EXECUTIVE SUMMARY

The first chapter of this year's report reviews the politico-economic conditions and outlook, which is unusually uncertain in Europe at the moment. In 2019, the United Kingdom looks on its way to crashing out of the European Union, while the other large member countries (France, Germany, and Italy) are all experiencing serious politico-economic problems, and the European Parliament election campaign will feature strong nationalist and populist voices.

Fragmentation and a tendency towards disintegration are also emerging within member countries. Europe is becoming increasingly similar to the late Habsburg Empire: a powerful example of problems arising in multinational, multi-linguistic and multi-ethnic integrated economic entities. To understand why and what the implications may be, the other three chapters of this year's EEAG report look inside countries, where a great deal has been happening in addition to European integration, and outside Europe, where powerful economic and geopolitical challenges have shaken specific European countries and sectors.

One chapter discusses the role of technological and trade developments in shaping country performance within Europe, and studies how, in specific cases, policy reactions and reforms have or have not dealt adequately with the resulting challenges. The next chapter shifts the focus from national policies to the European level, highlighting how international finance could help EU member countries face shocks and a rapidly changing global environment, and how some countries may instead try and break out of what they perceive to be unfair constraints in an incomplete European integration framework. The final chapter considers a fast-changing global environment's implications for the European Union, focusing in particular on whether and how policymakers should deal with China's emergence as a leading power in science and technology.

CHAPTER 1
Macroeconomic conditions and outlook

After the exceptionally long expansion phase that followed the very unusual Great Recession, global economic momentum slowed noticeably last year. Persistently high debt levels, lingering structural problems, and strong political uncertainties led to a relatively small expansion in physical capital stock, with production bottlenecks starting to emerge at the cyclical peak in 2017. In addition, the more restrictive monetary policy pursued by the US Federal Reserve implies capital outflows and slower growth in some emerging economies.

Global economic momentum will continue to level off this year. In the United States, the strong impetus provided by tax cuts and additional government spending will abate, but private consumption will continue to benefit from the good labour market situation and real wage increases. Economic momentum is weakening in China, despite looser monetary policy and fewer measures to tackle financial and debt risks, and in Europe, where production capacity is scarce in important parts of the economy and political uncertainty is increasingly reducing companies' propensity to invest. As economic growth in many emerging markets will be dampened by liquidity outflows and currency devaluations this year, foreign trade will give weaker impulses to the European economy.

At present it is still unclear whether the global economy will experience a significant downturn or a gradual deceleration in 2019. To date, most indicators point to a relatively soft landing with locally limited turbulence. However, the risk of a rapid downturn has recently increased globally and within Europe. The slowdown was, and will continue to be particularly pronounced in the largest European economies, which all face specific challenges that burden their economic climate. The United Kingdom is unsteadily approaching Brexit, Italy and France urgently need to implement reforms that either the government or the electorate find unpalatable, and Germany's exports are threatened by slowing world trade and the looming implications of trade wars.

CHAPTER 2
Coping (or not) with change

Economic developments differ across member countries and dissatisfaction with the European Union is growing while populist and nationalistic policies are gaining ground. However, it is obviously simplistic to blame the EU's economic integration process for the dismal economic performance of certain countries and the lack of overall convergence. A given country's performance in a particular period of time can reflect shocks, which often originate from outside the EU, and particularly from the EU's integration with the rest of the world, in combination with country-specific policies and institutions that make it easier or more difficult to adjust to shocks.

There are thus many reasons why country performances may differ, and why some countries may perform better in some periods, and worse in others. However, there are systematic differences across countries, particularly in their ability to undertake requisite reforms in a timely manner. It is particularly important to understand the mechanisms that underlie country-specific performances. We focus on structural change and reform patterns across the EU-15 countries, because a lack of convergence across these countries after decades of integration is particularly striking, and study some of their experiences in detail.

When shocks hit, many economic, political, and institutional factors play a role in determining whether reforms are undertaken or not, and whether the country differences observed in economic performance cannot be attributed to a single factor like economic integration. The European integration process is both a response to various crises in the past and an opportunity to gain from new opportunities, which need to be managed by policies that spread the costs and benefits of change appropriately.

There is much to learn from Italy, which has been a laggard since 1992, when trade integration was fostered by the Single Market Programme in Europe and the Cold War globally, and information technology began to be broadly adopted. These developments affected all countries, but Italy appears to either have been hit more negatively or, and more interestingly, to have reacted less appropriately. Italy, of course, is not the only country to experience increasingly turbulent politics and persistent productivity slowdowns. We also review the more positive shock and reform experiences of countries that managed to break out of relative decline including Denmark, the Netherlands, Sweden, Finland, and Germany. These cases show that luck matters, but reforms do make a difference. Some political processes are naturally more cohesive and pragmatic. Adjustment appears to be easier for smaller and more homogenous countries, where policymakers can coordinate reactions to shocks that hit the country and sectors within it.

Reforms are not a one-off effort. Future changes may call for new responses, and there is no simple blueprint to follow. It is all too easy not only to disregard the drawbacks of reverting to past solutions, but also to contemplate simplistic would-be solutions. The wealth of nations depends on circumstances beyond their control, and on policy reactions that should react constructively to new challenges. Some countries' political processes are naturally more cohesive and pragmatic, while others have to work on theirs. However, all countries should be aware that finding ways to share gains and losses helps to avoid stalemates and adapt to change.

CHAPTER 3
Struggling with constraints

The EMU in its current incarnation incorporates only a fraction of the important automatic stabilisation mechanisms of currency unions and/or federal states that run smoothly. This imposes serious limitations on its members' ability to respond to severe asymmetric shocks. In countries facing little or no growth, resentment of the currency union and the European Union itself is starting to rise. In this chapter we consider different ways of dealing with the constraints imposed by the incomplete currency union, both cooperative and non-cooperative.

Full fiscal and political union is unrealistic, but deeper integration in specific areas may significantly improve risk sharing across the union. One important step would be the creation of a capital market union for financial products, something akin to the Single Market for consumer goods. This would both deepen European capital markets and allow investors to spread risk across the union. Another key area requiring further development is the banking union. We focus on the European banking charter and the creation of European safe assets. Both issues are contentious, but crucial, if financial risks are to be shared and markets completely integrated.

Given the current political climate in Europe, Europe-wide cooperative solutions, while highly desirable, may or may not be easy to implement (and may certainly take time). A country facing a protracted economic downturn may be tempted to stimulate its economy in non-standard ways. This chapter reviews selected proposals to introduce parallel currencies or fiscal monies, and to use peer-to-peer cryptocurrencies. There is no compelling reason to believe that this would provide a viable solution.

Various cooperative or non-cooperative exit scenarios are a more radical and practical way of breaking out of unpalatable constraints, and may easily lead to the dissolution of the EMU or of the European Union itself, with dire consequences. Countries that resent constraints should realise that they often represent real and inevitable trade-offs, and should consider both the positive and the many negative implications of breaking out of supranational policy frameworks.

CHAPTER 4
Looking Outward: Western Disarray, China Rising

The shocks that shape country experiences often originate from outside the European Union, and particularly from the EU's integration with the rest of the world. While the internal dynamics of the European Union influence progress towards and obstacles to ever closer union, the global environment for the European Union is changing fast, and external developments may call for new ways of organising the

European Union. Relations with the United States are increasingly dominated by conflicts over defence and trade, and the rise of China as a leading power in science and technology may threaten the competitiveness of European companies.

These developments challenge the European Union to respond appropriately, but also offer opportunities for progress at both the member country and the EU level. The growth of China expands markets for EU exports, and growing supplies of goods and services to the EU greatly improves consumer welfare. Progress, however, has uneven implications. There have been employment gains in some EU regions and industries (such as luxury goods, sophisticated machinery, and premium cars), but there have also been job losses and falling wages, especially for low-skilled workers.

Growth in trade has been accompanied by growing capital flows between China and the rest of the world. As China has diversified its portfolio of foreign assets away from the United States, some Chinese FDI has taken the form of mergers and acquisitions among European companies. Those involving high technology companies and sensitive public infrastructure have attracted attention. China has also made advances in the fields of science and technology, and has invested heavily in research and development. There is concern that Chinese ownership of high-tech firms and infrastructure may have been achieved with Chinese government support, in a less-than-transparent way, albeit by ostensibly private firms, and could be used to influence the European Union politically.

An enhanced mechanism for screening inward investments, at the member state and EU level (as recently proposed by the Commission), would be a good response to these dangers, alongside stronger R&D expenditure in all member states. In addition, the European Union needs to strengthen strategic policies towards science and technology, balancing coordination from centralised investments in some areas with experimentation from individual member states' uncoordinated efforts in others. A policy of adaptation and imitation in some fields should be considered as an alternative to maintaining leadership across the board. Rather than employing a policy that tries to pick winners, Europe needs to create an environment that promotes entrepreneurship and innovation.