances within a monetary union. Countries with low productivity growth may experience rising imports due to relatively higher costs, while exports become less competitive. This can result in sustained deficits in the current account, especially for countries that rely on importing goods and services. Conversely, countries with higher productivity growth might run surpluses, exacerbating economic imbalances within the monetary union and creating tensions between member states. Such imbalances can put strain on the stability of the union, as countries with persistent deficits may face growing external debt and financial instability.

- Limited policy flexibility: In a monetary union, like the euro area, individual countries do not have control over their own monetary policies (e.g., setting interest rates or adjusting exchange rates). Poor productivity growth can exacerbate economic imbalances because countries cannot use these tools to correct them without imposing serious costs on investment and employment.
- Lower economic growth and competitiveness: Poor productivity growth means that the economy is growing at a slower rate, which can reduce a country's competitiveness in the global market. This can make it harder for the country to maintain or increase its market share, leading to weaker exports and less attractive investment opportunities.
- Widening income disparities: If a country's productivity is stagnating, income and economic performance gaps can widen. This can lead to regional disparities within the union, creating tensions and potentially undermining the cohesion of the monetary union.

c) Are similar productive structures across countries condition for an optimal currency area?

- An optimal currency area must follow criteria such as: 1) mobility of labor and capital as well as wages flexibility to allow for the smoothing of the cycle across different countries; 2) business cycle synchronization, through and homogenous production structure, thus minimizing the impact of idiosyncratic shocks, since monetary policies do not target any specific country; 3) fiscal federalism, allowing for the operation of automatic stabilizers across countries/regions; 4) strong international trade flows; 5) homogeneous preferences and solidarity across countries.
- Similar productive structures help facilitate an optimal currency area: When countries have similar productive structures, they are more likely to experience similar economic shocks and cycles. This makes it easier for a single currency and monetary policy to work effectively across all countries, as the policy needs are aligned. For example, if all countries in a currency union rely on similar industries or sectors, they are more likely to be affected by the same external factors, reducing the risk of divergent economic conditions.
- Difficulties in achieving similarity: Achieving similar productive structures across countries can be challenging and even undesirable, as economies naturally evolve in response to local factors like resources, culture, and history. In particular. Economies must explore comparative advantages, specialize and export those product in order to reap trade gains. Therefore, even within a

currency union, productive structures often remain diverse, which can limit the effectiveness of a single monetary policy in addressing local economic needs. Overall, while similar productive structures can improve the functioning of an optimal currency area, they are not at all a strict condition, and alternative mechanisms (such as fiscal coordination or labor mobility) may be necessary.

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4. The European Parliament stands as a very important European institution.

a) What is the role of the European Parliament in the EU?

- Legislative power: The European Parliament plays a key role in the EU's legislative process. It shares lawmaking authority with the Council of the European Union (co-decision process) and is responsible for debating, amending, and approving or rejecting proposed EU legislation across various areas such as trade, environment, and consumer protection.
- Democratic representation: The European Parliament represents EU citizens, with Members of the European Parliament (MEPs) directly elected by voters from member states. This provides democratic legitimacy to the EU's decision-making processes, ensuring that citizens' interests are considered in EU policy and laws.
- Budgetary control: The European Parliament has authority over the EU's budget, sharing this power with the Council. It scrutinizes and approves the EU's annual budget, deciding on expenditures for different programs and ensuring that funds are allocated efficiently.
- Supervisory role: The European Parliament monitors and holds the European Commission accountable for its actions. It approves the appointment of the European Commission's President and Commissioners and can also call for investigations or pass motions of censure if the Commission or other EU bodies are not functioning properly.

b) How do you compare the nature of the European Parliament with the Council and the Commission?

- The European Parliament is a directly elected body that represents the citizens of the EU. It consists of Members of the European Parliament (MEPs), who are elected by voters in each member state. This makes it the most democratic institution in the EU, as it directly reflects the will of the people.
- The Council is made up of representatives from each member state's government (usually ministers). It represents the interests of national governments rather than citizens.
- The European Commission is the executive body of the EU, made up of appointed commissioners, each responsible for specific policy areas. The Commission is tasked with proposing new legislation, implementing EU laws, and managing the day-to-day affairs of the EU.
- While the Council is a more intergovernmental institution, the EP and the Commission are federal institutions. The distribution of powers between the three ensures a balance between these two opposing views on European integration.

c) Which institutional changes would you recommend to improving the economic governance of the euro area?

- Enhance the European Parliament's role: Strengthen its influence in economic decisions and fiscal policy, improving democratic legitimacy and oversight of the Eurogroup and European Stability Mechanism.
- Create a central fiscal capacity: Establish common fiscal transfers to address economic shocks and support counter-cyclical measures, promoting stability across the euro area.
- Strengthen economic surveillance: Empower the European Commission to enforce compliance with fiscal and economic recommendations, focusing on long-term structural reforms in member states.
- Enforce adequate fiscal rules: Make fiscal rules more flexible and counter-cyclical, allowing for budget deficits during recessions while ensuring long-term sustainability. The new mid-term fiscal framework has moved in this direction, but its effectiveness is still to be seen.
- Advance banking and capital market integration: Further develop the Capital Markets Union (CMU) and strengthen the European Banking Union, especially with a common deposit insurance scheme to reduce financial fragmentation.