Summary

-Project European Integration in a Globalising Economy-

Bovemij Crowe EY GrantThornton KPMG pwc

The course starts with 10 lectures that will provide a theoretical background for several policy issues within the European Union. Theoretical insights will be presented on the following seven topics:

1. History, institutions, and political aspects
2. European Single Market and economic integration
    1. Regional policy
    2. Trade policy
    3. Migration policy
    4. European Monetary Union (EMU) and Monetary Policy
    5. Brexit

The Brexit topic is not in this summary because the information was not provide before the deadline of producing this summary.

Lecture notes & book summary

Lecture 1. Introduction to the European Union. Ch. 1 and 2.

Schism regarding the role of nation-states and European integration between federalism and intergovernmentalism disagreement about depth of European integration:

a. **Intergovernmentalism** = nations retain all sovereignty. All power would remain in the hands of national officials and any cooperation would have to be agreed unanimously by all participants. Cooperation between nations.

   OEEC (1948), Council of Europe (1949), Court of Human Rights (1950), and EFTA (European Free Trade Area) (1960).

b. **Federalism** = supranational institutions. A federalist structure is a supranational organization embodied with some of the powers that had traditionally been exercised exclusively by nations. Idea: to prevent another cycle of recovery and national rivalry that might lead to a third world war.

Examples of federalism:

ECSC, The European Coal and Steel Community. (1951): Belgium, France, Germany, Italy, Netherlands and Luxembourg (the 'Six'), coal and steel sectors under the control of a supranational authority. This has been the driving force behind European integration.

EEC, European Economic Community (1957): after the success of the ECSC, the Six committed to form a customs union, promise free labour mobility, capital market integration, free trade in services and a range of common policies.

- Countries in favour of more integration/federalism: the countries that had suffered the most in WOII, that experienced the greatest failures of governance.
- Countries like UK, Portugal, etc. were not in favour of supranational institutions and a more powerful Europe.
- Nowadays it seems like more countries are against more power from Brussels.
- Always in crises, people are more against Europe, people blame Europe.

EEC was created with the Treaty of Rome (1957).

- Free trade in goods: remove trade barriers: tariffs, quotas and non-tariff barriers.
- Common trade policy with the rest of the world = customs union.
- Ensuring undistorted competition.
- Unrestricted trade in services.
- Common employment and investment area, by free movement of workers and capital.
- Mechanisms for coordinating member's macroeconomic policies and fixed exchange rates.
- Common policy in agriculture, with goals and general principles.

Integration 1945-2016

WOII opened minds to radical changes.

1945-47: refugees, hunger and political instability.

1948-1975: **optimism**

- Optimism for the new cooperation between countries.

1975-1986: **pessimism**

- Political and economic problems. Economic crisis. Lot of unemployment in 1970s.
- Failure of monetary integration. UK inflation (printing money to finance Vietnam War) was transmitted into EU inflation, because of the Bretton Woods system.
- Oil crises (massive oil price hike) ended in an economic crisis and stagflation.
- Problem of Europe: 1980s policy of agriculture: boterbergen, overproduction. Minimum prices for farmers, production growth, costs went down. Problems within Europe.

After 1986: **Domino-effect**, more optimism.

- Domino theory of regional integration: the preferential lowering of some trade barriers creates new pressure for outsiders to join the trade bloc, and as the trade bloc gets bigger, the pressure to join grows.
- **Single Market**: duty-free access to each other's markets (but no free trade), designed to reinforce free movement of goods, services, people and capital. It eliminated many non-tariff barriers and liberalized capital flows within the EU.
- Deeper integration and enlargement of EU, e.g. Spain, Portugal, UK, Sweden, Finland.
- End of the Cold War resulted in more optimism and more countries that wanted to join.
- From nineties: EMU (1999). Politicians were optimistic, economists not. 2002: single currency
- May 2004: 10 CEEC's.

Domino-effect: The discriminatory effects of EU integration have created a powerful gravitational force that has progressively drawn all but the most reluctant Europeans in to the EU.

2007-2008: **credit crisis**

2010-2015: **debt crisis**

Reflection on cooperation? Budgetary controls of Brussels?

Important treaties (see also p. 34)

- *Maastricht Treaty*, 1992: most important part was the monetary union, the euro, EU criteria.
- *Amsterdam Treaty*, 1997: enlargement of the EU and voting/decision making in EU. A more substantial role for the EU in social policy formation. Stability pact. We might have a problem when more countries want to join, we therefore need rules about e.g. debt.
- *Nice Treaty*, 2000: policy and decision making in EU, since more countries joined. The critical Amsterdam leftover issues were not fully solved, as it was supposed to.
- *Constitutional Treaty*, June 2004: to present the EU heads of state and government with a fully written constitution (grondwet), and new voting procedure. This was rejected by the Netherlands and France (referendum). Was big surprise, since NL was always in favour of EU.
- *Revised Constitutional Treaty*, 2007.
- *Lisbon Treaty*, 2009: some kind of constitutional treaty. In practise already working, but not every country has approved of this.
- *Primacy of Community law*: National Law can be overruled by European Law. E.g. human rights, Bosman arrest

EU-Ukraine Association Agreement (AA).

The AA: provisions for a **Deep and Comprehensive Free Trade Area** (DCFTA).

- A framework for modernizing its trade relations and for economic development by the opening of markets via the progressive removal of customs tariffs and quotas.
- An extensive harmonization of laws, norms and regulations in various trade-related sectors. This will create the conditions for aligning key sectors of the Ukrainian economy to EU standards.
- Opportunities for sustainable economic development and prosperity to all the regions of Ukraine (as well as to its neighbors). [Some people think this is an entry ticket to EU].

April 6th 2016: (advisory) referendum about the AA in the Netherlands.

Future: TTIP?

Subsidiarity principle from the **Maastricht Treaty**:

Decisions should be made as close to the people as possible. EU should not take action unless doing so is more effective than action taken at national, regional or local level.

- Of course, local people have to decide about traffic light. But EU migration policy decisions must be made as close to the people as possible.

Institutions: The 'Big Five'

- **European Council**: heads of state and governments. The ministers/secretaries in a certain field. In Dutch, de raad van ministers. Dependent on the subject in Brussels, a secretary on that field will go there.

  Highest political body in the EU. Provides guidance to EU, especially to EU commission.

- **Council of Ministers** (or the Council of the European Union): the prime ministers of nations. Main decision-making body, tasks linked to economic integration.

- **European Commission**: appointed eurocrats. Very important. They are the normal government you could say of the EU. They took all the measures that are taken. Every country has one commissioner.

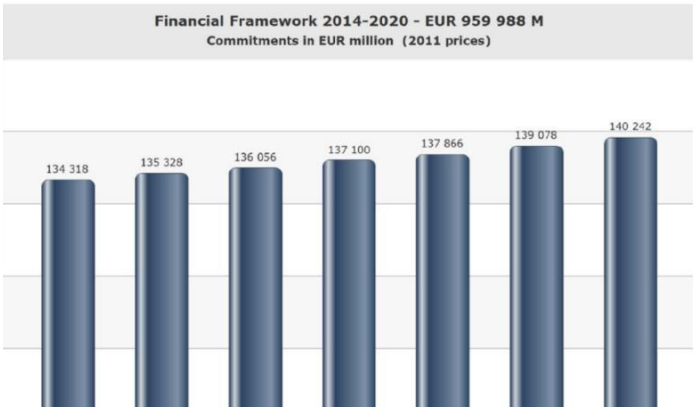
  Executive branch and safeguarding the treaties.

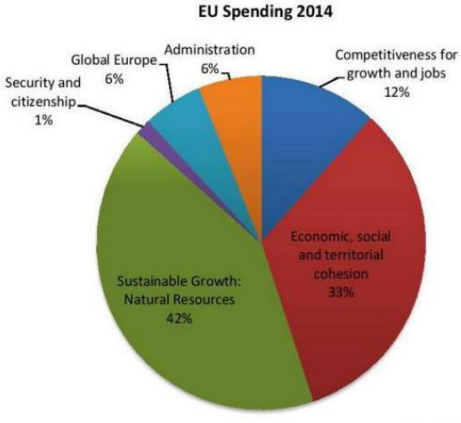
- **European Parliament**: directly elected. Becoming more important. Decide about e.g. budget, who will be commissioner. They don't have as much power as national parliaments.

  Sharing legislative powers with the Council of Ministers and the Commission; and overseeing all EU institutions, but especially the Commission.

- **EU Court**: appointed judges. Very important, since European law/legal system can overrule national laws, and is independent of the Member States' legal systems.

  Settle disputes of laws and decisions between Member States, EU, institutions individuals.





Total EU spending 2015 is over €135 billion = about 1% EU28 GDP.

Main expenditures: Farming and Poor regions.

Funding of EU budget - **EU's budget must balance every year**: EU must not have any debt. Financing sources: four main types (first two only one-seventh of revenues):

a) **Tariff revenues**, from tariffs on imports from non-member nations.
b) '**Agricultural levies'**: tariffs on agricultural goods that are important from non-member nations. They may vary from time to time, according to market conditions.
c) **'VAT resource'** (like a 1 per cent value added tax – reality is complex). VAT: value added tax.
d) **GNP based** (tax paid by EU members based on GNP). Most important part of the income.

Where does the money come from?

GNI-based resource: 73%. Customs duties and sugar sector levies: 15%.
VAT-based resources: 11%. Other revenue: 1%. E.g. fines for firms.

Who pays?

Germany, France and Italy the most. Most is GDP part. Mata, Cyprus and Estonia the least.

The poor countries gain, netto. The richer country like UK, Germany and France, their net contribution by member, %GDP 2012, is negative.

Problems of EU are all about **differences**.

Size, GDP, economic growth, economic structure, culture, language, legislation, taxes, etc. So many problems that EU has to be united in diversity.

Customs union (CU) = removing all tariffs and quotas on intra-EEC/EU trade and adopting a common tariff on imports from non-Member nations.

- Elimination rates between Member States.
- Setting common external tariff (CET).
- Agreements on distribution tariff revenues. All revenues go to Brussels and Brussels will spend the money in line with agreements with countries.

Effects on economy:

- Allocation Effects.
- Economies of scale effects.
- Terms of trade effects.

CU: trade creation and trade diversion

Trade creation: occurs when high cost domestic production is replaced by low cost imports from other members -> positive effect.

- Effects production: saves costs on import;
- Effects consumption: higher consumer surplus due to substitution to lower-cost producers.

Trade diversion: occurs when low cost imports from non-members are diverted (weggehaald) to high cost imports from member nations -> might cause extra costs.

- Increased costs due to substitution to partner. Might be more expensive to go to new partner, cause new tariffs will be higher.
- Loss of consumer surplus by imports from partner.

Trade creation increases as:

- More countries join CU;
- External rate decreases;
- Overlap in industrial structure increases; more competition between countries and firms.
- Cost differences in overlapping industries are bigger, then the cheapest industries may win and they will gain more and maybe have more innovation, more competitive than other parts of the world.

So more and more countries will join CU.

Chapter 1

SAQ 6. *What were the main challenges posed by eastern enlargement of the European Union and how was the Treaty of Nice meant to address these challenges?*

Main challenges:

- Get EU institutions, which had been designed for 6 members, ready for a dozen new members.
- There was disagreement among EU members on solutions to the problems of that time.
- East European countries were poor, former communists, huge population.
- Problems with decision making. More countries means more votes, means more problems with decision making. Need to reform the voting procedures.

The Nice Treaty meant to address these challenges by:

1. Defining a more precise division of powers between the EU and its members.
2. Clarifying he status of the Charter of Fundamental Rights proclaimed in Nice.
3. Making the treaties easier to understand without changing their meaning.
4. Defining the role of national parliaments in the European institutions.

SAQ 8. *Explain how Cold War politics accelerated European integration in some ways but hindered it in others, such as geographic expansion of the EU.*

During the Cold War, western Europe resisted communism, and the Marshall Plan and the OEEC helped with this. The OEEC divided the American financial aid among its members, and stimulated European economic integration. The USA demanded this integration too, in the form of trade liberalization. The Cold War formed a drive to prevent another intra-European war, which accelerated European integration, especially the integrating of Germany into a supranational Europe.

Cold War politics hindered the European integration in some ways, since western Europe was governed by the USSR: the USSR didn't want to integrate its part of Germany and other east-European countries into a supranational Europe.

After WWII iron curtain in Germany.

Common big enemy Sovjet-Union. They had to join powers to have more power. Break the power of Germany. Better be a friend than an enemy of it.

Also pressure from SU on countries not to join EU, e.g. on Finland and Austria. Also Poland of course, they were not allowed.

Corporation between former enemies, like France and Germany.

SAQ 9. *Explain when and by which means the organization that is known as the European Union has changed names since its inception in 1958.*

European Coal and Steal Union.

1958: EEC, the European Economic Community	The 'Six' sign treaties in Rome
1969: EMU, Economic and Monetary Union	
1978: EMS, European Monetary System ECU, European currency unit	By the Bremen European Council
1992: EU, European Union	By the Maastricht Treaty
1998: Eurozone	11 countries join

2009/2010: Disment Treaty

Chapter 2. SAQ 6. *List the main sources of EU revenue and the main spending priorities. Explain how each of these has developed over time.*

Main sources of EU revenue and how they developed over time:

1. Tariff revenue stemming from CET: tariffs imposed on imports from non-member nations.

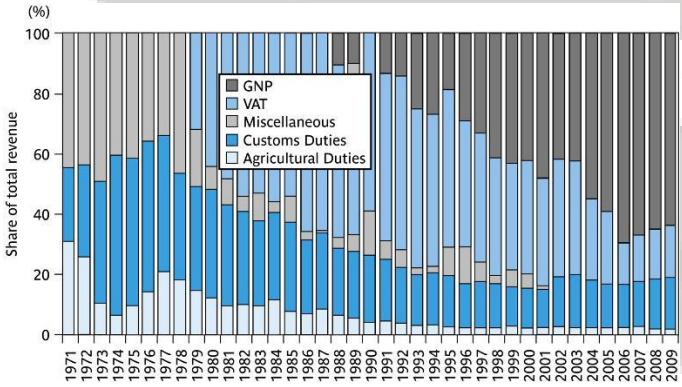
   The importance of this source has fallen over time. CET has been steadily lowered in the course of the WTO rounds. Moreover, a very large fraction of EU imports has become duty free.

2. Agricultural levies, tariffs on agricultural goods that are imported from non-members. Introduced in April 1970. The importance of this source has fallen over time. It has been reduced in the context of the CAP (common agricultural policy) reform.
3. VAT resource, 1 per cent value added tax.

   Introduced in April 1970. Increased in 1984. Its role reduced when the GNP resource was introduced. Further reduced with the Delors II package.

4. GNP-based tax on EU members.

   Introduced in 1988, with the Delors I package. Was increased in 1992, with the Delors II package.



Most important is that the GNP based contribution becomes more important.

Main spending priorities:

1. Farming (sustainable growth: natural resources).

   CAP (common agricultural policy) spending started in 1965 and dominated budget, with its peak in 1970. 2005: spending is moved away from agriculture.

2. Poor regions (economic, social and territorial cohesion).

Cohesion spending began in 1973, and started to rise in the 1980s. Is steadily growing.

3. R&D and training (competitiveness for growth and jobs). 2005: spending on competitiveness is increased.
4. Administration .
5. Development assistance (Global Europe).

2005: spending on poor regions is made more coherent and concentrated.

Farming was huge in the beginning. Is becoming less important now, but also is still rising. Poor regions is inclining in importance. Especially with the new countries in Eastern Europe.

Lecture 2. Ch3, 5 and paper Baldwin ea

Decision making (B + W ch 3) Tax competition EU

EU reforms ECB (Richard Baldwin, Erik Berglöf, Francesco Giavazzi and Mika Widgrén)

Trade creation, trade diversion, PTA (ch 5) -> decision making by central bank know for exam!!!!

Task allocation: Which level of government is responsible for policies in the EU?

a) '**Exclusive competences'**: areas in which the EU alone decides, e.g. agricultural policy, monetary rules, migration (should be but it isn't), trade legislation, competition policy

b) '**Shared competences'**: responsibility is shared between the EU and Member States; Two types:

1. Members cannot pass legislation in areas where the EU already has.
2. Existence of EU legislation does not hinder members' rights to make policy in the same area.

'**Supporting, coordinating or complementary competence'** where the EU can pass laws that support action by members.

'**National competences'**: national or sub-national governments alone decide.

The use of the tasks is guided by two principles:

1. **Subsidiarity**: keep decisions as close to the citizen as possible (i.e., EU action only if it is more effective than action at national, regional or local level). Allow EU for problems that cannot be addressed by national policies alone, and guard national sovereignty in areas that cannot be dealt with more effectively at EU level.

2. **Proportionality**: the EU should undertake only the minimum necessary actions.

Of course every parliament wants more power. European parliament doesn't have much

power so far. It is growing though. Can imagine they want more power.

- National parliaments are 'subsidiarity watchdogs'. There are anxious about extra power for Brussels. They want their power in national parliaments. Due to economic crises, more and more parliaments are critical at Brussels.

Common rules, common actions?

Monetary policy (EMU countries), CAP, Competition policy, Foreign policy?, Migration?, Social policy? (different cultures), Defense and security?, Taxes?, Pensions?

Economic integration and the assignment of function of taxes:

Allocation function

- Due to taxes, you can allocate production and consumption.
- Hardly allocation function in EU. Most taxes are national, so fiscal federalism predominant.

Redistribution function

- By taxing income, you can redistribute the income.
- Hardly in EU.
- Effective fiscal control possible due to absence of mobility of labor.

- Monetary integration not combined with fiscal integration. Most economists say we first have to have fiscal integration before monetary integration is possible.

Stabilization function

- The same problems as on national level (affectivity, time-lag, monetary- or fiscal policy, permanent/temporary shocks). Even worse at European level. Not very effective to have stabilization functions in EU.

Other problems:

- Non-flexible labor markets. People don't move a lot between parts of EU.
- Is unified policy more effective?

- Spillovers into other countries. Stabilization policy in Germany might affect Netherlands as well. But stabilization policy in border regions might affect non-member countries (?).

Fiscal harmonization and indirect taxes - Principles VAT (value added taxes):

1. **Origin principle**: VAT on home-produced goods. All production is taxed in the country were they are produced.

2. **Destination principle**: VAT on consumption of goods (own production and import-goods), no VAT on export-goods. Most/all VAT in Europe is on the destination principle. That might cause some problems, see several examples below.

Starting point: No VAT & Flexible exchange rates.

Two countries:

H [?] clothes and cars (comp. adv. cars).

P [?] clothes and cars (comp. adv. clothes).

No complete specialization caused by increasing cost conditions (that means that comp.adv. disappears when you produce more due to higher costs, that doesn't hold here).

Introduction VAT:

Situation 1: H: 20% (uniform) and P: 10% (uniform).

Consequences destination principle and origin principle?

No effect on real trade when destination of origin principle is introduced.

VAT-rate not important → Equivalence theorem (Robson).

On the medium term, exchange rates will adjust. Country that had comp.ad. in short run, will become more expensive in the medium term. In the long term, there will be no differences. No effect of introduction of different VAT when there are flexible exchange rates.

Situation 2 - Introduction VAT

H: cars 20%, clothes 0%.

P: cars and clothes 10%.

Consequences destination and origin principle?

H: cars will become 20% more expensive and clothes will have the same price. People will buy more clothes and less cars = consumer distortion.

P: cars and clothes both are taxed by 10%. If they spend more or less the same on cars and clothes, it will not have a great effect on the exchange rates.

But once countries specializes:

H specializes in clothes and P in cars.

This might cause distortion of production.

Distortions on production, consumption, trade: not optimization of trade.

What to do? When you want to avoid these distortions?

Maybe: spontaneous tax harmonization (lowest tariff standard).

IN EU: VAT harmonization, you need same systems of VAT.

- In general, we have the same system. Only small differences.

With fixed exchange rate?

Then the country with the best comp.adv. will remain most competitive. Its position will be better for years. On the very long term, things could change, in wages e.g., but that is on the very long term.

Principles in direct taxes:

1. **Residence principle**: tax in country where person/firm is resident.
2. **Source principle**: tax in country where income is earned or capital is located. Usually this.

Needed for optimal allocation of production

a) **Capital export neutrality**: same fiscal treatment as in home-land when investing abroad. So if

   you invest in Germany, you have to pay the same tariffs as other Dutch firms. ? residence-based- principle.

b) **Capital import neutrality**: same fiscal treatment as local firms for foreign company when

   investing. Somebody coming from Nijmegen needs to pay the same tariffs as other firms in Germany ? source-based principle.

If you want to have both, you need to have the same tariffs ? tax harmonization solution.

Gorter-Parikh elasticity's = The change in investment caused by a change in corporate taxes. -14,3 means if Portugal lowers its tariffs with 1%, the FDI in Portugal will increase with 14,3%. Germany has an elasticity of minus -3,3.

Small countries have relatively high elasticities. Which means smaller countries have more profitability from lowering taxes. That's why countries like Portugal are against tax harmonization.

If countries follow tax cuts of neighboring countries (tax competition):

? increasing cost of income redistribution.
? how to finance public goods? Because lower tariffs means less government income.

Better alternative: tax coordination in Europe.

But in general, we don't have the same corporate taxes in Europe.

Most countries have lowered their corporate Income Tax rates the last 20/25 years by 10/12%. But same rules/corporate taxes should be better in the whole European market.

Fiscal federalism theory says what countries should do on their own and where Europe has to do something. Should we have centralized or decentralized allocation?

Optimal allocation of policy-making tasks depends on trade-offs:

1. *Diversity and local informational advantages*

Choosing a one-size-fits-all policy leads to an inferior outcome when people have diverse preferences. Local governments can acquire information more cheaply and so the decision-making task might better be allocated to the local level, decentralization.

2. *Scale economies*

   Per-person cost of a service falls as more people use the service, favour centralization.

3. *Spillovers*

   Decision making locally may be suboptimal, but centralization not always best option. Negative and positive externalities. Better to centralize policy.

4. *Democracy as a control mechanism*

   Favours decentralization: decisions should be made close to voters, to control politicians. If you want to have more democracy, maybe it's better to have local or national arrangement, instead of Brussels.

5. *Jurisdictional competition*

   Favours decentralization: competition between regions provides the best local services. People want to live in the city with the best politics. It might be better to have decision making centralized. But decentralization if you want better cities, if people have an exit-option. Then more competition between cities.

Germany, UK, France and Italy each have 29 votes. Spain and Poland 27. Etc. The more population you got, the more votes, but not proportionally. E.g. Malta still has 3 votes but small population. The more population you have, the less influence you have, you could say.

Decision making in Europe is a big issue. How many votes for each country?

Current **QMV, qualified majority system**, rules from Nice Treaty:

- Each Member State's minister casts a certain number of votes in the Council (increasing in population but less than proportional).
- A proposal passes the Council with at least 255 votes (out of 354, 72%).
- Agreement of 50% of Member States representing.
- At least a representation of 62% of the population.
- In fact: *triple majority*.

2017: Lisbon Treaty - *Double majority*.

- 55% of Member States is necessary for a proposal to pass.

- Representing a minimum of 65% of the EU's population.

- Also: restricted right of veto. At this moment, almost every country has a veto. But after the

  Lisbon Treaty, more and more veto's will be canceled.

Efficiency in EU the EU decision-making context means the ability to act.

Passage probability measures how easy it is to find a majority under a given voting scheme. It's the number of all possible winning coalitions divided by the number of all possible coalitions.

Power = the ability to influence EU decisions by being in a position to make or break a winning coalition in the Council. We focus on the likelihood that a Member State will be influential.

- Most direct: national voting shares in the Council, dependent on population size.
- Voting power always turns out to be an influential determinant of budget allocations.
- *Normalized Banzhaf Index (NBI)* gauges how likely it is that a nation finds itself in a position to 'break' a winning coalition on a randomly selected issue.

Nice Treaty: equal-power-per-person view, since it shifted power to big nations.

Constitutional Treaty: less clear-cut, since it boosted Germany's power, but also boosted the power of EU members with populations below that of a medium-large city.

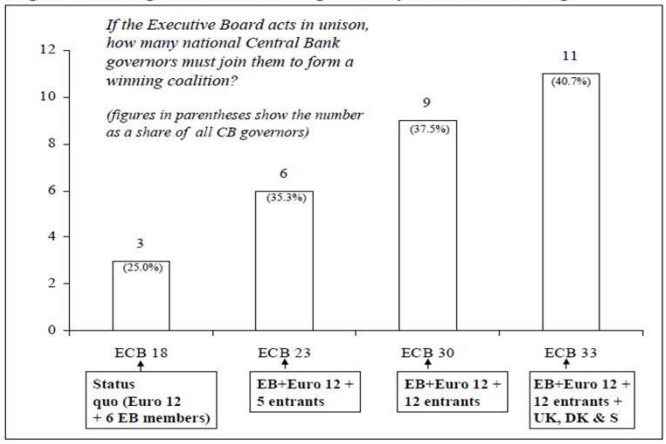
Problems ECB:

The more countries will join, the less possible coalitions in the Governing Countries and the less synchronized countries will be.

Less synchronized countries will get more and more power within the decision making of the ECB.

It is even worse when you compare it with population and GDP shares. With 30 EU countries, countries with 20% of GDP have 43% of the population share. Which means that the core countries lose their influence. This might be a problem in the future when decision monetary policy.

Figure 14: Enlargement and the Rising Difficulty of Decision-Making



Solutions ECB voting system.

- More powerful Executive Board. Six members.
- No power/votes presidents national banks.
- More votes for members Executive Board.
- Presidents of NCB advisory committee .
- Weighting of votes in Governing Council (f.i. share in GDP).
- More power European Commission/European Parliament/Ecofin in monetary policy and targets (f.i. inflation), Executive Board should really execute.

Problems:

- Members of EU (old and new) want to retain influence upon monetary policy.
- Choice/demand for independent ECB (Germany!).

- Time-problem: reforms more difficult after enlargement (right to vote on this matter!).

Reform of voting system ECB: Not in Nice Treat or Lisbon treaty. So it will continue how it is not, with one country one vote. Every country will have one vote and every board member will have one vote.

This is a problem, because different parts of Europe have different business cycles. So you need different monetary policy and this is a problem for the ECB.

Discriminatory liberalization (ch 5)

Unilateral discriminatory liberalization = remove import tariffs from only one of the trading partners.

Preferential liberalization: e.g. when Home unilaterally removes import tariffs from Partner only:

a) **Adam Smith**: foreign/partner firms gain, they enjoy higher price and more exports to Home, when tariffs against them are eliminated (preference).

b) **'Haberler's spillover'** : third nations – those excluded from the preferences – must lose. RoW exporters suffer a drop in both prices and sales to Home (discrimination).

c) **'Viner's ambiguity'** by Jacob Viner: preferential liberalization might harm the preference-giving nation. Liberalization part associated with trade creation, and discriminatory part with trade diversion.

- Trade creation occurs when high cost domestic production is replaced by low cost imports from other members positive effect (Adam Smith said this).
- Trade diversion: we used to import product from a country very cheap, and it might be more expensive to import from a new trade partner.

Discussion on TTIP: Trans Atlantic Trade and Investment Partnership.

Also about FDI, cooperation between firms. Between EU and US.

- Who will benefit from TTIP? Some think only MNO's.
- Debate among economists/politicians about TTIP. Most economists are in favor.
- Consumers, small firms have doubts. Lot of politicians are against it.
- Farmers (both in US and EU) fear TTIP.
- Will the effects in every country in the EU be the same?
- Will the effects in every economic sector/region be the same?
- Will TTIP effect health, animal treatment/welfare?
- Will TTIP effect power of multinationals/governments?
- Will TTIP stimulate FDI?

Why is TTIP so important ?

- Far beyond a simple trade deal.
- Huge strategic significance vs BRICS + Geopolitics

- Very controversial in public opinion in EU.

- Secrecy: what is on the agenda?
- Huge potential impact on domestic standards.

- Investor-to-State Dispute settlement system very heavily criticized on both sides of the Atlantic. Investors may sue the state if there is e.g. some change in policy. Suppose you invest in NL and coming from US. Then government in NL raise min. wage. That means you'll higher costs and your investment will have lower profits. Then you can get money from NL.

- Huge influence of big corporates is visible everywhere.

Assumption of no imperfect competition and no increasing returns (NICNIR). Assume Rest of the World (RoW) and Partner are identical.

Free trade eq.p is P_{FT}

Initial free imports is M

RoW import is X_R

Partners import is X_P

If Home applies non-discriminatory tariff T on imports from both nations:

- MS shifts up by T, to MS_{MFN}
- Eq: P' and M'
- New border P: P' – T
- X'_R and X'_P

When Home removes T only for imports from Partner (= unilaterally liberalizes on a preferential basis):

MS_{PTA} (preferential trade arrangement) lies halfway between MF_{FT} and MS_{MFN}, until P_a, the zero-supply P of RoW (P*).

So below P_a, only Partner firms will supply imports.

Home's domestic price falls from P' to P''.

The border price falls from P'- T to P'' – T for RoW imports.

The border price rises from P'- T to P'' for Partner imports.

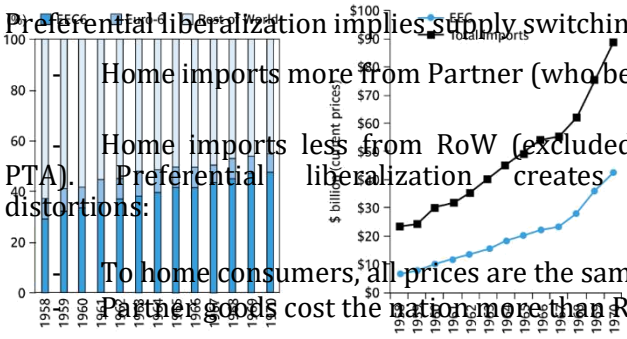
RoW exports fall.

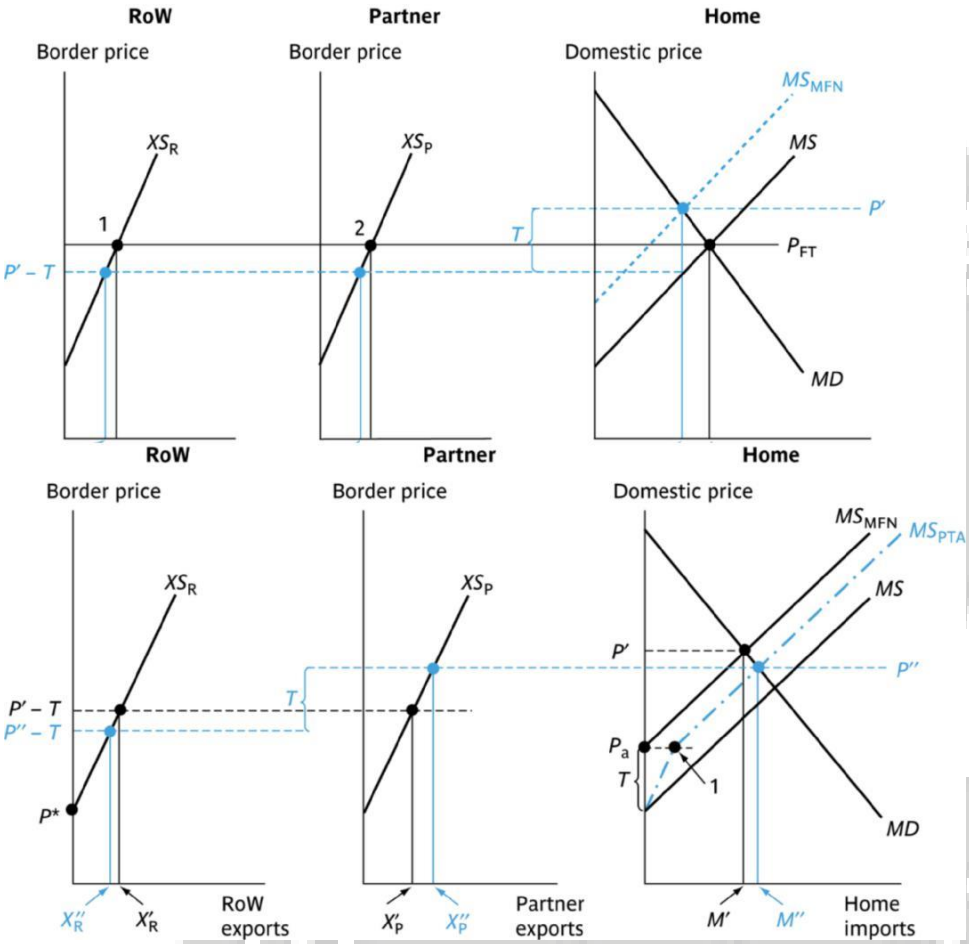
Parner import rise.

Total Home imports rise from M' to M''.

Preferential liberalization implies supply switching i.e. "trade diversion".

- Home imports more from Partner (who benefits from PTA).
- Home imports less from RoW (excluded from PTA). Preferential liberalization creates price distortions:
- To home consumers, all prices are the same (P").
- Partner goods cost the nation more than RoW goods (P" > P"-T).





More trade. But there has been some diversin.

Less import from the RoW.

Addition from the book, that haven't been discussed in the lecture:

Welfare effects (See page 127):

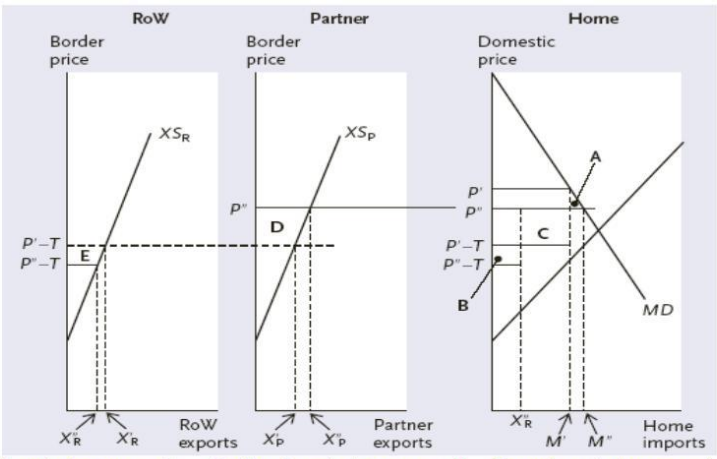
- Partner gains D: positive border-price and trade volume effect (Smith's certitude).
- RoW loses E: negative border-price and trade volume effect (Haberler's spillover).
- Home's welfare changes by A + B – C, which may be positive of negative (Viner's ambiguity).

[A: more imports raises welfare. B: goods from RoW have fallen in P, Home gains. C: goods from Partner have risen from P'-T to P", so Home loses].

Analysis of a customs union

European integration involves reciprocal (two-way) preferential liberalizations.

Assumption Home, Partner and RoW are symmetric initially in all aspects, incl. MFN tariff on imports. Assume three goods are traded: good 1,2 and 3. Each country produces all goods, but cost structures are such that each nation exports two of the three goods while important the remaining one.



RoW's net change = -E Partner's net change = +D Home's net change = A+B-C

- Home imports good 1. Partner imports good 2. RoW imports good 3.

Customs union between Home and Partner: T becomes the common external tariff.

- What happens to Home's exports when Partner lowers its barriers is exactly what happened to Partner's exports when Home lowered its barriers.

Rules of origin restrict (beperken) duty-free treatment to goods that are actually made in the Free Trade Association (FTA). Problem: difficult in today's highly globalized markets.

Free Trade Association versus Custom union: eliminate all tariffs and quotas on trade among partners, and harmonize common external tariffs (CET), on imports from non-member nations, which requires some integration of decision making.

Importer's border price = what the importing nation actually pays for the imports.
Exporter's border price = what the exporter actually gets paid for the export.

Importer's border price is higher with T, reflects real costs involved in overcoming the frictional barrier.

Baldwin, Erik Berglöf, Francesco Giavazzi and Mika Widgrén (EU reform for Tomorrow's Europe, CEPR discussion paper 2623, November 2000)

[own summary]

Part 1: Voting in the Council of Ministers

Challenge: construct EU decision-making system that meet the efficiency, legitimacy and acceptability criteria, after +- doubling of number of Member States. Most reform plans fail in this.

Measure for efficiency: the **passage probability** = how easy it would be to pass a randomly selected issue. The ratio of winning coalitions to total coalitions (all possible coalitions among Member States)

- Indicates whether reform proposal maintains EUs current level of decision-making efficiency.

- Usefulness: showing how the various reforms and enlargements will *change* the current passage probability [exact level of pass.pr. is almost entirely useless].

The dual simple majority (DSM), 50% majority rule, maintains current level of efficiency in an EU27. c) More members ? more winning ánd blocking coalitions ? pass.pr. remains same.

Plausible alliances in EU27: East and Poor Alliance. Efficiency can only be maintained if the 71% threshold is lowered. Otherwise, these alliances could have a blocking minority in the EU27.

Legitimacy dilemma (legitimiteit = rechtmatighed, wettigheid), EU is Union of People and States:

- Union-of-People rule: one-person-one-vote (proportional representation).
- Union of States: one-nation-one vote (intergovernmentalism).

Normalized Banzhaf index (MBI) = how likely it is that a nation could 'break' a winning coalition on a randomly selected scale.

Dual simply majority plan: weighted Council votes, combines Union of States and People legitimacy. Gives weight to small nations on the one-vote each membership threshold, and gives weight to big nations on the demographic threshold. This is the only plan that is efficient and legitimate.

Part 2: ECB restructuring before EU enlargement

ECB restructuring will be necessary and it will be much harder post-enlargement.

More members weakens the Board's relative power, and the newcomers' national perspectives will systematically differ from those of the core-7. After enlargement, it will be difficult to agree on any reform, and new members will have a veto over it. So action must now be taken.

Part 3: enlargement 'examination' dates

The EU should make reform a priority rather than a precondition. Accomplished by a firm commitment to Maastricht-style dates for the enlargement process.

- Specify 'exam' and 'signature' dates, not accession (toetreding) dates.

Questions: Ch3: SAQ 1, 2.

SAQ 1. List the main trade-offs stressed by the theory of fiscal federalism. Discuss how the tension between negative spillovers and diversity can explain the fact that the EU has adopted only very limited harmonization of social policies.

1. Diversity and local informational advantages
2. Scale economies
3. Spillovers
4. Democracy as a control mechanism
5. Jurisdictional competition

Negative spillovers mean that one region's policy has a negative effect on other regions. Moreover, countries in the EU are very diverse. Because of this, it is hard for EU members to agree on the same social policies and this explains why the EU hasn't harmonized social policies.

E.g. you have to pay social tax to the country from which you want to receive social benefits from social policies. Difficult when you work in e.g. GER but want to profit from NL social policies.

SAQ 2. In many European nations, the trend for the past couple of decades has been to decentralize decision making from the national level to the provincial or regional level. How could you explain this trend in terms of the theory of fiscal federalism?

Trade-off 1, 4 and 5 favour decentralization, whilst only trade-off 1 favours centralization (trade-off 2 favours them both). This could imply that there are more advantages than disadvantages to decentralize policy decisions and this explains the trend of decentralization in many EU nations.

E.g. decentralization on the health part in NL, because of government wants to save money.

Chapter 5 SAQ 1: *(Kemp-Wan theorem) Starting from a situation like that shown in figure 5-1, where the three nations are symmetric in everything, incl. the initial MFN tariff T, suppose that Home and Partner form a customs union and lower their common tariff against RoW to the point where the new, post-liberalization border price facing RoW exporters is the same as it was before the liberalization, i.e. P' – T. show that this 'Kemp-Wan' adjustment ensures that Home and Partner gain while RoW does not lose from this CU-with-CET reduction scheme.*

Logical that RoW does not lose, since the border price facing RoW exporters is the same as it was before the liberalization. So that doesn't change anything.

After an agreement with Partner, border price for rest of the world will decrease less import in country from Home.

Then put lower tariff for rest of the world, situation will not be bad for RoW and might increase for Partner compared to the beginning.

Question We just make a smaller tariff T. The import from RoW will not decrease, cause their border price is now the same as before.

Partner: import will be between X before and after. Will be better for partner. Import all together will be increased. Price will be lower in Home.

Lecture 3. Ch 6, 7, 8.

Chapter 6. Market size and scale effects

Market size matters.

Tearing down intra-EU barriers → bring a 'pro-competitive effect' → puts pressure on profits → response is 'merger mania' → more efficient industrial structure, with fewer, bigger, more efficient firms competing more effectively with each other.

Schematically: liberalization → defragmentation → pro-competitive effect → industrial restructuring

(usually more free trade within Europe).

Trend: more M&A since 2000.

- Globalization.
- High cash flow after 2000. Lot of profits from companies. They started to invest.
- Influence private equity. Also people/investors have lots of money. Sometimes: split up of companies.
- Dumping of less profitable parts.
- Big firms: bureaucracy → cost savings.
- Acquisition (parts) cheaper.

Example: TNT: TNT Express (deliveries packages) and TNT post. Or La Place (acquisition by Jumbo).

Market size matters: some evidence.

A study on French manufacturing firms shows that implementation of the Single Market Programme and the Economic and Monetary Union Treaty (Maastricht Treaty) lowered the price–cost ratio margin 4 to 5 percentage points (and other studies find similar qualitative results).

Threats (international) M&A

- Adverse selection, hidden information (lemons) about the firm you want to take over.
- How to retain "tacit knowledge". Mentality, culture, way of doing business.
- Hold-up problem. Workers from the taken over firm and the firm that took over are tied to each other. Some workers will not be happy and not be motivated.
- Opportunism? Especially with international mergers and acquisitions.

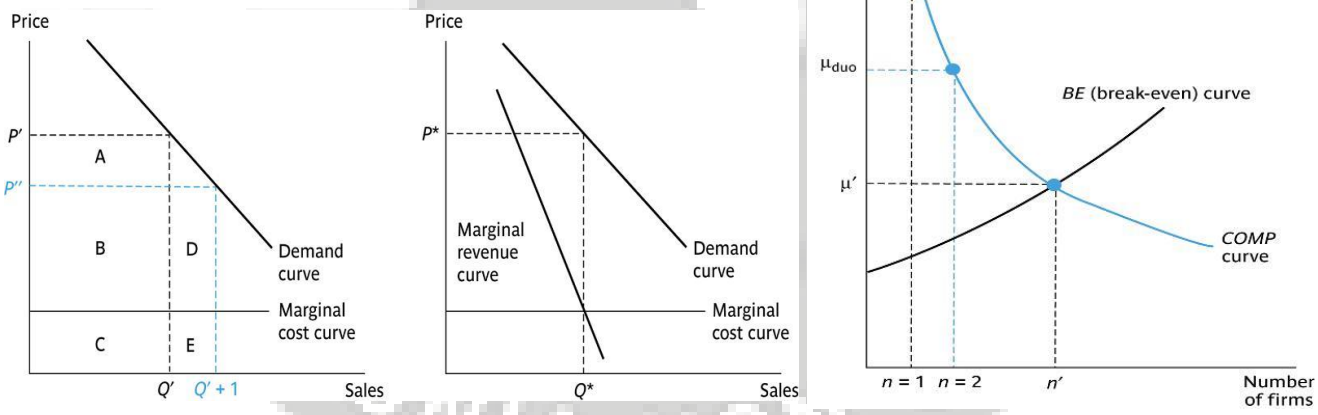
Consequences of FDI

- Product market effects: more products in a country.
- Factor market effects: e.g. change in local wages, might harm local companies.
- Spillovers: Technological (might bring their machines abroad) and Pecuniary (lot of money from the profits will flow out of the country again).
- Employment, Output, Wages, Price level.

Theoretical preliminaries: monopoly

Profit-maximizing strategy: marginal revenue = marginal cost Q* and P*.

The BE–COMP diagram in a closed economy



COMP curve: competition-side relationship. Competition drives μ ('mu') down as n rises.

- Firms would charge μ' when thre are n' firms in the market.
- Mark-up = price – marginal costs. The more firms, the lower P and the lower μ.

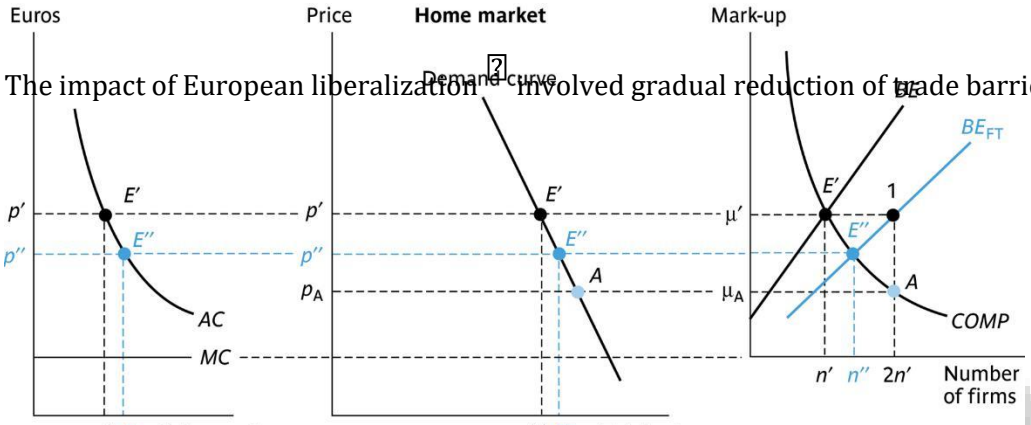
BE (break-even or zero profit) curve: taking the mark-up (μ) as given, the BE curve showd the number of firms that can earn enough to cover their fixed cost. More firms can BE when mark-up is higher.

- N' firms could break even when the mark-up is μ'.

Firms are not always on BE, since they can earn above-normal or below-normal profits for a while. In the long run, however, firms can enter or exit the market, so n rises or falls until firms

cover FC. Firms are always on COMP curve since firms can change P quickly in response to change in n.

Intersection BE and COMP curve in closed economy: equilibrium μ ad long-run n.



The impact of European liberalization involved gradual reduction of trade barriers.

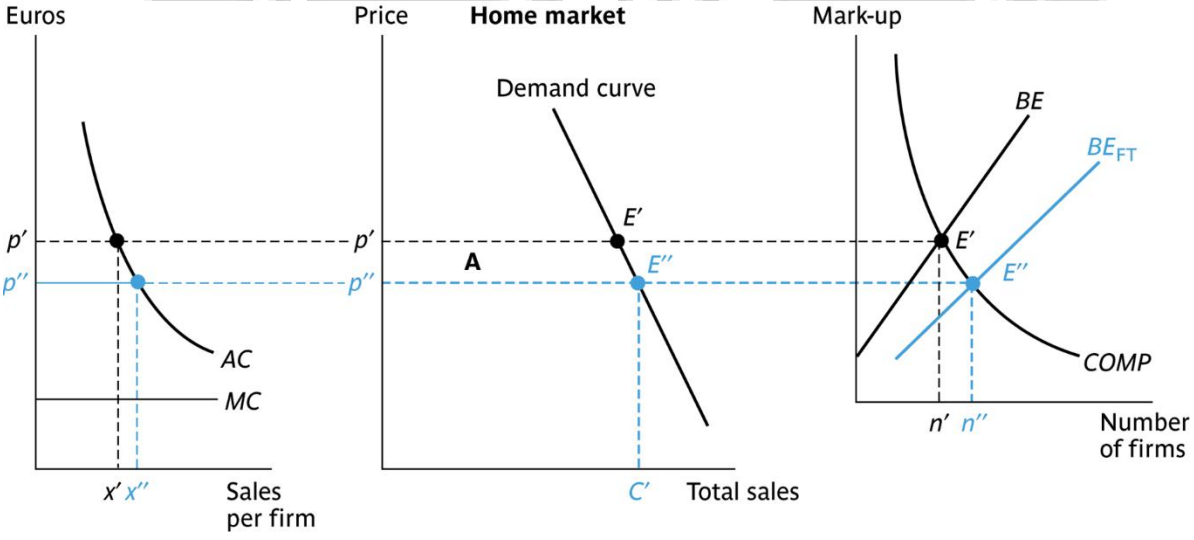
Step 1. Short term: defragmentation and the pro-competitive effect (from E' to A).

- Short term: before n can adjust. From 1/n' share to n'/2 market share per firm.
- Liberalization decreases price-cost mark-up, from E' to A.
- Prices and sales drop from p' to p_A.

Step 2. Long term: industrial restructuring and scale effects (from A to E").

- Point A is below BE curve: profit is insufficient to cover FC for a typical firm/ to breakeven.
- Overall number of firms has to fall from 2n' to n". In EU: typically via mergers and buy-outs. Some firms will quit or go bankrupt. Lot of firms will have to disappear. Reconstruction.
- As industrial consolidation occurs, the economy moves from A to E". Less firms means higher prices. There will be lesser firms than 2n' but they will be bigger. More effective firms.

The impact of European liberalization: welfare effect



Gain in Home consumer surplus: A = Home's long-term welfare gain, since there is no offsetting loss to producers before liberalization and there was no tariff revenue to begin with. Firms earn zero profits both before and after liberalization. (Note that this ignores medium-term adjustment costs).

Chapter 7. Growth effects and factor market integration

The logic of growth effects schematically:

European integration (or any other policy) → allocation effect (firms with best competition will win)

→ improved efficiency (most sufficient firms survive) → better investment climate

→ more investment in machines, skills and/or technology → higher output per person.

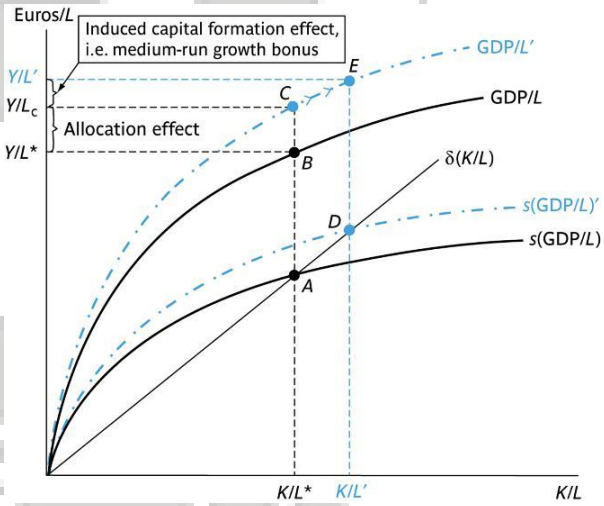
- Evidence for this is better on the short run than on the long run.

- Under *medium-run growth effects*, the rise in output per person eventually stops at a new, higher level.
- *Under long-run growth effects*, the rate of growth is forever higher.

Medium-term growth effects

Assumptions B&W:

- EU as a single, closed economy.
- fully integrated capital and labour markets.
- the same technology everywhere.
- Long term growth: Solow-model. To prove that there are maybe medium turn growth effects.



Medium-term growth effects: **the Solow diagram** Integration → improves efficiency → higher GDP/L

→ higher investment-per-worker → economy's K/L ratio starts to rise towards new, higher eq. value → faster growth of output per worker during the transition from the old to the new K/L ratio, called induced capital formation. New steady state in E.

Accession countries provide a natural experiment to evaluate the medium-term growth effects of European integration since these countries experienced a rather sudden and well-defined increase in economic integration when they joined.

The logic described above should lead to observe the following for new assessing countries:

1. Stock market prices should increase. Cause if you join EU, higher growth, more profit.

2. The aggregate investment to GDP ratio should rise.

3. The net direct investment figures should improve.

- See graphs ppt or p. 178. Prove that there were some medium term growth effects in Spain, Portugal and France. France as reference point. After P and S joined, stock market index and FDI improved, and more in S. investment in Spain went up faster than Fr and P. Until P and S reached steady state. Also Baltic States did well after they joined, compared to France then.

The evidence on long-term growth effects of European integration is much harder to find.

- Long-term growth rate seems to return to its pre-integration average.

- Focus on medium-term growth effects. Research showed that there are more medium term growth effects.

Misery index (De Grauw, 2009) is the sum of inflation and unemployment.

Centralization index: the higher, the less centralization. The lower, the higher centralization, which means that unions are very powerful.

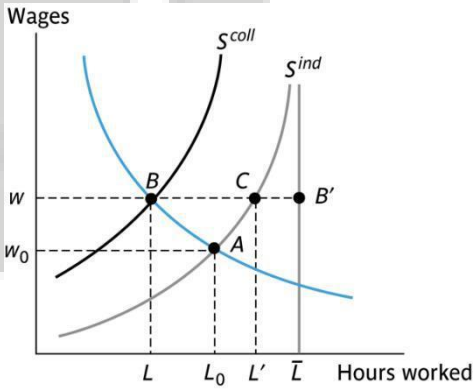
- Not very centralized: firms have most power. Los wages means low inflation. Score better.

- Very centralized: score also better on misery index. Wage bargaining is very high. Government is very powerful, they can force labourers to accept lower wages, e.g. when economy is doing badly. Rise in wage will then not be very high.

<u>Chapter 8. Economic integration, labour markets and migration</u>

Labour markets: collective negotiations

MPL represents the firm's demand for labour. Supply of labour is by people.



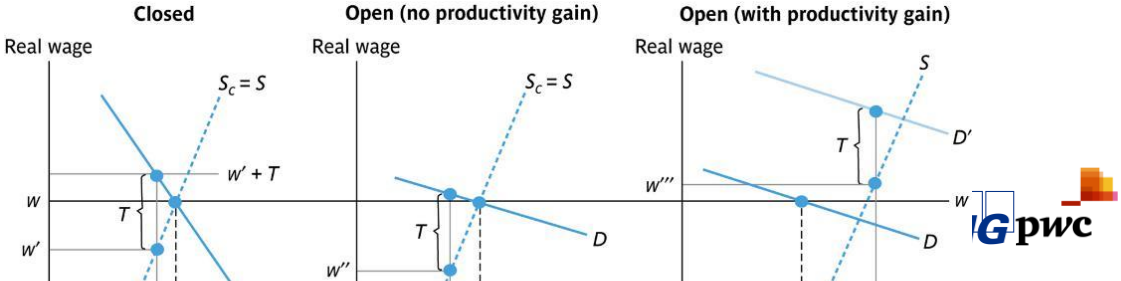
S^{ind} describes how individuals trade off income from work against leisure time.

S^{coll} is the collective supply, representing collective negotiations (e.g. in trade unions).

A: free interplay of individual D and S in the absence of rigidity (not realistic).

B: outcome of collective negotiations. Raise real wage, declines employment to L.

Involuntary unemployment is BC.

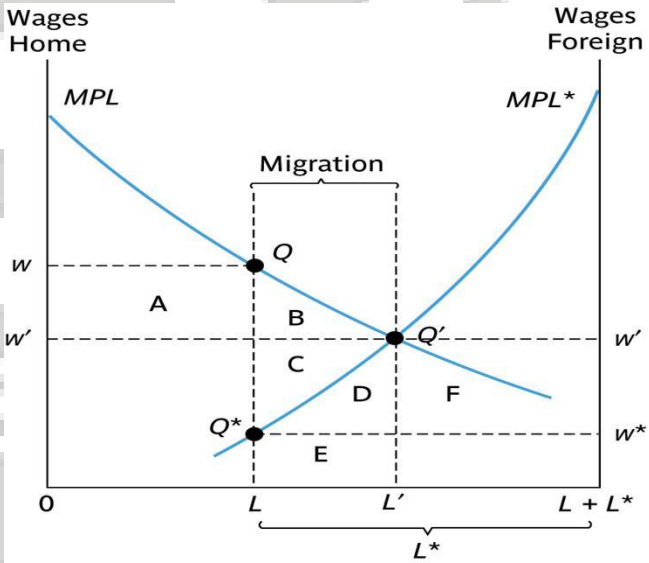


'**Social dumping**' = competition from new Member States reduces social protection in older Member States. Social security system will then be less luxurious.

- Without any social policies and close to trade, eq. is real wage *w* and employment level L.
- Suppose social policies raise cost workers by T, which shifts D. New eq. 'take-home' pay is *w'*.
- Free trade → consumers have more options → flatter D → take-home wages to *w"*.
- With productivity gain → value workers rise, D shifts up → *w"'* and *L"'*.

T goes down when social protection is reduced.

Migration: the simplest framework
Initial situation: Home in Q, with w and L, and Foreign in Q*, with w* and L.



Post-migration situation: Q', cause labour will flow from Foreign to Home. Higher wages in Foreign and lower wages in Home.

- Loss of native Home workers: A (less wage).
- Gain of Home capital-owners: A + B (increased earnings).
- Gain of foreign-workers staying abroad: F (rise in wages).
- Loss of foreign capital-owners: D (people disappear, less output) + F (higher wages).
- Gain of migrant workers: C + D (they used to earn E, now they receive C+D+E).
- So, Home gains: B.
- So, Foreign gains: C.

Two key results emerge:

1. Immigration is likely to raise employment and national income.

2. Immigration is unlikely to affect unemployment in either direction.

But pressure on the lower skilled workers' wage. Not on the medium and high skilled workers.

These results provide a strong endorsement for the fundamental principle of freedom of movement of workers within the EU. To achieve more economic growth. Still, there is low mobility within EU:

- Restrictions for new EU members' nationals mobility.
- Different Pensions systems.
- Unemployment benefits.
- Language, housing, health systems, etc.

Ch. 6 SAQ: 1, EQ: 3

SAQ 1. Suppose that liberalization occurs as in section 6.4 and the result is a pro-competitive effect, but instead of merging or restructuring, all firms are bought by their national governments to allow the firms to continue operating. What will be the impact of this on prices and government revenues?

Now that the governments are the owners, will they have an incentive to continue with liberalization? Can you imagine why this might favour firms located in nations with big, rich governments?

Liberalization shifts the BE curve to the right, because of the greater market size.

In the short run, due to the extra firms and more competition, the mark-up of each firm will fall. With that, prices fall and the total sales rise. Since the government is now the owner of the firms, it will receive all the sales but must pay all the cost to. In the graph you can see that the mark-up is too low in the short run to break-even, since point A is below the BE line. This means the firms are making loses, which means that government revenues will fall.

In the long run, firms must break even and they must heighten their mark-up and prices, in order to survive. This can only be achieved when the total sales in the market will be reduced and this can be accomplished by lowering the number of firms in the market. Only the most efficient firms will survive on this market. This implies that governments will only have an incentive to continue with liberalization, if they are sure that their firms are the best and are able to survive on the market. Otherwise, the take-overs will only costs money to the government.

Firms located in nations with big, rich governments will have more of a 'cushion' in the short run, since their new owner, the government, will then have more money to tear on. There is then not a necessity to break even in the short run and this will able the firms to stay in the market longer than firms that are taken over by small governments.

Move to point A: P<AC [?] reconstructing of firms to E'.

But now suppose government will subsidize firms to continue operation. Price will be lower and will be too low to have profits for firms. Government revenues decrease because they'll have to pay money. Rich government can continue doing this, but poor governments cannot.

Problems for Southern Europe but not for e.g. Germany, the Netherlands.

EQ 3. Some EU members allow their companies to engage in 'anti-takeover' practices. Discuss how differences in EU members' laws concerning these practices might be viewed as unfair when EU industry is being transformed by a wave of mergers and acquisitions.

If EU industry is being transformed by a wave of mergers and acquisitions, it means that the firms that remain after these mergers and acquisitions are bigger, have more knowledge and will probably more efficient. This means that the firms in the EU countries that engage in 'anti-takeover' practices

will not be that big and inefficient. Because of this, they might have some problems in competition with the other big and efficient firms.

On the other hand, when a market is forced to transform because of, say, a sharp decline in demand, firms are forced to merge or otherwise go bankrupt, since the total sales in that market must decline then. In the EU countries with anti-takeover practices, firms will be defended against these take-overs. In this way, more firms of that certain country will dominate the market and this can be unfair competition.

Number of firms must decline. One member state can insure that companies might survive. Governments help their own industry. If you are not allowing bill outs and mergers, it might be a problem for other foreign countries that not forbid these kinds of things.

Ch 7: SAQ: 2, 4

SAQ 2. It is often said that the prospect of EU membership made central European nations a better, safer place to invest. Using the Solow diagram, show how this would affect medium-term growth in these nations. What sort of 'footprints' would this leave in the data?

If central European nations are a better, safer place to invest, the investment rate in those countries will rise. The s(GDP/L) curve will rotate upwards. The inflow of capital at the old K/L ratio would then exceed the outflow/depreciation of it. Because of this, the K/L ratio will rise to a new equilibrium. At the same time, Y/L will also rise to a higher equilibrium. This affect the medium-term growth in these nations, since the medium-term growth will be higher during this process of attaining a new equilibrium.

The footprints in the data would be that for these central European nations, (1) stock market prices should increase, (2) the aggregate investment to GDP ratio would rise, and (3) the net direct investment figures should improve.

Higher steady state. Higher growth rate if you go there. Firms that will invest will invest in new machinery as well. Factories will then be far more competitive than firms elsewhere in the world. Innovation improved productivity. Some of the east EU countries recovered very fast.

SAQ 4. Just after WWII, the economies of the Six experiences massive destruction of physical capital. Although many workers also died, the war tended to do more damage to the capital stocks than it

did to the labour force. Use a diagram to illustrate how this may help explain the 'miraculous growth' in the late 1940s and 1950s.

If the capital stock fell more than the labour force, it means that K fell more than L K/L ratio fell. If K/L is lower than the equilibrium, it means that the investment rate is higher than the depreciation rate. This implies that there is more input than output of capital, which will rise the K/L ratio until the equilibrium is reached again. During this process of attaining the equilibrium, the medium-term growth rate is higher than it normally would be the miraculous growth.

There were huge investments, e.g. Marshall from US. We had new investments in better equipment, modern machines. A lot of sectors were reconstructed and became more productive than before the war. The steady state improved because we had more productive capital after WWII.

Germany recovered pretty strong. They did the best job: they became most important country in EU.

Ch. 8: SAQ: 6, EQ: 2

SAQ 6. Explain why the immigration of low-skilled workers can hurt native low-skilled workers and benefit high-skilled workers.

Assumption: immigrant are willing and able to perform the same jobs as natives but at a wage that is below the union-set wage w.

Assumption: immigrants are most of the time low-skilled workers.

The demand curve for low-skilled native workers shifts to the left, since low-skilled immigrants replace them. The union-set wage and native employment for low-skilled native workers fall because of this shift. This hurts native low-skilled workers.

Because of this lower wage for low-skilled workers, firms can hire more high-skilled workers for a higher wage. This is beneficial for high-skilled native workers.

Het is een idee dat wordt gevoed. Maar er is geen wetenschappelijk bewijs voor. Mits ze betaald worden door de cao. Denk aan Groningse scheepswerf met mensen die daar werken die betaald worden met het lage loon van een Hongaars bedrijf en cao.

Als economische activiteit toeneemt door meer laaggeschoolden die werken, heb je meer hoogopgeleiden nodig en dan kunnen die mensen profiteren.

EQ 2. It is argued – and it is the case in some countries – that the minimum wage should be set at different levels for the young, for the older, for the unskilled or for particular industries. Evaluate this argument.

I think it is beneficial for the level of employment to set different levels of minimum wages for different groups of people, since different groups of people have different 'values' for firms. For example, a young person is unexperienced, but flexible. And an older person is experienced, but not so flexible and expects most of the time a relatively high wage to take care of his/her family. Moreover, one industry could have a negative shock in demand, whilst another industry can be flourishing at the same time. Firms must be able to take into account the current market situation and adjust their wages on it, in order to survive on the market on to achieve maximum efficiency. For example, when the minimum wages are relatively low in a sector that is doing economically

bad, firms can hire more workers than they otherwise would have done if the workers had demanded a higher minimum wage. This means higher employment, which is better for the economy and the government expenditures.

In NL: bij de 23e krijg je je maximale minimumloon. Daarvoor veel minder. Er zal veel weerstand komen van vakbonden als je verschillend minimumloon wil invoeren voor verschillende sectoren.

Lecture 4. Ch. 10, 11, 12.

Chapter 10. Location effects, economic geography and regional policy

Europe's economic geography, the facts:

a) Rich regions are clustered and form the 'core' of the EU economy, as shown by regional GDP per capita (PPS) in 2010. Poor regions in the east and in Spain/Portugal. ? problem for social cohesion: people in the 'core' enjoy higher incomes and lower unemployment rates.

b) Most EU-nations are becoming more specialized. Ireland and Greece are very specialized, France and UK are not. See ppt: high number means sectors as EU mean/ more specialized.

European integration have led to:

- +/- narrowing of income inequality across nations, but increase of inequality within nations.
- Modest relocation of industry among nations. Manufacturing activities have become more geographically dispersed (verspreid), while most European nations have become more specialized on a sector-by-sector basis.
- Two main theories to account for these facts.

Theory part I: comparative advantage

Suggests that nations specialize in sectors in which they have a comparative advantage.

- Explains why nations have become more specialized while at the same time income differences have narrowed.
- Trade liberalization ? nations specialize on a nation-by-nation basis ? economic resources get shifted between sectors within each nation ? production is being allocated sector by sector across nations.

Example:

- Germany abundant in high skilled labour.
- Portugal abundant in low skilled labour.
- With trade: Germany specializes in pharmaceuticals and trades them for cloths from Portugal and the industrial structures of both Portugal and Germany would become more specialized.

Theory part II: new economic geography

New economic geography suggests that integration tends to concentrate economic activity spatially. It is based on two pillars:

1. **Dispersion forces** = anti-concentration, discourages the spatial (ruimtelijke) concentration of economic activity. Favor the geographic dispersion (verspreiding) of economic activity (e.g., higher rent and land prices, high cost of non-traded services, competition with other firms). It is not that common that a firm leaves it region. But a firm might consider to move.
2. **Agglomeration forces** encourage spatial concentration:

    - Demand linkages: big markets in a concentrated area is good for sales.

    - Cost linkages: availability of suppliers. More companies means more suppliers, means more goods. It will be cheaper to transport goods from one company to another. Agglomeration force bit bigger than dispersion force.

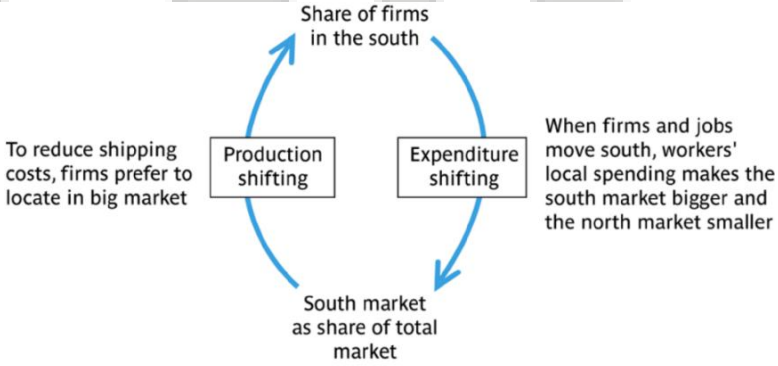
Pro-agglomeration force: firms would, all else equal, prefer to locate in the big market in order to save on trade costs, i.e. to be close to more of their customers than they would be if they were located in the small market.

Pro-dispersion force: firms would, all else equal, prefer to be in the market where there are few local competitors and that means locating in the small market.

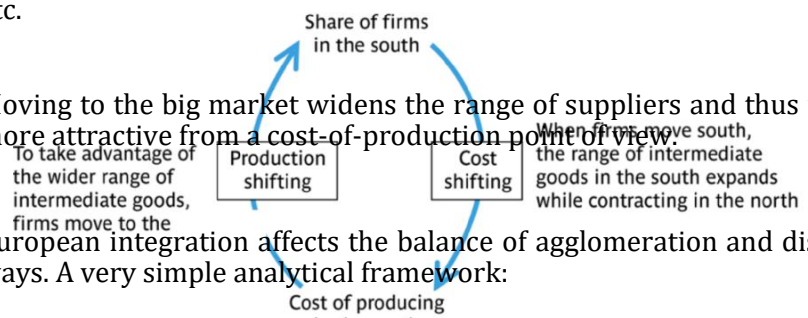
Demand-linked circular causality (right):

Firms desire to minimize shipping costs.

Involves production costs.



It all ends in the bigger region. More firms, bigger market, more firms are attracted etc.



Moving to the big market widens the range of suppliers and thus makes the big market even more attractive from a cost-of-production point of view.

European integration affects the balance of agglomeration and dispersion forces in complex ways. A very simple analytical framework:

- Assume away all dispersion forces except 'local competition'.
    - Assume away the demand-linked circular causality.

- Assume away cost-linked circular causality (by assuming firms buy no intermediate inputs).

    - one pro-agglomeration and one pro-dispersion consideration:

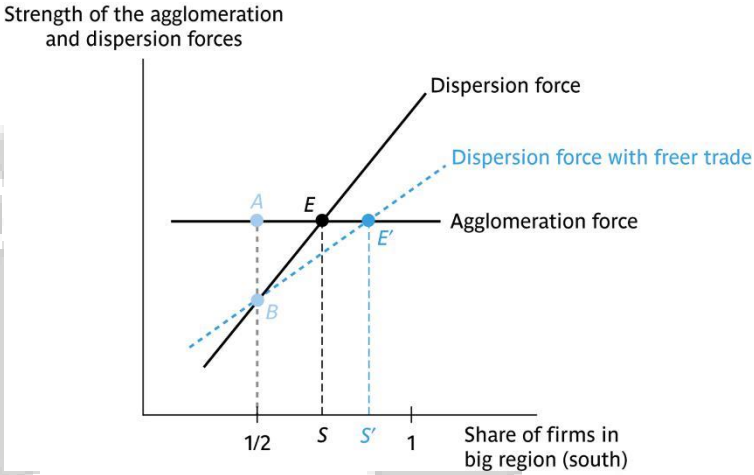
(1) Firms would, all else equal, prefer to locate in the big market in order to save on trade costs.

- Agglomeration force' line is flat, since we assume away circular causality, i.e. the market-size difference does not vary with the share of firms in the south.

(2) Firms would, all else equal, prefer to be in the market where there are few local competitors.

- 'Dispersion force' line is rising: firms benefit more of staying in north as share of firms in south rises.

Close economy some kind of concentration of firms in the big region.



If there are more and more firms coming to the big region, it might be interesting to go on the dispersion force: might be cheaper to move.

The more concentration, the more firms might consider to go to the country side.

Equilibrium E: incentives to agglomerate are balanced by incentives to disperse.

European integration lowers trade costs,

due to improvements in technology and transportation infrastructure (especially with EU spending on it) dispersion force might diminish.

 'dispersion force' curve rotates around point B (1/2 share for north and south), line comes down since lower trade costs provide less protection against competition from south-based firms.

 new locational equilibrium at E': higher share of firms in the big region.

- Free trade promotes the agglomeration of economic activity in the initially big region.

e.g. abroad firm wants to invest, invest first in the big region. That means that the big region will be more competitive and attract even more companies. Might be advantageous for other firms to join this investing firm in the big region.

- EU budgetary expenditures: more and more money is going to the poor regions. Also more votes for poor countries. Farming share from the budget is falling.
- Countries with the highest GDP per capita get the lower receipts per capita and vice versa.

- The goal of EU's regional policy is to help to disperse economic activity to less-favoured regions. Most of the money is spent on so-called convergence regions that typically have per-capita incomes that are less than 75 percent of the EU average. The EU spends about a third of its budget on these policies.

The EU's regional policy has 3 main objectives:

1. *Convergence*: aimed at reducing income differences across regions;

2. *Regional competitiveness and employment*: aimed at strengthening the competitiveness and attractiveness of the regions, as well as regional employment;
3. *Territorial cooperation*: aimed at reinforcing cooperation at cross-border, transnational level.

Europe's 2020 strategy (first this was the Lisbon strategy for 2010, but it failed so they prolonged it and changed it a little bit) for smart, sustainable and inclusive growth:

Smart growth

1. Strengthening research, technological development and innovation.

2. Enhancing access to, and use and quality of, information and communication technologies.

3. Enhancing the competitiveness of small and medium-sized enterprises (SMEs). Sustainable growth
4. Supporting the shift towards a low-carbon economy in all sectors.

5. Promoting climate change adaption, risk prevention and management.

6. Preserving and protecting the environment, and promoting resource efficiency.

7. Promoting sustainable transport and removing bottlenecks in key network infrastructures. Inclusive growth
8. Promoting employment and supporting labour mobility.

9. Promoting social inclusion, combating poverty and countering discrimination.

10. Investing in education, skills and lifelong learning.

11. Enhancing institutional capacity of public authorities and stakeholders, and promoting efficient public administration.

<u>Chapter 11. EU competition and state aid policy</u>

To prevent anti-competitive behavior, EU policy focuses on:

Antitrust and cartels. The Commission tries:

- To eliminate behaviours that restrict competition (e.g. price-fixing arrangements and cartels)

- To eliminate abusive behaviour by firms that have a dominant position.

Merger Regulation, introduced only in the late 1980s:

- Anti-competitive behaviour addressed: 'a concentration which would significantly impede effective competition in the common market'. Don't want firms to have a significant effect on prices and/or the market so sometimes mergers are not allowed.

- No role of national competition authorities (sole power for EC).

EU policy on state aid

- Treaty of Rome bans state aid (broadly defined) that provides firms with an unfair advantage and thus distorts competition.

- Exceptions relate to social policy, natural disaster aid, economic development aid to regions. Example: the airline industry.

- EU members' governments differ over how much they can or want to subsidize loss-making firms: the outcome may be 'unfair' since restructuring is forced upon the firms in nations that do not subsidize.

- This may create the impression that European economic integration gives an unfair advantage to some nations' firms. Disciplines on state aid forces governments to proceed with painful and politically difficult reforms!

- Governments can give tax benefits to attract firms. Governments can give concessions. Or you can ask a higher price for a square of land to foreign firms. And other things a government can do to give unfair advantages to their national firms.

Collusion (unfair cooperation, like kartels) among firms result in high prices leading to lower demand and production: it is illegal under EU law and economically harmful for Europe as a whole.

Perfect collusion in the BE-COMP diagram:

- Firms co-ordinate prices and sales perfectly.
- Maximum profit at monopoly price and split sales among firms.
- Assume that firms all have equal market share.

See graph below.

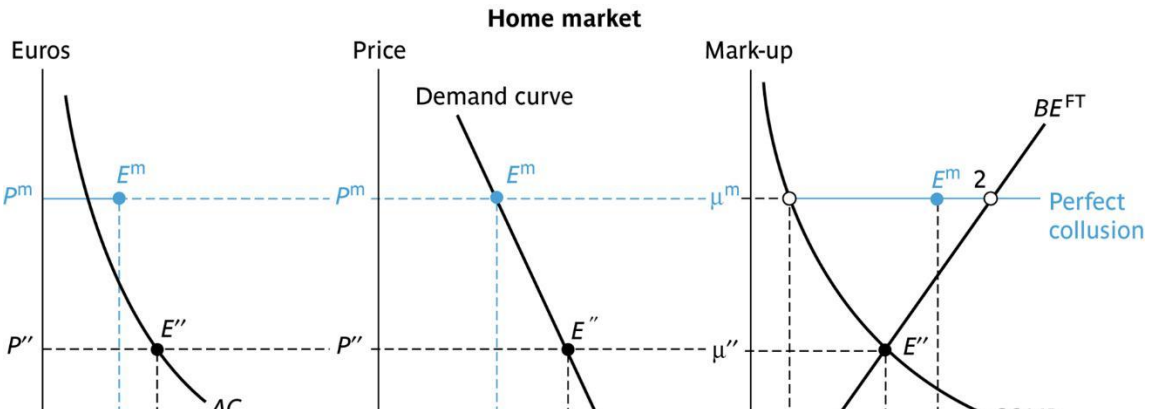
Long run outcome without collusion: E'.

Perfect collusion outcome: E^m.

Mark-up μ^m corresponds to the monopoly price P^m, which extracts the greatest profit from the market. We assume that firms manage the collusion by allocating an equal share to all firms, the

'perfect collusion' line. Maximum number of firms that could BE is point 2. This would involve new entry (happens rarely) or 2n' firms would stay in business (firms make pure profits since E^m is above AC curve and BE^{FT}.

Collusion is good for firms' profits, but bad for society as w hole, since price is higher, and consumption and production are lower. Moreover, since firms are smaller average costs are higher, so the industry is less efficient.



Economics of cartels

Suppose price without cartel would be P=AC while the cartel raises price to P′:

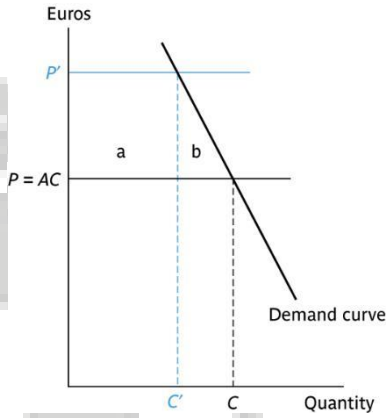
- Consumer Surplus = –a – b.
- profit = a.

- net welfare effect = –

b. Outcome:

- '*Ripoff' effect*: firms profit at the expense of customers.

- *Inefficiency effect*: the gain to firms is less than the loss to consumers, so the cartel is inefficient from a purely technical point of view.

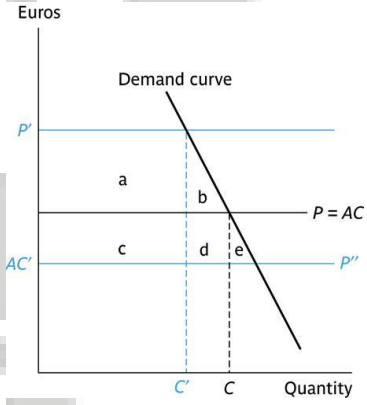


Merger control: elke fusie moet gemeld worden bij EU. Initially P=AC (no profits).

Merger of firms lowers AC to AC' (efficiency gain, by eliminating redundant capacities in marketing, accounting, sales representatives, etc.) but raises price to P':

- CS = –a – b.

- PS = a + c (profits).
- net welfare = c – b.



With free entry eventually P driven down to AC', boosting efficiency also for consumers. The merger-with-efficiency gain is always positive and equal to c+d+e since the CS gain from the lower long-run price P' is not offset by any loss of PS; profits were zero to start with (P=AC) and to end with (P"=AC').

State aid. Subsidies that prevent restructuring (each government makes annual payments to all firms equal to their losses):

- 2n' firms will stay in business.

- Equilibrium doesn't change (i.e., A).

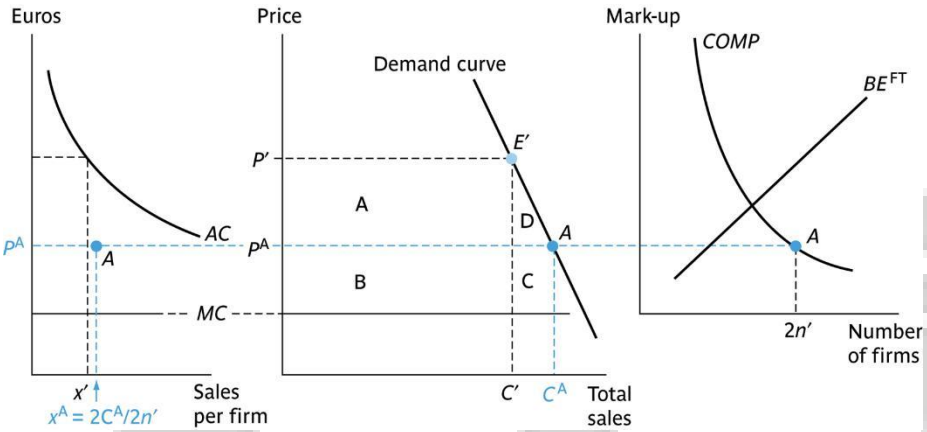
- All firms in analysis break even, but no new firms will enter (since no extraordinary profits).

- Now, taxpayers pay for inefficient small firms. Since competition drives down the price but this comes at the cost of extra pay-outs from the national treasuries.

- Economy at point A. Lower price P^A, consumption rises to C^A, sales of each firm increases somewhat to x^A. The government offsets their losses with a subsidy.
- After liberalization, industry's operating profit is B+C, the drop in operating profit is C – A. The subsidy would have to offset the loss, so is equal to A – C.

- CS = A + D.

- Net welfare effect: A + D – (A – C) = D + C.



France: state aid champion of EU

- "EU orders France to recover state aid from ferry operator" (Reuters November 20th, 2013).
- "State aid: Commission approves French aid for construction and renovation of stadiums for UEFA EURO 2016 Championship" (EC December 18th, 2013).
- "EC caves in over Air France state aid: dispute erupts over approval for aviation subsidy" (The Independent, March 4th, 2014).
- "EU approves 20.5 million euro French aid for Renault hybrid fuel project" (Reuters, October 2nd, 2013).
- "France Télécom loses state-aid court appeal" (European Voice, December 8th, 2011).

<u>Chapter 12. EU trade policy</u>

The facts: EU's Common External Tariff (CET).

The average CET rate is about 6%, with wide variation.

EU institutions for trade policy

- First step: the customs union (requires political coordination!).

- The Treaty of Rome: supranational powers to the EU's institutions (i.e., 'exclusive competence').
- Last 20 years: trade barriers broadened, and competence of the EU extended.
  - Small steps in the Maastricht and Nice Treaties.

- Big step forward with the Lisbon Treaty:

extended the Common Commercial Policy to include: trade in services.

foreign direct investment.

aspects of intellectual property rights (copyrights, patents, etc.). - Try to avoid "bra wars" (China 2005).

For most of its life, EU external trade policy meant negotiating:

- Reciprocal tariff cuts in FTAs with other Europeans.
- Reciprocal tariff cuts with non-European nations in the GATT/WTO.
- Unilateral tariff preferences for developing nations. From 2006: Global Europe
- EU identified ASEAN, Korea, India and Mercosur as priority partners for new FTAs.
- Shift towards deeper agreements covering other issues.

The EU's external trade policy is extremely complex; in the European Mediterranean area (see slide 41).

TTIP!

Reality is very complex.

EU trade policy with former colonies.

Colonial ties almost always involved important trade relations. To avoid imposing the CET on imports from former colonies, EEC6 signed agreements with many of them: asymmetric deals where EU tariffs were set to zero but the poor nations did not remove theirs.

These agreements have been renegotiated various times and in 2000 the EU and the ACP nations agreed to modernize the deal (also because it was inconsistent with the WTO as it distinguished among developing nations on the basis of colonial ties).

With the Cotonou Agreement, ACP nations commit to eventually removing their tariffs against EU exports by negotiating bilateral Economic Partnership Agreements (EPAs). Interim agreements have been signed with many of the ACP nations but only one final agreements has been implemented (with Caribbean countries).

Ch. 10, SAQ: 3. *The educational level in all EU nations is rising. How would this affect the spatial allocation of production in the Heckscher-Ohlin framework?*

The basic result of the HO model is that freer trade induces nations to specialize in producing products that they are relatively good at and importing products that they are relatively bad at producing. When the educational level in all EU nations therefore rises, EU nations will specialize in products that need high-skilled labour, and will import goods that require low-skilled labour. Since the educational level in all EU nations rises, all EU nations will invest more

in highly-skilled labour goods so the spatial allocation of production will everywhere be more high skilled labour.

Als iedereen hetzelfde niveau omhoog gaat, zal er niet zoveel veranderen. Maar als er in Portugal meer mensen op de universiteit afstuderen, zullen ze niet allemaal in P aan de slag kunnen. Als de verdeling een toename van hoge opgeleiden niet evenredig is, zal er een beweging komen van landen waar het aantal hoge opgeleiden meer toeneemt naar landen waar het minder toeneemt. Nadeel: braindrain. Nadeel: kosten van de studies betaald door Portugese overheid terwijl Duitsland de opbrengsten ervan hebben.

Ch 11, SAQ: 1. *Suppose that liberalization occurs as in figure 11.1 and the result is a pro-competitive effect, but instead of merging or restructuring, all firms are bought by their national governments to allow the firms to continue operating. What will be the impact of this on prices and government revenues? Now that the governments are the owners, will they have an incentive to continue with liberalization? Can you imagine why this might favour firms located in nations with big, rich governments?*

After liberalization, 2n' firms will be on the market and stay on the market since all are bought by their national governments to continue operating. The higher market size shifts the BE curve to the

right and the COMP curve stays the same. With 2n' firms, the BE point is higher than the COMP point and the mark-up and with that the price are lower than before liberalization, which implies that the price is lower than the AC and that firms make losses. Government revenues will fall since the government now has to deal with the losses of the firms they bought. Therefore, they will not have an incentive to continue with liberalization. The bigger the government, the longer it is able to handle the losses of the firms. So, this policy favour firms located in nations with big, rich governments, since they are then able to survive on the market.

Ch. 12, SAQ: 4. *Why did the EU extend unilateral tariff preferences to former French and Belgian colonies, and why did it extend these to former British colonies in the mid-1970s.*

Maybe to help these countries develop their economy, since the colonial age was negative for the economic development in these countries.

<u>Lecture 5. Ch. 15, 17, 19, paper de Grauwe (2012)</u>

- Is EMU an Optimum Currency Area?
- Balassa Samuelson effect.
- The future of Euro.
- Belangrijkste bijdrage van de Grauwe: invoeren van blue bonds en red bonds.

The average CET (Common External Tariff) rate is about 6%, with wide variation.

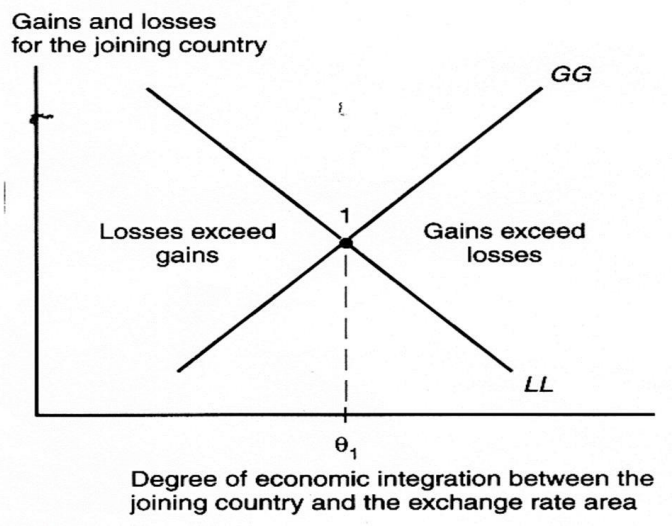
<u>Chapter 15. Optimum currency areas</u>

Theory of optimum currency areas.

When should a country peg its own currency to the currency of a foreign country?

Systematic way of trying to decide whether it makes sense for a group of countries to abandon their national currencies.

Trade-off: as a currency area grows larger, it becomes more diverse, means more costs vs a large currency area is desirable because it enhances the usefulness of money. Optimal where MR=MC.



Cost-benefit analysis van het hebben van het hebben van één munt:

Costs of a currency area: Giving up political and monetary autonomy. Al gebeurd. A single monetary authority is unable to react to each and every local particularity. Diversity translates into asymmetric shocks.

- Loss of seigniorage. Nog niet gebeurd. Landen die een eigen monetaire politiek hebben, kunnen een deel van hun tekort financieren met geld bijdrukken. Dan heb je hogere inflatie maar het is voor sommige landen in tijden van crisis gunstig. Een groot deel van de schulden van Griekenland is veroorzaakt doordat ze dit instrument kwijt zijn.

- Different preferences regarding unemployment and inflation of countries. Zuiden heeft andere ideëen dan het Noorden. Iemand of allebei moet preferences opgeven.

- Differences in growth rates. Verschillende groeicijfers en kans op asymmetrische schokken: land met grootste groeicijfers kunnen hierdoor het meeste benadeeld worden.

- Costs: fast growing countries.

Voordelen:

- Price certainty (no exchange rate risk, no exchange costs) direct (transaction) cost reduction.

- More transparent pricing. more trade and competition, higher economic growth.

  indirect cost reduction. benefits.

- The benefits grow with the size of the currency at a declining rate (marginal benefits).

See figure 15.4

EP/P*: real exchange rate, E is exchange rate, P is price level, P* is price level RoW.
AS: aggregate supply, producers provide more of the good if EP/P* appreciates. AD: aggregate demand, EP/P* appreciation weakens demand for domestic goods.

Initial situation: A.

Adverse shock leftward shift AD to AD'.

- If nominal exchange rate is allowed to depreciate, or if prices are flexible, the short-run effect will be a shift from A to B: the real exchange rate depreciates from λ to λ'.

- If the exchange rate is fixed and prices are rigid, the economy moves to point C: AC are unsold goods. Something has to give and production will fall recession prices fall economy moves to B.

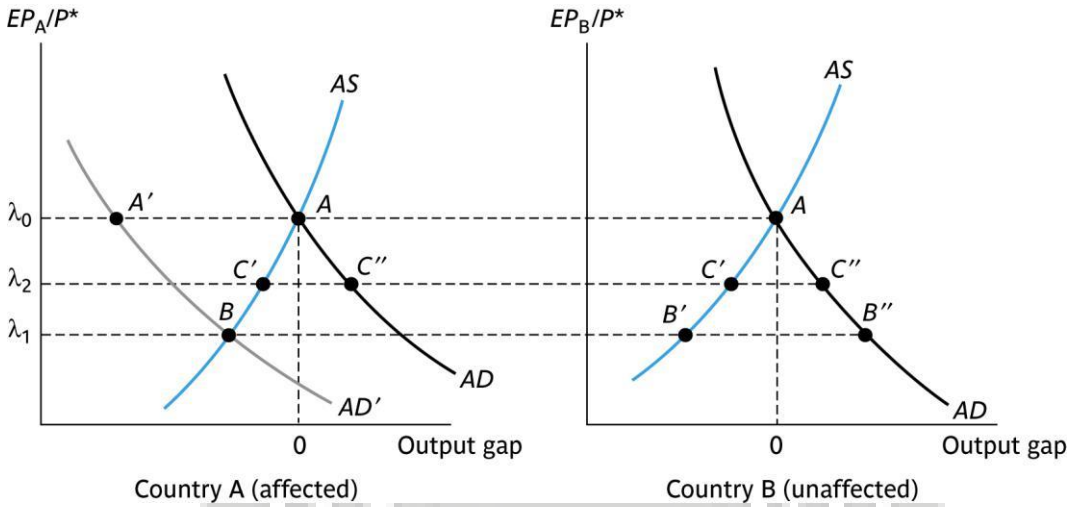
Figure 15.6: asymmetric shock in a currency union, only country A is affected.

Downward shift of AD to AD' in country A, but not in country B.

- If CB cares only about A: depreciation of common exchange rate to E_1. Real exchange rate λ_1 is equilibrium for A (point B) but potentially inflationary excess demand for B (B'B").
- Is CB cares only about B: keep E_0. λ_0 is equilibrium for B (point A) but excess supply for A (A'A)
- If the union's common external exchange rate floats freely, it will depreciate to E_2 (exact point depends on countries' characteristics). Excess supply in A, excess demand in B (C'C").

  Over time, prices are flexible country A to λ_1 and point B, country B to λ_0 and point A.

This analysis also holds for the case of symmetric shocks that produce asymmetric effects, due to differences in the structure of banking and financial markets or in the size of firms.



Uit het college:

Twee landen die dezelfde munt hanteren zitten aanvankelijk in A: de reële wisselkoers is eerst aan elkaar gelijk.

Als er aan asymmetrische schok komt in land A, gaat AD' naar links. De reële wisselkoers van de munt zal dan een gewogen gemiddelde van A en B worden. Tussen de oude en nieuwe reële wisselkoers. Als 2 de nieuwe wisselkoers wordt, hebben beide landen er last van. Land A: vraag < aanbod, crisis situatie. B: vraag > aanbod, inflatie. Onevenwichtige situaties.

Je zou kunnen zeggen, B is Noord-Europa en A Zuid-Europa.

Characteristics features of financial markets.

	Short-term (<1 year)	Medium and long term (>1 year)	Of which long term (>5 years)
Italy	49.4	50.6	24.8
Germany	18.5	81.5	-
Netherlands	6.7	93.3	63.0

Source: OECD, *Economic Surveys, Italy*, no. 1, 1999.

Distribution of government bonds (% of total):

In NL is het grootste deel van de staatsobligaties medium and long term.

Costs: adjustment of financial markets.

<u>Impacts of shocks</u>

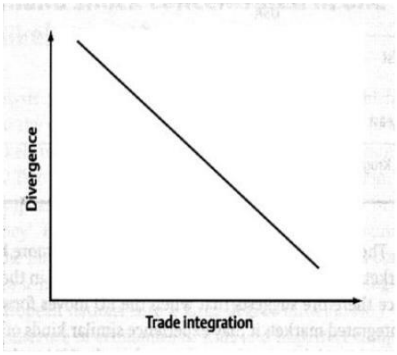
Uit een paper gevonden op internet:

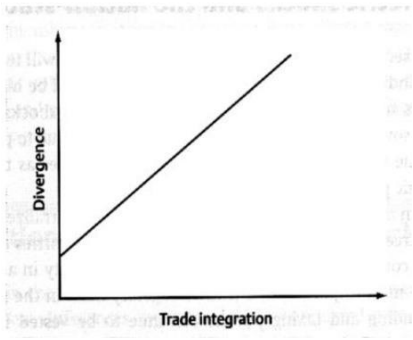
According to the European Commission (1990), closer integration leads to less frequent asymmetric shocks and to more synchronized business cycles between countries. However, for Krugman (1993) closer integration implies higher specialization and, thus, higher risks of idiosyncratic shocks.

Krugman: als je meer trade integration hebt, heb je meer specialisatie, en meer divergentie.

European Commission view: integration means less costs

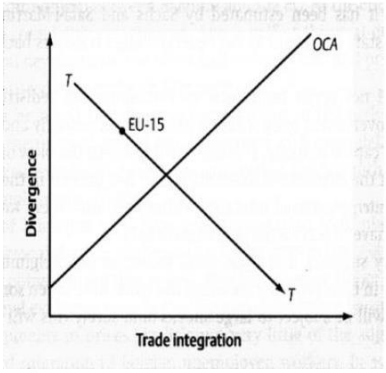
Krugman: integration will lead to higher costs (specialization)



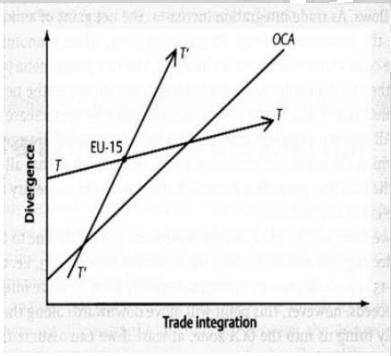


Trade-off costs-benefits

The European commission view



The Krugman view



EU commission: als je in het gebied onder OCA en boven T komt (rechts), is het optimum currency area. Bij meer trade integration, heb je minder divergentie.

Terwijl Krugman: als de T' lijn stekt naar boven loopt, gaat hij sterk af van de voordelen van een currency area. Het is de vraag of je ooit een optimaal gebied kan bereiken. Het kan op een gegeven moment geen voordelen meer opleveren om één munt te hebben.

The six OCA-criteria:

1) Criterion 1 (**Mundell**): Labour mobility. Als je landen hebt die zich niet hetzelfde ontwikkelen, moet je iig labout mobility hebben. Werknemers moeten migreren van het slechtere naar het betere deel.

   Boek: Optimum currency areas are those within which people move easily.

2) Criterion 2 (**Kenen**): widely diversified production and export and similar structure. Als je landen hebt die een vergelijkbare economische (productie) structuur hebben, dan zal een schok zich in beide landen tegelijk voordoen. Dan kan je rustig eenzelfde munt invoeren. Boek: Countries whose production and exports are widely diversified and of similar production structure form an optimum currency area.

3) Criterion 3: **Openness (McKinon):** very open to trade and trade heavily with each other. Je hoeft niet hetzelfde te produceren, als je elkaar maar aanvult door veel handel. Openness betekent volgens Krugman alleen dat de onevenwichtigheden niet automatisch opgelost worden.

   Boek: Countries that are very open to trade and trade heavily with each other form an optimum currency area.

4) Criterion 4: **Fiscal transfers**. Agree to compensate each other for adverse shocks. Je kunt als landen je onevenwichtig ontwikkelen, maar je kan problemen oplossen door fiscal transfers. Boek: Countries that agree to compensate each other for adverse chocks form an optimum currency area.

5) Criterion 5: **Homogeneous preferences**. Wide consensus on the way to deal with shocks. Global dezelfde problemen hoe je economische problemen oplost. Als er hier teveel verschillen over zijn, zal één munt lastig worden.

   Boek: Currency union member countries must reach consensus on the best way to deal with shocks.

6) Criterion 6: **Solidarity**. Need to accept the costs in the name of a common destiny. Je moet Europese verbondenheid voelen.

   Boek: When the common monetary policy gives rise to conflicts of national interest, the countries that form a currency area need to accept the costs in the name of a common density.

Criterion	Satisfied?
Labour mobility	No. Asymmetric shocks unemployment
Trade openness	Yes. Most EU economies are very open and well-integrated
Product diversification	Yes.
Fiscal transfers	No. Small EU budget and almost only spend on 3 items.
Homogeneity of preferences	Partly.
Commonality of density	? EU citizens don't feel either high or low solidarity

See figure 15.14, p.380

Als er wel een hoge kans van asymmetrische schokken is, moeten er aanvullende dingen komen om een OCA te krijgen. Als er aan eentje is voldaan, heb je een OCA, anders moet je nog dingen aanpassen.

Is EMU an OCA? NO!

Others (de Grauwe, Robson en Krugman) zeggen ook dat Europa geen OCA is.

- Labour mobility almost zero in combination with free movement of capital.

 harmonization (lowest wages standard). more speculation (capital flight).

- EU is economic union but not (yet) a political union (ECB economic power, Commission in Brussels? credibility in view of European citizen?

- Structural funds of EU no alternative for fiscal federalism.

Chapter 17. Fiscal policy and the Stability Pact [eigen samenvating]

Without national monetary policy, fiscal policy is the only instrument remaining with which to deal with asymmetric shocks when they arise.

- Major drawback of fiscal policy: it is very slow to implement.

- The government borrows and pays back on behalf of its citizens; During a slowdown: budget deficit, finances trough public borrowing. In an upswing: budget surplus to pay back debts.

- **Automatic stabilizers** = come into play without any policy action because deficits increase when the economy slows down, and decline or turn into surpluses when growth is rapid.

  - E.g. Slowdown of economy low incomes, low corporate profits, low spending less tax collection and more spending on unemployment benefits and other subsidies budget worsens = automatically expansionary.

- **Discretionary fiscal policy** = results from explicit actions taken by the government. Government is cutting spending or raising taxes.

- however, undisciplined fiscal policy results in high public indebtedness. There is a budget deficit bias as governments are eager to please voters with generous spending not financed by commensurate tax revenues.

Output gap = actual GDP minus potential GDP. It indicates whether the economy is underperforming/operates below its potential (negative gap) or is booming (positive gap). **Cyclically-adjusted budget** = estimate of what the balance would be in a given year if the output gap were zero. When output gap < 0, actual budget balance < cyclically-adjusted budget and vice versa.

- An improvement indicates that the government tightens fiscal policy whereas an expansionary fiscal policy worsens the cyclically-adjusted budget balance.

Externalities = spillovers = one country's fiscal policy actions can help or hurt other countries.

- Question: does the deepening economic EU integration calls for coordination?
- Promotion of deeper ties versus limitation of sovereignty.

Channels for spillovers:

a) Cyclical income spillovers: The spillover is stronger the more the countries trade with each other, and sharing the same currency increases income spillovers via exports and imports. There is ample (veel) room for mutual beneficial cooperation.

b) Borrowing costs: one country's deficits might push up interest rates (not very likely). Heavy borrowing may elicit capital inflows, euro appreciation, less competitiveness and growth.

c) Excessive deficits and the no-bailout clause: the fear that a default by a government on its public debt would hurt the union's credibility.

d) The deficit bias and collective discipline: it's appealing to blame Brussels.

Broader question: at which level of government – regional, national, supranational – should policies be conducted?

Theory of fiscal federalism: how should fiscal responsibilities, in one country, be assigned between the various levels of government?

- Arguments for sharing responsibilities: externalities and increasing returns to scale.
- Arguments against: heterogeneity of preferences and information asymmetries.
- In addition, governments do not always act in the best interest of their citizens, so we need to keep in mind that a good solution may transpire to be bad if governments misbehave.

Principle of subsidiarity: Unless there is a strong case of increasing returns to scale or of externality, the presumption is that decisions remain at the national level. It suggests exercising caution in the centralization elements of fiscal policy.

- On the other hand, the spillovers that could result from *excessive* deficits are important.

Stability and Growth Pact (SGP), an application of the **excessive deficit procedure** (EDP), enviosioned in the Maastricht Treaty, is based on five organizing principles:

1) A definition of what constitutes an 'excessive deficit' (3% deficit and 60% debt of GDP limits).

2) A preventive arm, designed to encourage governments to avoid excessive deficits. Starts with a warning of the commission and ends with a fine of 0.2% of GDP.

3) A corrective arm, which prescribes how governments should react to a breach (schending) of the deficit limit. Gradually increasing peer pressure, ending with a fine of 0.2 a 0.5% of GDP.

4) Procedures designed to embed (inlaten) each country's budget process within a European framework that is meant to be over-riding.

5) Sanctions.

- The EDP) applies to all EU countries but fines only to Eurozone members.

The difficulties encountered in the implementation of the SGP can be traced to both economic and political considerations:

- From an economic viewpoint, targeting the annual budget deficit can lead to pro-cyclical policies, i.e. policies that reinforce either a slowdown or a boom. Revisions of the SGP have moved the focus somewhat to cyclically-adjusted budgets and the debt level.

- From a political viewpoint, the SGP faces a formidable contradiction. Fiscal policy is a matter of national sovereignty, in the hands of democratically elected governments and parliaments. At the same time, fiscal policy is recognized as a matter of common concern.

The EDP has been complemented with a Macroeconomic Imbalance Procedure (MIP) that runs in parallel to it. It rests on a scoreboard of indicators designed to identify early on unsustainable external deficits, excessive labour costs and prices that cannot be corrected though exchange rate depreciation and a host of other potential threats to macroeconomic stability.

<u>Vervolg van het college:</u>

Why higher inflation in CEEC's? **Balassa-Samuelson effect**

- Transition economies: lower wages and prices than in EU fast growing labor productivity in tradable sector higher wages tradable sector higher wages in non-tradable sector as well extra inflation (BS-effect)
  - Estimation: 1.5 - 4.0% yearly
- Price liberalization because of restructure/transition of economy.
- Increasing quality of goods and services.

Landen die in transitie zijn hebben een tradable sector die gericht is op export en je hebt producten uit de dienstverlening die niet goed verhandelbaar zijn in het buitenland. Die tradable sector heeft een hogere arbeidsproductiviteit dan de non tradable sector.

- Als Phillips investeert in een fabriek, gaat de arbeidsproductiviteit omhoog. Terwijl het lastig is een arbeidsproductiviteitsstijging krijgen in de gezondheidszorg bijvoorbeeld.
- Werknemers in tradable sector willen een hoger loon omdat ze een hogere productiviteit hebben. Kosten blijven relatief gelijk, geen inflatie.
- De non tradable mensen willen dat ook, terwijl hun arbeidsproductiviteit niet toeneemt. Dit veroorzaakt wel inflatie.
- Over het geheel genomen zou de inflatie in dit land vrij sterk zijn.
- Landen in West Europa zijn al uit de transitie fase. Maar landen in Hongarije hebben wel hogere inflatie. Als ze continu hogere inflatie hebben, terwijl ze de euro gaan invoeren, verliezen ze voortdurend concurrentie positie. Voor de euro hadden ze het kunnen compenseren door hun wisselkoers te verlagen.

B/S-effect

- 2 years ERM 2 (CBA?).
- After ERM 2: accession EMU?

CEEC: accession to EMU as soon as possible, judgment of inflation criteria not to strict. E(M)U-countries: strict inflation criteria.

- interest of EU: exchange rate of Euro.

- interest of CEEC's: avoiding real appreciation.

Country 1 is (e.g.) Hongarije, 2 Duitsland.

	Country 1	Country 2
Inflation trad. goods	-1%	-1%
Rise labor prod.		
Tradable sector	5%	2%
Non-trad. sector	0%	0%
Inflation non-tradables	+4%	+1%
Ratio trad.-non trad.	50-50	50-50
Ratio GDP	30	70

Inflation in country 1 (P1) and 2 (P2)?
Inflation in land 1+2 (π_{emu})?

Het is moeilijk om goed monetair beleid te voeren als er verschillen zijn in inflatie.

Inflation in 1 en 2:

P1 = 0,5*-1 + 0,5*4= 1,5%

P2 = 0,5*-1 + 0,5*1 = 0%

Inflation in land (1+2) (= monetary union): emu = 0,3*1,5 + 0,7*0 = 0,45%

 suppose: inflation target ECB
0,45% inflation in 1 = 1,5%

inflation in 2 = 0%

Country 1: transition economy with B/S-effect.

If differences in labor productivity tradable and non-tradable sector increase: B/S-effect higher.

 to avoid deflation in EMU (north): inflation target must rise when on short term accession to EMU of CEEC's (or other transition countries).

The Euro: why?

We zijn begonnen met optimisme en dat is omgeslagen in pessimisme.

- Momentum beginning 90's: optimism.
- German reunification.
- Maastricht criteria: problems Germany and France.
    - Participants: 12 (5/6 would have been better).

- Growth and Stability Pact: pressure on governments expenses (theory....). Unsuccessful attempt to repair flaws of EMU.

- Already in the 90's: scepticism (Bundesbank, DNB) .

Voortdurende verslechtering van concurrentieposities in het Zuiden.

- Differences in productivity between the North (especially Germany) and South.
- Lots of money to Germany; surplus current account.
  Banks in the north looking for investments.

  - invest in debt South (Greece and Portugal).

  - invest in real estate (Spain and Ireland).
- Since the introduction of the euro, same rate in the euro area; indication of lack of risk assessment.

Solutions N-S-problem EMU

- European Financial Stability Facility (EFSF) temporary facility that provides loans to Member

  States and should intervene in bond markets (bonds up to € 780 billion, lending capacity to €

  440 billion).
- Conditions for aid: reforms (labor, youth unemployment, taxation, etc.).
- ECB buys government bonds to reduce interest.
- European Stability Mechanism (ESM) replaced the EFSF in 2013 and will be a permanent

  mechanism.

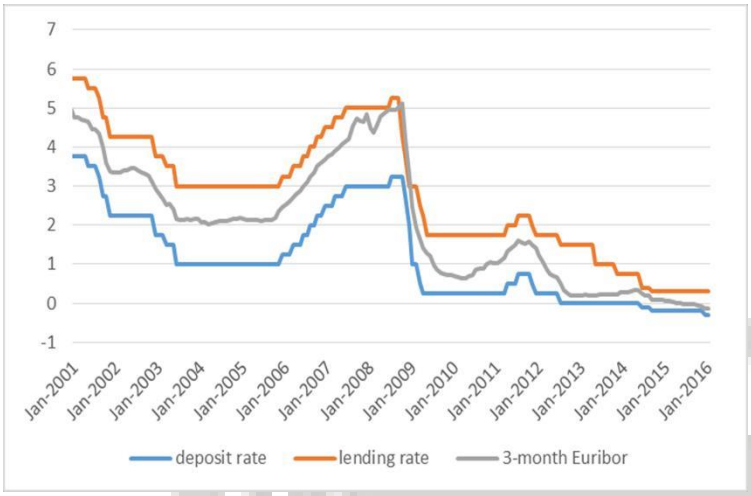
Since beginning of March 2015: ECB buys bonds in every EMU-country!

No structural solutions!

Question: Should European Commission get more power?

Problem ECB: how to get higher inflation in EMU?

- Deposit rate: negative (-0,3%)
- Marginal lending facility: almost 0%
- Buying bonds: 60 billion per month until March 2017.
  - boost money supply (Germany: is ECB allowed to do this?).
  - mainly treasury bonds from banks mainly concerns.
- At the same time:
  - More stringent liquidity requirements.
  - Reluctance of banks in providing loans.
- EMU in liquidity trap? ? Wij lijken in een soort liquidity trap te zitten.



Future EMU? More integration or, split up or exit euro.

Alternative 1. More integration

- Consistent with Plan van Rompuy
- Permanent emergency fund and eurobonds
- Banking Union
- Budgetary Union
- Macro unbalance procedure
- Consistent with OCA theory

Pros:

a) Price transparency, low transaction costs, more trade.

b) Specialization and better competitive position EMU in world market.

c) Ability to conduct structural European policy.

Cons:

a) Politically unfeasible (NL, Fin will not accept greater influence from Brussels; higher interest unacceptable).
b) Prolonged fiscal transfers necessary because differences are partly structural.

c) Subsidiarity will be lost.

<u>De Grauwe: Budgetary Union (Autralian Review, 2012, 45/3, pp. 255-68)</u>

Verschil tussen blue bonds and red bonds is belangrijk. De Grauwe is voorstander van meer macht voor Brussel.

Zolang je onder de 60% en 3% mag je **blue bonds** uitgeven. Dit zijn veilige obligaties.

Kom je daarboven, moet je het met **red bonds** financieren, eigen obligaties met een hogere rentestand.

Dit is een aardig gezichtspunt met de twee kampen van de euro erin.

- In the South of EMU: liquidity problem → solvability problem (bad equilibrium).
- Needed: political union.
    - ECB: lender of the last resort.
    - Mechanism of transfers.
- Inflation? Liquidity of banks will increase, but not M3.
- Fiscal consequences? Price of financial stability.
- Moral hazard? "Blue bonds" and "Red bonds".

From October 2015: **The European Semester**

Implementation of the EU's economic governance is organised annually in a cycle, known as the European Semester, as part of which:

- The European Commission **analyses** the fiscal and structural reform policies of every Member State, **provides recommendations**, and **monitors their implementation;** the Member States **implement the commonly agreed policies**

Three pillars of ES

1. Boosting investment.
2. Reinforcing sturctural reforms (labour markets, pensions, social protection, innovation, R &

   D, etc….).
3. Persue responsible and growth-friendly fiscal consolidation.

In line with Europe 2020. Problem: EU can only make recommendations.

Findings EC for the Netherlands (EC, February 2016)

- The current account continues to show a marked surplus.

- Surpluses in the non-financial corporate sector explain the high level of the current account surplus, but not its increase.
- Investment declined strongly during the crisis and has recovered only partially since.

- The large second pillar of the pension system plays a central role in shaping household finances and the household saving rate.
- Levels of private sector debt remain high.
- The tax treatment of owner-occupied housing remains generous and encourages mortgage borrowing.
- Inefficiencies remain in the social housing sector.
- The total tax burden on labour is high, but is being addressed by policy measures.
- Rising long-term unemployment and potential segmentation of the labour market are of concern.
- In spite of the strong scientific base, research and development (R&D) spending is lower than that of top performers.

Alternative 2: Split up or exit Euro

Pros:

a) Monetary autonomy → competitive policy possible.

b) More political autonomy.

Cons:

a) Offsets advantages monetary union (specially in North).
b) Enormous transition costs.
c) Position of Europe in World Economy?
d) Return to speculations on financial markets.

Which alternative is Most desirable?

Uncertainty about costs / benefits. Uncertainty about overcoming cultural differences.

- Choice as an economist / voter / civilian / European / Dutchman?
- What is feasible?
- Exit euro (or EU) and more power to Brussels seem politically impossible.
- Waiting for new momentum?
- Continued support to Greece (and others)?

Ch. 15 . SAQ: 8. EQ: 6

Ch 17: SAQ: 9.

Ch. 18. EQ: 2

Ch. 19. SAQ: 5. EQ: 1.

<u>Paper, P. De Grauwe (2012). The Governance of a Fragile Eurozone. Eigen samenvatting:</u>

In this article, de Grauwe argues that the governance structure that has emerged after a series of decisions of successive European Council meetings, although an important step forwards, fails to address some fundamental problems in a monetary union.

The sovereign default risks is o.a. based on whether the country is part of a monetary union or not. e.g. UK faces less favourable sovereign debt and deficit, but has lower interest rate than Spain. Members of a monetary union issue debt in a currency over which they have no control.

 No guarantee to bond-holders that the cash will always be there to pay them out.

 Important, potentially destructive dynamic in a monetary union: members of a monetary union are very susceptible (gevoelig) to liquidity movements. Two fundamental problems:

(1)In a monetary union, countries become vulnerable to **self-fulfilling** movements of distrust that set in motion a devilish interaction between **liquidity and solvency crisis**.

- Self-fulfilling prophecy: the country can become insolvent because investors fear insolvency.
- Investors fear payment difficulty withdrawal liquidity from national markets liquidity crisis and rising interest rates solvency crisis.

(2)Members of a monetary union are sensitive to movements of distrust that have self-fulfilling properties and that can lead them to be pushed into a **bad equilibrium**.

- The latter arises because distrust can set in motion a devilish interaction between liquidity and solvency crises.

Consequences of being pushed into a bad equilibrium:

a) Trough significant losses for domestic banks (i on government bonds rises and domestic banks are usually the main investors in the domestic sovereign bond market) and funding problems, the sovereign debt crisis spills over into a domestic banking crisis.

b) Once in a very bad equilibrium, members of a monetary union find it very difficult to use automatic budget stabilisers:

   - Recession higher government deficits markets' distrust liquidity and solvency crisis. In stand-alone countries, the distrust triggers a stabilising mechanism.

Connection sovereign debt dynamics with imbalance problems.

- Fundamental imbalance in Eurozone: increased divergence in competitive positions of the members of the Eurozone since 2000.
- Given the impossibility of using a devaluation of the currency, an internal devaluation in low-competitive countries must be engineered: lower wages and prices deflationary macroeconomic policies will lead to a recessions thus increases in budget deficits.

- This can lead to distrust and eventually to liquidity and solvency crisis.

- If a sovereign debt and banking crisis then occur, the domestic long-term interest rate increases dramatically → more budgetary austerity → more intense recession.
- The country is then stuck in a **bad equilibrium**: deflation, high interest rates, high budget deficits and a banking crisis.

- In contrast with stand-alone countries that can devaluate their currency to avoid deflation and a sovereign debt crisis. A devaluation even might boost output and inflation.

To solve these problems, **collective action is necessary**. It can be taken at two levels:

(1) Level of the central banks: the ECB as a lender of last resort in the government bonds market.

- To prevent countries from being pushed into a bad equilibrium.

- Critique: by buying government bonds, the ECB increases the money stock, thereby leading to a risk of inflation.

    - But when the ECB buys government bonds, it increases the money base (currency in circulation and bank's deposits at the CB). This does not mean that the money stock (M3) increases: if banks pile up the liquidity provided by the ECB without using it to extend credit to the non-banking sector, the money stock doesn't change.

- Critique: by intervening in the government bond markets, the ECB is committing future taxpayers (potential losses of the ECB has to be borne by taxpayers).

    - All open market operations carry the risk of losses and thus have fiscal implications. Losses can be necessary, even desirable, to guarantee financial stability.

- Risk of morzal hazard: the ECB gives an incentive to government to issue too much debt.

    - But this isn't a good reason to stop its role. And you can deal with moral hazard by constraining governments in issuing debt and by regulation and supervising.

(2) Level of the government budgets: a joint issue of Eurobonds.

- In this way, the participating countries become jointly liable for the debt they have issued together. More trust and protection against liquidity crises.

- Problems: 1. Moral hazard, an incentive to issue too much debt. 2. Countries like Germany, Finland an NL may have to pay a higher i on their debt.

De Grauwe does a proposal for a new sort Eurobond to solve these problems.

- **Eurobond** = bonds collectively issued and guaranteed by Eurozone governments. They could replace some current national bonds or could be used to finance future deficits.

- This common bond issue is an instrument to shield countries from being pushed into a bad equilibrium. Moreover, the average debt costs will decline (makes it easier to service the

debt), whilst the marginal cost of the debt will increase (strong incentives towards reducing the level of debt). ? this will reduce the moral hazard risk.

- The i is different for each participating country, so that the bond is also attractive for the countries with the best credit rating.

Common Eurobond ? creates a large new government bond market with a lot of liquidity ? attract outside investors, making € a reserve currency ? additional premium on bonds ? makes it possible for Eurozone countries to lower the average cost of borrowing.

Chapter 19. The Eurozone in crisis. Eigen samenvatting:

Blue bonds: to a value up to 60 percent of a countries GDP.

Red bonds: the rest. They remain purely national, are inferior to blue bonds and offer no collective protection.

Europe has experiences two successive crises: the global financial crisis that began in the USA, and the Eurozone sovereign debt crisis.

After the financial crises struck, central banks took vigorous measures to provide banks with liquidity and to cut interest rates. governments too intervened quite forcefully. They used fiscal policy to avoid a protracted recession, deepening budget deficits. In many countries, they also bailed out banks, sometimes at great cost.

? Result: rapid increase in public debt. ? second leg of the crisis, only affected Eurozone countries.

? Financial markets in panic and the Euro system remained 'behind curve' for an extended period, more concerned about inflation than about the quickly deepening recession.

The ECB recovered the initiative b declaring its intention to buy, if needed, an indefinite amount of distressed public bonds. This declaration brought the acute phase of the sovereign debt crisis to its end.

- All in all, the Eurozone's economic performance has been poor and inflation has declined significantly below the ECB's own definition of price stability.

The Eurozone banks and governments have been locked in a **diabolic loop**. Banks bought large amounts of domestic public debt in return for lenient supervision. Governments faced the risk of yet another bank crisis, but the high debt levels reduced their ability to bail our banks in case of need.

As the ECB has taken over the supervision function – for large banks only – it has requested that banks undergo challenging stress tests. If the ECB delivers, the banking system will recover its credibility. This should lead to a progressive end of its fragmentation.

The crisis has shown that the Eurozone construction suffered from important weaknesses. These weaknesses include the lack of fiscal discipline in some member countries, the absence of Eurozone-wide banking regulation, supervision and resolution, the ECB's difficult position as

lender of last resort, and poor economic governance. Some progress has been achieved on all these fronts.

The legacy of very large public debts in a number of countries remains.

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Tips and remarks about the summary can be send to secretaris@esvnijmegen.nl.