

## **Correction manual**

Written Exam for the M.Sc. in Economics winter 2013-14

### **The Economics of the EU**

Master's Course

16 December 2013

(3-hour closed book exam)

#### **Question 1:**

Describe the role of Economics in EU's institutional framework (see Figure 1). Include in your analysis the follow aspects:

- 1.1. How – and with the involvement of which institutions - is the yearly EU budget and the seven year financial perspective developed and decided?

**SUGGESTED ANSWER:** Baldwin & Wyplosz p. 84-85: Commission prepares preliminary draft budget. Presented for Council for amendments and adoption. Once passed goes to the European Parliament, which has some powers to amend the budget. After two readings in the Council and the Parliament, the European Parliament adopts the final budget, and its President who signs it. Procedure augmented by institutional agreement between European Parliament, the Council and the Commission.

- 1.2. Describe – broadly – the development over time of the revenue side of the yearly EU budget?

**SUGGESTED ANSWER:** B & W Figure 2.15, page 83. Answer should include development of GNP-source, VAT, Customs duties, agricultural duties and miscellaneous. Definition of sources and descriptions of sources improves quality of answer. Broadly speaking movement from customs duties and agricultural duties towards VAT and later on GNP-based resources that now dominates completely. The idea of “system of own resources” should be mentioned, and the fact that the EU does not borrow money.

- 1.3. What are the main differences between EU's budget and Member States' national budgets?

**SUGGESTED ANSWER:** B & W pages 77-79 give the qualities of EU's budget, and in figure 2.16 on page 84 the contribution versus GDP by EU members is given. The student should be able to draw parallels to Member States national budgets, that generally are much larger in percentage of

total GDP than the size of EU's budget (only about 1 % of EU GDP). The structure of either having and ability to pay system or benefit system where you contribute as much as you benefit could be mentioned. The case of the UK abatement could also be mentioned.

- 1.4 An important part of EU's budget regards expenditures for the Common Agricultural Policy (CAP). Describe the economic rationale behind the change within this area from coupled to decoupled payments/support.

SUGGESTED ANSWER: B& W Chapter 9 on the CAP. Especially section 9.31. on pages 254-255. Basically Figure 9.9. on the new logic – with decoupled direct payments can be used as an illustration. The decoupling lowers price face by EU farmers and consumers from the price floor to the world price. EU production falls and consumption rises. EU consumers gain from the lower prices, the EU budget saves, and overall there is a welfare gain. The farmers could either be fully or only partially compensated. Since a full compensation may well be larger than the cost of dumping the surplus, this policy reform is unlikely to reduce the cost of the CAP. The decoupling solves many problems: the disposal problem, the dumping problem, the over-intensification of farming problem. Only problems not fixed are the budget problems and the farm income problem.

- 1.5 On the diagram in Figure 1, one important EU institution is missing, namely the European Central Bank (ECB). Explain the economic rationale for having an independent central bank in terms of being able to obtain economic (debt) sustainability.

SUGGESTED ANSWER: Combination of De Grauwe pages 138-139 and pages 159-162 could be used preferably. Possibly combined with De Grauwe page 212 box 10.2 of debts and deficit. Mentioning of the sustainability criteria on the one hand, and the difference between the government and/or dependent central bank from an independent central bank in terms of time-inconsistency, and adoption of a policy that gives higher or lower weight to combating inflation based on how independent the central bank is.

- 1.6 Explain the economic consequences of the dilemma that monetary policies are fully integrated and institutionalized with the ECB in the EU, while economic policies generally are performed in a less institutionalized manner, though more and more coordinated.

SUGGESTED ANSWER:

De Grauwe various chapters.

- Background on recent developments 2010-2013 has been extensively given in addition to the readings so it would be realistic for the student to make perspectives to recent developments – that would be a plus.
- Chapter 2 (pages 33-39): the examples with asymmetric shocks and the possibilities of adjustment with or without wage flexibility and labour mobility.
- Chapter 9 (pages 187-190): The trade off between price stability and financial stability.
- Discussion on pros and cons regarding fiscal discipline in monetary union also in De Grauwe, section 10.4 pages 220-223.

## Question 2

Analyse the economic importance of EU's external economic relations. Include in your analysis the following questions:

- 2.1 In Figure 2 in appendix, you may find a figure showing the supply switching effects of the formation of the EEC customs union. Describe the developments in the figure.

B & W. Pages 146:

**SUGGESTED ANSWER:** Description of columns should be included.

The rise in EEC6 share of exports to itself, the share of EEC imports from other nations had to fall. Part of displacement occurred with respect to imports from other non-EEC European nations. The import share from six other western European Countries fell during this period by a small amount. The main displacement came from the rest of the world, mainly imports from the US. The right hand panel shows that imports from all sources were in fact growing rapidly. Supply switching is a relative thing. If the customs union had not been formed, imports from non-EEC6 members would have risen even faster.

- 2.2. Develop – for instance using diagrams of price and quantity for Rest of the World (RoW), Partner, and Home - the theoretical background of the supply-switching effect.

**SUGGESTED ANSWER: B & W:** Figure 5.2 as background and then figure 5.4 and 5.5. with all the welfare effects shown should be used.

- 2.3 In the light of the existence of the supply-switching effects, describe how these effects are sought to be minimized through trade agreements with third countries, such as Free Trade Agreements, preferential arrangements with former colonies, and preference agreements for poor countries.

**SUGGESTED ANSWER: B & W:** Chapter 12.: section 12.4, pages 339-345.

- 2.4 Analyse the importance of EU's external economic relations (with a focus on trade) for the success (the optimality) of EU's Economic and Monetary Union (EMU) and vice versa, i.e. include also an analysis of the impact of EMU on EU's external economic relations.

**SUGGESTED ANSWER:** De Grauwe: Chapter 2, pages 23-27. Importance to catch the different Krugman and Commission view on symmetry and trade integration and in the vice versa study to be able to describe e.g. Rose's study on the impact of a monetary union on the trade.

### Question 3.

Essay question.

When the ten newcomers (the CEEC countries) joined the EU in 2004, some Objective 1 regions became statistically rich. That is, the lowering of the EU average pushed their incomes above the 75 % threshold for Objective 1 status. Referring to the two theoretical frameworks in Baldwin and Wyplosz chapter 10 on comparative advantage and economic geography, do you think it is correct to remove their Objective 1 status, and why is that so?

#### SUGGESTED ANSWER:

- Essay: so importance here is the depth of the analysis and the ability to apply theoretical knowledge from the book to a concrete politico-economic question.
- B & W Chapter 10, pages 270-291.
- the student should be able to clarify the statement that there was a substantial phasing out of regions between the different regimes.
- the enlargement of the ten former CEEC very unique and demanded very special treatment – there would simply not have been money enough on the budget if regional policy should have continued with the old objective 1 regions continuing as objective 1 with all the new regions complying with the objective 1 criteria.
- Using comparative advantage approach EU should support trade liberalization in order to benefit the most. The former objective 1 region should benefit from the enlargement.
- Using the economic geography approach trade liberalization leads to more concentration of firms in the larger or stronger regions than before so in theory according to this the former objective 1 regions should have received an indirect benefit from the enlargement.
- That being said the removing of support for the reason of enlargement for some formerly supported regions may not have been the smartest move due to the enhancement of factor mobility across nations that would tend to increase the agglomeration forces, and tend to make economic activity leave the region.
- On the other hand, much greater mobility of factors permits backward and forward linkages to operate. As one region grows, it becomes more attractive to firms for demand reasons and cost reasons, so more firms and more factors move to the region, thereby fuelling further growth.

Figure 1

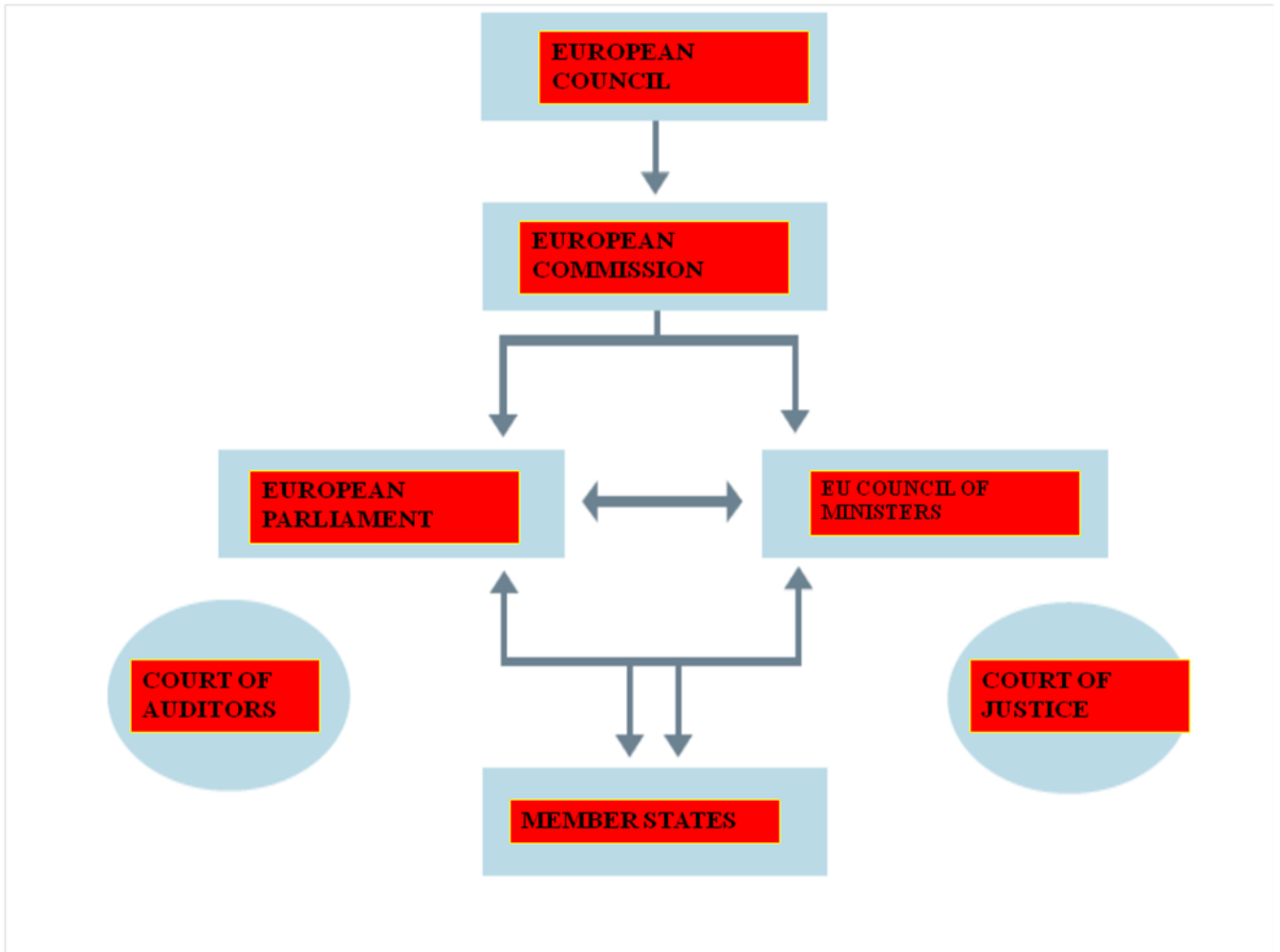


Figure 2.

