What now, With whom, Where to - The future of the EU

Recommendations for Europe

- Low levels of trust are both a cause and a consequence of institutional weakness and opportunistic behaviour. Trust is fostered by reliable information and shared expectations of long-lasting repeated interactions. Such tools have been deployed by European nation-states in the past and should continue to be implemented in the European Union.
- Results that fall short of excessively optimistic promises undermine trust. Trust can and should be rationally supported by a realistic narrative that convincingly highlights the advantages of a future together and the perils of alternative arrangements.
- To reinforce trust international policy integration should define rights and responsibilities clearly, which can be easier when it is focused on specific areas such as defence, but also ensure cooperative behaviour, which is easier in a comprehensive policy framework with limited opt-outs. Commitment and cooperation can be self-enforcing when members can trade-off advantages and disadvantages. Short-sighted opportunistic behaviour would be difficult to control in fragmented and unstable "Europe à la carte" institutional structure.
- While heterogeneity of policy preferences is stronger in a larger group of countries, it can be dealt with more effectively when a broader set of policies is negotiated. A clear case can be made for deeper integration in such public-good policy areas as customs administration, border controls, common immigration visa, and defence. Extending supranational competences to harmonization of social policy could however weaken trust in an integration process that cannot realistically deliver results in such areas.
- Economic integration does not automatically lead to income and policy convergence, but its politico-economic sustainability is threatened by lack of convergence. To prevent resentment against integration, it should be recognized that in the current institutional setting the European Union's policy toolbox cannot foster cohesion: convergence depends mostly on the policies of the member states.
- Economic integration offers valuable opportunities for development, but requires policy adjustments that can be difficult for countries to implement. Policy coordination at the European level can ease the necessary reforms by providing information and encouraging dialogue. It should focus on areas where the effects of national policies spill over country boundaries, and involve national institutions to improve the quality of information and let public opinion receive recommendations favourably.

Summary

The report begins with the usual review of economic conditions and outlook. Both are benign at present, but a decade of economic and migration crises and Britain's decision to exit pose a strong challenge to the previous path of ever closer union and bold enlargement in Europe. The other three chapters of this year's EEAG report focus on the symptoms and possible cures of the current integration malaise. One highlights the role of trust in allowing not only national and supranational organizations but all human societies to function, and analyses the sources of the current lack of trust in international dialogue. The next one reviews the role of admission criteria and governance rules in the operation of clubs that supply services to their members within states, and of the club-like groups of states that within Europe supply various public policies. The final chapter considers economic convergences across EU countries and discusses which public policies are indeed suitably organized at

the European Union level, and whether and how those policies may reduce, or be hindered by, the member countries' heterogeneity.

Chapter 1
Macroeconomic conditions and outlook

The global economy has moved from a recovery mode to a strong upturn. Robust development of private consumption and a considerable increase in investment in the advanced economies made a major contribution to the current global economic expansion. Output gaps in the euro area and the United States are expected to be closed soon or already fully closed, and strong contributions are also coming from East and Southeast Asia. The Chinese economy and the Japanese economy expanded strongly, both fuelled by economic stimulus. In Latin America, the recovery was dampened by the sluggish economic recovery in Brazil and the aftermath of the devastating earthquakes in Mexico. In India, the economy is regaining footing after a banknote demonetisation and a reform of the VAT system.

In recent years, the low interest rate environment has promoted financial leverage and stimulated investors to go into riskier assets in search of higher yields. Stock market valuations in some European countries and in the United States are at historic highs and yields on speculative-grade bonds are extremely low. While the Japanese central bank continues to stick to its ultra-expansionary monetary policy, the European Central Bank has halved its bond purchases and is expected to increase the interest rate in 2019, and the US Federal Reserve is already on the path to normalization.

The gradual flattening of the yield curve in the United States is a sign of financial market concern about future developments. Flat yield curves have been reliable empirical predictors of imminent economic downturns. Interest rates increases, in fact, can trigger excessive loan defaults and major distortions on financial markets, as they did when too hasty in past episodes. However, the size of assets at risk of default is nowhere near as high as it was prior to the last financial crisis in 2007, and the financial system has become much more resilient. This decreases both the likelihood and the impact of future crises.

The global upturn is likely to continue for a while and gradually slow down as factors of production become increasingly over utilized, in North America and in European countries that have been experiencing relatively strong growth after the crisis. In the latest Ifo World Economic Survey the assessment of the current situation is still at a high level in the advanced economies, while expectations for the upcoming six months regarding economic developments have deteriorated somewhat. In contrast, developing and emerging countries assess the current situation negatively, but look optimistically into the future as they are likely to benefit from a revival in world trade and the recovery in commodity prices.

Chapter 2
Building Trust Between Suspicious Minds

Trust is one of the most important elements that hold societies together. It enables economic, social and political interactions both within countries and internationally. It is strengthened when there is contractual security in a relationship, but also by repeated and continuing interactions between people. Sovereign nation-states historically relied on strong levels of trust within their boundaries. But their policies and economic success or failure clearly impacts conditions beyond those boundaries. Those spill-overs call for coordination between nation states, which requires trust, and is not necessarily compatible with the philosophy of the nation-state and with choices made by citizens in the national context.

As in nation-states, so in the European Union a common legal infrastructure and common symbols (such as flags, coins, banknotes) aim to strengthen a sense of identity that in nation-states was also built by pooling resources through social welfare schemes. Globalisation of economic activity has over time made states that were the right size for social protection too small to contain and regulate markets that increasingly involve complex value chains rather than just trade in goods. In the absence of a sufficiently high level of trust, pooling resources across national boundaries may be perceived as painful and destructive extraction and erode rather than build common identity.

The extent to which one can integrate Europe into a functional community of nations is greatly influenced by how different nations view themselves and each other, as well as by trust or distrust in national and European institutions. Empirical measures of trust vary greatly within and across European countries in ways that can be explained not only by ethnic and linguistic factors but also by quality and prestige of institutions, and especially by familiarity: countries that are long-standing members of the European Union are trusted more than recent members and non-members. From this perspective, the rapid enlargement of the EU is a double-edged sword. It can increase familiarity, reduce negative stereotyping, and dismantle the hidden barriers that lack of trust implies for economic cooperation. Increasing diversity, however, can strengthen suspicion and reduce trust. The next two chapters examine whether trust might be built up by plural arrangements ("clubs") that ease issues coordination among heterogenous states, or by convergence processes that over time reduce heterogeneity.

Chapter 3
All Together Now: European Union and the Country Clubs

A founding principle of the European Union is that all member states and citizens should participate equally in a single process of ever closer integration. Exceptions have been made, however, and more flexible structures were proposed after the fall of the Berlin wall and in the run-up to the introduction of the euro single currency. The euro crisis, Brexit and global geo-political trends now make it interesting to revisit the issue of whether European states might subscribe to only some of the rights and obligations of membership.

Supranational groupings of countries are in many ways like the clubs that within states provide facilities to their members and exclude non-members. In both cases, member selection and internal governance should be consistent with each other and with functional goals. Inspection of the euro area, of the Schengen Agreement, and the European Union itself suggests that the mixed performance of those *country clubs* is better explained by governance problems than by misguided membership criteria.

The lessons from those experiences can be brought to bear on how international clubs may be improved and possibly extended to other policy areas. One might envision policy-specific country groupings that move at variable speeds towards one final steady state, or crystallise into a multiple club geometry. That structure could be more flexible and focused than the European Union. Defining clearly and enforcing effectively the rights and obligations of members, however, can be difficult for small single-purpose clubs. Heterogeneous members may disagree strongly about any single issue, and this can very well be more problematic in smaller clubs: one formed by just France and Germany, for example, would in some key respects be most heterogeneous. Hence, a single-policy club cannot do much without implementing compensatory transfers, or enforcing decisions that will make minorities unhappy and eager to leave.

A comprehensive and stable policy-making framework allows advantages and disadvantages to balance out across policy areas as well as over time, and the resulting give-and-take opportunities make it more stable and effective than a plethora of single-policy clubs. Effective governance is better supported by *voice* in well-informed discussions among members of a large and permanent Union than by the possibility of *exit* (or expulsion) from more flexible clubs. Not all countries need join a single convoy of European states, but there were and still are good reasons for one such convoy to be formed.

Chapter 4
It's ok to be different: Policy coordination and economic convergence

Because trust plays a crucial role in ensuring stability and effectiveness of policy-making institutions, these should in turn be structured and operate in ways that rationalize and strengthen trust. Some of the European Union's current woes may be traced to the trust-eroding effects of misleading information and unrealistic promises.

The European Union is officially supposed to "aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions." Income and employment have converged for some groups of member states and during certain periods. Both before and after the global financial and euro area debt crises, however, there has been significant divergence in those dimensions as well as for policies and indicators of institutional quality. Inequality has also increased within countries, eroding trust in the ability of national governments to provide social protection, and the distributional impact of economic integration tends to undermine trust also in European institutions.

Neither economic theory nor historical experience suggest that economic integration automatically implies convergence of economic outcomes, or of institutional and policy inputs: diversity is natural and valuable, and policies should be adapted to specific circumstances.

The European Union does aim to support economic convergence with regional and structural funds, which however have a limited impact on the economic development of the receiving regions. It may be possible to improve their effectiveness, but increasing regional transfers is unlikely to spur convergence: history shows that even countries with strong national institutions and considerable fiscal redistribution across regions have often been unable to bring about economic convergence between rich and poor regions. In the existing institutional setup, economic convergence depends mostly on the policies of the member states. The European Semester policy coordination process aims at raising awareness of the cross-border European implications of national policies. Implementation of the resulting recommendations, however, is politically difficult at the national level where public debate and democratic control currently takes place.

Giving the European Union additional competences in areas where national economic policies generate large spill overs can be helpful, but may blur responsibilities and allow national politicians to blame Europe for poor results primarily caused by the shortcomings of national policies. The European Union can easily undermine trust in its own effectiveness if its cohesion and coordination initiatives are not equipped with the instruments needed to deliver results, and its policy recommendations lack political ownership and legitimacy at the national level.