

## ESSCA. European Economics. Exam 2013

### Answers

Answer ALL questions. 100 marks. *2 HOURS*

ANSWERS MAY BE IN NOTE / LIST FORM. DICTIONARIES AND CALCULATORS CAN BE USED.

**1. What was the US 1929 crash and The New Deal? (4 marks)**

*The US 1929 crash was caused by cheap credit and lack of regulation. The cheap credit led to a housing boom and to borrowing to speculate on the stock market bubble in which share prices didn't reflect the real company values. The stock market crashed resulting in a banking crisis.*

*William Maynard Keynes advised Roosevelt to start a massive public spending programme, mostly on infrastructure (roads, train lines, bridges...) designed to create stable jobs and hence confidence; this relaunched consumer spending and employment. Stable trade unions and increased wages also helped the economy to recover.*

**2. What institutions were created at Bretton Woods? (3 marks)**

*The General Agreement on Tariffs and Trade (GATT) (that became the WTO), the World Bank and the International Monetary Fund (IMF)*

**3. Why did the EU decide to launch the Galileo project? (3 marks)**

*In order to avoid dependency on the American GPS system, and hence provide EU satellite security (3 orbits of 9 satellites plus 3 'spares') that is inter-operable with the GPS system.*

**4. What is EGNOS? (3 marks)**

*EGNOS is the EU GPS-improvement satellite-navigation system whereby EGNOS receiver stations pick up GPS signals, correct errors, and send an improved signal to EGNOS satellites that send an improved signal to users (navigation, farming...)*

**5. Eurozone countries should apply the Growth and Stability Pact; what does it consist of? (3 marks)**

*After joining EMU, countries should apply the two Maastricht criteria related to borrowing (max. 3% GDP deficit and max. 60% GDP debt)*

**6. Some economists foresee serious world food security problems by the year 2050. What might the causes and consequences be? (5 marks)**

*Demand side: increasing world population (particularly Africa) and changing food needs (particularly developing country populations eating more meat that requires more cereals for animal feed)*

*Supply side: diminishing farmland (desertification, urbanisation...), water supply problems (over-use, pollution in China, reduced snow-melt in the Himalayas...) and the switch of cereals into bio-fuel production.*

**7. If the Bulgarian economy (whose exports are mainly clothing, footwear, iron and steel, machinery and equipment) were suffering from inflation, what fiscal or monetary changes should it make, and how would this effect its trade with the Eurozone countries? (5 marks)**

*Bulgaria has monetary sovereignty, so it would raise the interest rate to reduce consumer spending (rather than using fiscal control). This would lead to the currency value increasing, hence exports would become comparatively more expensive. EU countries producing the goods that Bulgaria exports would benefit in the world market and also in the Bulgarian market (double-whammy effect).*

**8. What were the proposed benefits and potential disadvantages behind the creation of the Euro? (2 marks)**

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*Advantages: positive political symbol of Europe, no more export-import risk due to exchange rate fluctuations in the Eurozone, increased visibility and competition.*

*Disadvantages: loss of monetary sovereignty leading to dependence on the ECB that fixes the Euro interest rate; cost of changing administrative documents (taxes, etc.), vending machines... to Euros.*

### **9. What is the current state of EU energy security? (3 marks)**

*The EU is currently dependent on fuel (gas and oil) imports, particularly from Russia that uses bilateral and not EU agreements. The EU Commission favoured projects such as the Nabucco pipeline (from Azerbaijan through Turkey) to counter dependency on Russia but had difficulty getting support from industry. The 2020 programme plans for 20% of renewable energy by the year 2020 as well as a 20% improvement in energy use. There are also solar-energy programmes with N. Africa to import electricity. At present each EU country dictates its own energy security.*

### **10. If I increase the interest rate, how will it affect: Consumer saving, Employment, Currency value, Exports and Inflation (5 marks)**

*Consumer saving will increase; employment will decrease; currency value will increase; exports will decrease; inflation will decrease.*

### **11. If Ireland (a member of the Eurozone), were suffering from deflation, what measures should it take and what might be the consequences? (5 marks)**

*Ireland cannot change the interest rate of the Euro (no monetary sovereignty, and therefore has to use fiscal policy and hence decrease taxes. A decrease of indirect taxes (VAT, duties...) have quick results; a decrease in direct taxes (income tax, corporation tax...) have slower results. The choice of tax reduction depends upon progressive or regressive fiscal policy.*

### **12. What is meant by: EEA, ECB, EMU and WTO? (4 marks)**

*EEA: European Economic Area*

*ECB: European Central Bank*

*EMU: Economic and Monetary Union*

*WTO: World Trade Organisation*

### **13. Croatia wants to join the European Union. What criteria should it fulfill? (5 marks)**

*(The question is looking for a description of the Copenhagen criteria, but is perhaps not a good choice since Croatia is already an accession member)*

*A country wishing to join the European Union should fulfill the Copenhagen Criteria, these being:*

*Geographical criteria (on the European continent – exception – Cyprus, Turkey 3%)*

*Economic criteria: have a free-market economy, non-government controlled banking sector, capacity to compete with other European countries.*

### **14. Give some reasons for the success of Airbus against Boeing (3 marks)**

*Same cockpit for all models and reduced spare parts meaning that pilot training and maintenance costs are lower; selling Airbus in US\$ (competitive visibility); set-up credit provided by the EU; specialisation of production in different countries; production in the US and China as well as Europe.*

### **15. List advantages and fears about Turkey joining the EU (4 marks)**

*Advantages: Trade base for the EU into Asia; young population for EU employment; model of Muslim democracy; future agricultural development area; energy security via Nabucco pipeline; future market to consume EU goods.*

*Fears: different culture (Muslim country in the EU 'Christian' club; number of seats in parliament due to population size; emigration into EU; problems about occupation of*

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*Northern Cyprus; denial of Armenian genocide; transfer of structural / regional funds to Turkey from current beneficiaries.*

### **16. What were the causes of the US-based 2008 crash? (3 marks)**

*Cheap credit and lack of regulation in a housing boom led to 'bad' loans (including NINJA loans) which were packaged into complex sub-prime mixed packages that got triple A rating. Once the householders couldn't pay their loans (when the 'teaser rates' finished), they were evicted leading to a crash in the housing market and a credit run on banks holding toxic loans. Hit the US banking and mortgage sector plus the financial centre of London (the City) and other countries such as Iceland.*

### **17. I am a UK producer of washing machines (with high negative elasticity). I import 70% of the raw materials from China and 80% of my production is exported to the EU. The ECB has just decreased the EU interest rate. The UK has increased the pound interest rate. What will be the consequences for my company? (6 marks)**

*The increased UK interest rate will lead to a stronger £ that makes imports cheaper – hence a decrease in production costs (70% raw materials imported from China). The ECB has increased the € interest rate which will lead to a stronger € making exports from the UK comparatively more expensive. The high negative elasticity of my product in my main (80%) export market (EU) leaves me very vulnerable to a marked drop in sales as well as the double-whammy effect of EU producers selling their comparatively cheaper goods in my home market. The solution is to use the cheaper production costs to reduce the sales price in £ (which will improve home-market sales), leaving my product with the same € value as before.*

### **18. What led to the creation of the CAP and how does it function? (4 marks)**

*During the Second World War, the UK had difficulty getting provisions from its former suppliers (colonies, Canada, US, Australia, New-Zealand...) leading to a food security crisis as Europe was unable to produce sufficient food. Rationing continued after the war. The priority of the new EEC was to provide food security by protecting the European market from imports and subsidising food production in Europe. The agronomy revolution of the 60's (mechanisation, chemical fertiliser, pesticides...) led to increased productivity and the over-production was sold off (dumped) with the help of export subsidies.*

### **19. I normally sell 5,000 lawnmowers per year. If the elasticity of my product is -1.5, and I decrease the price by 20%, what will my new sales be? (4 marks)**

*A price decrease of 20% will lead to a 30% increase in sales ( $20 \times 1.5$ ).  $30\%$  of  $1,500 = 350$ .  $1,500 + 350 = 1,850$  units.*

### **20. What is the Schengen Agreement? (3 marks)**

*Members of the Schengen area agree to the free transfer / movement of goods, services, capital and people (not labour). Some non-EU members are in the Schengen area (including ex-EFTA members), such as Iceland, Norway, Switzerland) and some EU members are not part of the Schengen area (UK, Ireland)*

### **21. What are the differences of increasing the following different taxes?**

**Income tax, Corporation tax, Value-Added Tax, Duties (alcohol, tobacco etc.) (4 marks)**

*Increasing income tax: politically unpopular, slow process, reduces consumption and inflation; can be more or less progressive depending on the bands and rates.*

*Increasing corporation tax: slow process; can lead to tax drift if companies move to countries with lower corporation tax; increases company costs; can lead to increased product prices.*

*Increasing VAT: quick to do; needs EU approval; a regressive tax (everyone pays the same); reduces consumption due to higher costs.*

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*Increasing duties: quick to do, EU approval needed depending on duty; regressive tax – hits the poor more than the rich since a higher % of income is spent on duties.*

**22. When a government prepares its annual budget, how does it calculate tax revenues? (2 marks)**

*The government takes the previous year's receipts and expenditure and estimates the growth rate in terms of GDP. This provides an estimate for revenue in the next year with which (plus borrowing within the Growth and Stability Pact) it can determine its budget (divided into the different ministries)*

**23. Why has the EU been criticised for the CAP subsidising food exports? (3 marks)**

*Subsidising food exports leads to selling food products on the world market at less than production costs (hence defined as dumping). Countries without subsidised agriculture have difficulty competing with these artificially low prices. Developing countries tend to be more dependent on agriculture (up to 70% population) than developed countries (EU circa 2.5% population), so the effect is considerable. Developing countries not only have difficulty exporting their produce, but the dumping also undermines their own production. Examples – butter dumping in the USSR, chicken dumping in Cameroon, sugar dumping affecting some of the world's poorest countries such as the Dominican Republic. Food is not covered by WTO fair-trade rules. The US also subsidises agriculture, but only about half as much as the EU.*

**24. What was the reason behind the creation of the CAP? (4 marks)**

*Bad question as it was already asked before!*

**25. New EU members should join EMU (the Eurozone); what criteria should they fulfil? (5 marks)**

*Joining EMU means fulfilling the Maastricht criteria:*

*Deficit equal to or less than 3% GDP (or near to it and going in the right direction)*

*Debt equal to or less than 60% GDP (or near to it and going in the right direction)*

*Inflation rate must not exceed the average inflation rate of the three best performing Member States by more than 1.5%. (Inflation is measured by means of the consumer price index.)*

*Interest rate should not exceed by more than 2% that of the three best performing Member States in terms of inflation (interest rates are measured on the basis of long term government bonds).*

*Must belong to the Exchange Rate Mechanism (ERM) for at least two years. Most countries have agreed to a 15% margin within ERM 2.*

**26. How can fiscal policy (taxes and tax subsidies) affect producer and consumer behaviour in the electricity market? (5 marks)**

*A country can affect consumer behaviour by promoting alternative energy (tax-rebates or VAT-free for solar panels, wind turbines...). It can guarantee to buy back energy at a fixed price. A government can tax different electricity usage rates (low rates for the first 'block' of consumption, high rates for the third 'block' of consumption...)*

*The private sector will normally follow consumer behaviour in terms of the market, but can also be influenced by reduced corporation tax for 'green' energies or VAT exemption.*