

SUMMARY

2015 has created many uncertainties for Europe. The unprecedented and unexpected inflow of refugees, asylum seekers and migrants from the war in Syria and surrounding areas, the Middle East and North Africa to Europe have led to unresolved arguments about how these people and their related costs are to be distributed among EU member states. No longer-term solution to this issue has been found to date. Border controls reintroduced in the Schengen area threaten the practice, if not the principle, of freedom of movement. The terrorist attacks in Paris in November 2015, the scares in Brussels, and the mob sex attacks on New Year's Eve in German cities, linked to organised groups, raise concerns about security, the eventual integration or otherwise of immigrants, and the evolution of European societies. The substantial inflow of people will *inter alia* change demographic structures, the balance of skills in the labour force, and will also affect public finances. The United Kingdom's planned referendum on EU membership, the possibility of a 'Brexit', is creating uncertainty for the United Kingdom and, to some degree, for the whole EU.

Meanwhile, a slow and fragile economic recovery continued in the developed world, including much of the EU. Emerging markets, constrained by China, bolstered by a resilient India, slowed down. Oil prices collapsed, and inflation remained low. The United States is taking cautious steps towards normalising its monetary policies by making modest increases in its interest rates. But although the Federal Reserve is moving towards exiting Quantitative Easing, the Bank of Japan and the European Central Bank are continuing to pursue their policies of large-scale asset purchases. In the coming years, the equilibrium real interest rate (the interest rate net of inflation needed to keep the global economy growing near to its potential) is likely to be very low, and perhaps even negative. With inflation hovering around zero, the central banks will have little room for manoeuvre should growth falter. In many developed economies, fiscal policy will not be able to sustain demand were another downturn to come along.

Against the backdrop of this febrile conjuncture, the macroeconomic outlook of which is detailed in Chapter 1, the EEAG Report 2016 provides a detailed examination of two long-standing issues that will have a strong bearing on Europe's medium-term development. As European societies age, the political weight of the old grows, threatening intergenerational fairness, which is explored in Chapter 2. Developments in secondary education, the subject of Chapter 3, have been triggered by budget pressures and the changing environment in which young people of widely varying aptitudes have to be equipped for adult life and work. Chapter 4 focuses on the apparent success of Denmark, whose flexible labour markets, inclusive welfare state, flourishing economy and harmonious society invite admiration and imitation. Chapter 5 reviews developments in the Western Balkans, the countries that formerly made up Yugoslavia, which were wracked by war and ethnic conflict in the 1990s, but are now recovering economically and socially, boast strong links with the EU and harbour aspirations to join it.

Chapter 1 Macroeconomic Conditions and Outlook

Whereas the industrialised countries remained in recovery mode last year, economic development in the emerging markets slowed down markedly. Latin America and Russia actually went into recession, albeit for different reasons. Whereas in previous years the emerging markets were the main drivers behind world economic development, and thereby the slow recovery of the industrialised world, these roles were reversed last year. Good business cycle conditions in the United States and the United Kingdom, together with recovery towards moderate growth in the euro area, had a stabilising influence on the world economy in 2015. This development is in essence expected to continue, allowing countries like the United States and the United Kingdom to slowly change their monetary policy stance and make it less accommodating. The recessions in Latin America and Russia will lose their strength and the smaller East Asian economies will be able to return to somewhat higher growth. All in all, this will allow the world economy to remain in

the moderate recovery mode that has been witnessed since 2011.

Dependence on oil and other raw material prices has led to very heterogeneous developments within the emerging world: India's growth rate now exceeds that of China. Demographic developments and the slow transformation of the Chinese economy into one less reliant on world demand and increasingly on domestic developments have and will continue to cause structural growth to slowly fall. Nevertheless for the current year, low and, in recent months, further declining oil and commodity prices, the announced infrastructure investment plans and measures to stabilise demand for housing, together with more expansionary monetary policy, will allow the Chinese economy to continue to grow at its current pace.

For oil-exporting countries, such as Brazil, Russia and many in the Middle East, the dramatic decline in oil prices over the last couple of years means a loss of national income and places a heavy burden on their economies. On the other hand, for oil-importing countries, these dynamics provide a welcome stimulus to domestic demand. Exerting downward pressure on inflation rates, they allow monetary policy in most of the industrialised world to remain expansionary for longer than otherwise would have been the case.

The current recovery in Europe has largely been driven by an improvement in consumer demand. This has been boosted by steadily improved consumer confidence and an inflation rate that has been even lower than expected. Business, however, remains reluctant to invest. Despite the ECB's ultra-expansionary monetary policy stance, the demand for corporate credit merely stabilised at a low level in 2015.

ECB monetary policy currently seems to work most strongly through exchange rates. The euro depreciated last year, increasing the competitiveness of all its member countries vis-à-vis the rest of the world. As a result, all of the larger economies and several of the smaller ones already gained market shares last year. Countries like France and Italy, which have been suffering for years from similar structural problems and have substantially lost price competitiveness since the introduction of the euro, are now being helped by its low value. The danger is that this may slow down structural reforms of labour and product markets, and thereby backfire as soon as the euro strengthens. Low interest rates, a result of low inflation and expansion-

ary monetary policy, further reduce the pressure for fiscal consolidation. Although this supports the business cycle, it creates a significant risk of instability. Public debt is still high. There would be little room for manoeuvre should conditions deteriorate.

Progress in the crisis-afflicted countries of the euro area towards improving international competitiveness, achieved by reducing relative price levels, will continue to be made. Not only Ireland, but also Spain and Cyprus, will exceed the euro area average growth rate this year, while maintaining below average inflation. These countries are therefore on the path to recovery. The political turmoil during the first half of 2015, by contrast, sent Greece back into recession.

Chapter 2

Intergenerational Fairness

The idea of a contract between generations is the basis of an equitable social order, stability and sustainability. In many countries the public sector is now expected to replace the family by funding education and pensions, but social welfare models are facing major challenges. This chapter is concerned with the interaction of generations, the way that generational clashes are translated through the political system, and the long-term consequences for the sustainability of the economy and society.

Modern Europe is ageing rapidly. The changing demographic pyramid might give politicians incentives to cater for the demands of the elderly, since they are becoming numerically ever more dominant, and to overlook the concerns of young people. Gerontocratic politics focuses more on the paying-out of past saving than in investment for the future. The policy results in burdens on the younger generations.

Labour regulations offer security of employment that benefit fundamentally older workers, and establish disincentives for employers to hire younger people (the dual labour market, that particularly characterises Mediterranean Europe). Young people have received expensive training (perhaps not enough of it), but they are in no position to repay into the social contract. Relatively high rates of youth and younger generation unemployment have been a phenomenon of crisis economics, but the phenomenon of high exclusion rates in some parts of Europe preceded the crisis. The emigration of the young and talented makes the

demographic pyramid even more lop-sided, and raises the question of how social security systems will be financed in the future.

Housing resources are inefficiently allocated, with dwellings that are too big for the old and unavailable to the young. Older people have real estate, and younger purchasers (especially in urban centres) are deterred by rising prices (and cannot get onto the lower rungs of the “property ladder”). The younger employed or unemployed are especially disadvantaged.

Pension schemes, mostly originally designed as Pay As You Go systems, are increasingly precarious. The funding of the pension entitlements of younger people is threatened, as demographic projections predict that there will be fewer new earners paying in (“as you go”). In addition, pensions have increased because of provisions that often both index and guarantee a certain increase, even when there is a low cost of living increase. There are strong cases for raising retirement ages, but even stronger political pressures to resist such reforms.

In socialised medical insurance systems, increasingly expensive care for older people, in the last years of their life, dominates the cost structure. The health care explosion will disproportionately affect the most prosperous European countries, and they are also likely to face the prospect of exit, especially by skilled younger people.

When productive and innovative (young) people abandon their country, they leave behind a highly indebted country. Now the debt has to be paid off by a smaller, less productive, ageing population. In a sense, individual citizens have an option to “walk away” from their government debt obligation by leaving the country. Emigration can be seen as an individual’s “private default option” on government debt. Government debt, often incurred in order to maintain the advantages of the elderly, is becoming unsustainable.

Finally, environmental damage threatens the future of the young, as present day output is obtained cheaply at the cost of future generations who will have to bear the burden of the clean-up costs.

Europe is confronting a radical choice on where the responsibility lies for enforcing an effective and fair social contract. In a world of high mobility the old model of competing national examples is threatened

by the possibility of exit from policy failures. There is a need to Europeanise some part of the intergenerational contract and, at the same time, protect it from political interference – an interference that is characteristic not just of states with poor performance and failed policies, but also of apparently successful economic models.

Chapter 3 Tuning Secondary Education

The question of how best to organise secondary education is fraught in every country. Nations are continuously comparing the performance of their own educational systems with others, seeking improvements. Education is expected to achieve many economic and social objectives, often mutually incompatible. Governments tinker with it obsessively. There have been substantial school reforms in recent years in Italy, France, Finland, and the United Kingdom, to take just four examples. These reforms have variously addressed issues of the degree to which the curriculum has a practical orientation, the autonomy of schools, the relationship between publicly and privately funded schools, and the management of teachers. In all cases reform has been deeply controversial.

Secondary education is almost entirely publicly funded because it is recognised as producing public benefits, accruing to society as a whole, not only to the recipients of the education: it is largely a public good. It produces general skills that employers are unwilling to provide, rather than job- or firm-specific skills, which are primarily of value to a specific employer and which that employer is normally willing to provide. The students themselves, or their parents, are not called upon to finance their education because future earning power is poor collateral for a loan, so relying on parental resources disadvantages children of poor parents. In addition to the problems caused by limited financial markets, education also suffers from the problems created by imperfect information: the customers of the educational industry, the students, and even their parents, cannot judge the quality of the product they are receiving, justifying public regulation and certification, if not provision. Furthermore, education is a group activity. Children cannot be educated separately and individually: it would cost too much, and in any case the social element is important per se. Thus the curriculum and organisation of schools are a matter of common concern, unsuited to provision in a

private market. While comprehensive education dominates in practice, there is a heated debate about the merits of providing different streams or tracks through the system for students of different aptitudes, and the merits of providing both academic and more practical or vocational paths. In many countries the vocational path has languished with low prestige and often poor resources and structures, while the academic path has enjoyed excessive prestige and resources.

School systems differ widely across Europe, but there is slow convergence in some respects: for example, the average number of years of schooling across countries is becoming more similar. Family background has a major influence on achievement. Different systems attempt to offset it in different ways. The tracking or streaming of students is done differently. Some countries, like Germany, Switzerland and Austria, provide a better vocational route than others, such as the United Kingdom. The role and scale of the private sector in education differ across countries.

Evidence suggests that schools perform better when they are externally evaluated, but given sufficient autonomy. Competition from private schools may also enhance performance. Giving schools more resources moderately improves students' achievement, although it matters less than socio-economic background. While higher teachers' salaries raise students' achievement, their motivation and the respect they enjoy matter more.

Pressure for reform was partly generated by the fiscal pressures on EU member states after the financial crisis. The widespread growth of university education throughout Europe, and the resilience of the German system of dual tracks, both academic and vocational, with a strong link to apprenticeships, has prompted a rethink of secondary education.

Educational systems are the preserve of national, regional and local governments. The EU has only a minor role to play. Nevertheless it may be useful to ask what, if anything, might usefully be done at the EU level. The EU has long-established programmes for fostering exchanges between member states' educational systems. They monitor and document the evolution of school systems, and provide data for international comparisons that are highly valuable. A very useful addition to the current system might be standardised examination results. There are sound arguments for further coordination of educational systems

across the EU, particularly as and when a Union-wide labour market develops. But any such coordination and harmonisation are a very long way off.

Chapter 4

Denmark: Too Good to Be True?

Denmark boasts both high income levels and relatively equal income distribution. These facts stand out by international comparisons and have attracted a great deal of attention, not least because Denmark has a very large public sector, and thus a high tax burden, it is a small and open economy, and has successfully pursued a fixed exchange rate policy.

The Danish experience may thus seem paradoxical to some, and an exceptional recipe for circumventing common policy dilemmas to others. The Danish economy's relatively favourable performance is not the result of a quick fix, but rather the outcome of a long string of reforms addressing structural problems; and very explicitly taking into account the constraints faced by a small, open economy. The latter is immediately clear from Denmark's fixed exchange rate policy, and the need to ensure its credibility. This policy has passed the market test since the interest spread vis-à-vis the euro area has been very small for years, and even occasionally negative.

The Danish case shows that policy choices are possible, even in an era of globalisation. The public sector plays a larger role than in most other countries. The interesting lesson is how the welfare state has been designed to balance concerns for economic performance on the one hand, and for the public provision of welfare services and the pursuit of egalitarian outcomes on the other. Two points are particularly important. Firstly, while the public sector is large, the private sector is very liberal in Denmark. The Danish model is thus not "politics against markets". Secondly, Denmark's welfare arrangements have a strong active focus on supporting labour market participation and human capital acquisition. Since the financial viability of the welfare model ultimately depends on maintaining a high employment level in the private sector, the conflict between welfare state objectives and economic performance is not as stark at it may appear at first.

The specific policies pursued by Denmark do not make its economy immune to crisis, neither of domestic nor of foreign origin, as seen during the recent

financial crisis. What stands out, however, is that Denmark's labour market has maintained its high degree of flexibility, and although many individuals are affected by unemployment, unemployment spells are short. Thanks to the high level of turnover in the labour market, youth and long-term unemployment are low by international comparison. High turnover rates thus effectively function as an implicit work sharing mechanism. Equal burden sharing is important from a distributional perspective, but it is also of structural importance. The alternative would be longer unemployment spells concentrated on a smaller group of individuals, more long-term unemployment and a corresponding depreciation of human and social capital. In short, high turnover rates reduce the negative structural implications of high unemployment.

Looking to the future, a sequence of reforms is being implemented to ensure the financial viability of Denmark's welfare model. The main focus of these reforms is to strengthen labour supply and private sector employment. A key feature of the reforms is gradual increases in statutory retirement ages, and their eventual indexation to developments in longevity. These reforms ensure that the conditions for fiscal sustainability are satisfied.

Another strategy to combat the labour markets of demographic ageing, namely migration, is a particularly thorny issue for a country with extensive welfare arrangements. Even if welfare arrangements are not magnets attracting migrants, the financial viability of the welfare model rests on a high employment level. Egalitarian objectives imply high entry requirements in the form of qualifications to find jobs (to qualify for high minimum wages), as well as generous social transfers. This creates a very close relationship between the employment rate and how public finances are affected by immigration. Denmark thus faces a difficult trilemma of having to choose between extremely tough immigration rules (constrained by international treaties and EU rules), lowering minimum wages or differentiating between social rights. All three avenues challenge the basic objectives of the welfare state. To date Denmark has largely pursued the first and third avenues, but how far is it possible to proceed in these directions?

While challenges remain, the political focus on medium- and long-run issues is notable. If anything in these developments stands out, it is in the political

economy of establishing consensus across a broad political spectrum, leading to support for reforms, as well as continuity and consistency in policies. This consensus has been achieved, despite the fact that most governments have been minority governments (and usually coalitions among several parties), and despite frequent shifts in government.

Chapter 5

Western Balkans: Coming Together

The chapter on the Western Balkans (WB) outlines some of the important features of the economic transformation of the region in the past 15 years. The region's countries have come a long way from establishing a fragile peace towards increasing cooperation. Their economies are undergoing a transition towards the market system and several important improvements in that area have been made. The financial system was restructured with the forceful entrance of reputable European banking groups. Inflation, a long standing problem, has been eventually brought under control. With a significant help from the EU, the physical and institutional infrastructure of the region is being rebuilt. Nevertheless, there are still many important challenges ahead. We discuss the achievements, as well as some pitfalls and challenges facing the WB. In doing so, we draw lessons from the countries of the Baltics and central and south eastern European regions, which have been undergoing similar processes for a decade longer. Finally, we propose possible paths towards the sustainable development of the region.

The WB region grew strongly in the period 2001–2008, fuelled by an influx of foreign investments and growth in consumption, primarily of imported goods and services. Such growth proved unsustainable, as it led to unsustainable current account deficits and to a virtual destruction of the tradeable sector of the WB's economy. In the post-2008 period, with the exception of Albania, which was able to sustain modest growth levels throughout the crisis, most other countries of the region are either struggling to exit recession or are growing very slowly. Unemployment, already a large problem even in the boom period, is even higher in the post-crisis period. Banks operating in the region (typically, subsidiaries of the large European banking groups) are experiencing high levels of non-performing loans and are reluctant to lend. The situation is made even more challenging by unusually high levels of euroisation of both deposits and loans, reducing

the scope for standard monetary policy measures. People react to prolonged economic woes by renewed emigration from the region at both the low and the high end of skill and experience spectrum.

Clearly, significant changes in the economic model are needed in order to return to healthy growth and, increasingly, countries of the region are recognising that. It is essential that economies re-orient themselves towards creating increasingly higher value-added tradeable goods and services utilising the creative potential of the people more fully. The physical, institutional, educational, and financial infrastructure would need to be further improved to achieve that. Just as importantly, the level of cooperation between countries needs to go beyond free trade and investments to include free movement of people and ideas across the regional borders. The creation of a regional labour market would make the region potentially much more attractive to foreign investment. Regional institutions of higher learning could play an important role and benefit significantly from the creation of the regional labour market, which would, in turn, enhance the region's prospects of eventual integration with the EU.