SUMMARY

The world economy continued to recover in 2014 aided by strong growth in the United States. The situation in Europe, however, remains fragile. Several countries outside the euro area, particularly the United Kingdom, grew robustly. The performance of the euro area improved compared to 2013, but remains weak and uneven across member states. Unemployment is high in several countries, keeping social tensions at a high level. Depreciation of the euro is helping the economic recovery in general, but as international competitiveness varies greatly across the euro area, the positive effect of depreciation also differs from country to country. Despite the progress made in consolidating fiscal positions, high debt levels foreshadow future fiscal problems in some countries. Moreover, the outcome and impact of the reforms currently being implemented in several euro area countries are still uncertain. On balance, however, the reforms will support the recovery in 2015. This year's EEAG report emphasises that tighter coordination of national policies is required to achieve desired objectives in some key areas; while a lack of coordination may turn out to be particularly costly both for individual countries and for the European Union as a whole.

Chapter 1 of the report discusses the immediate macroeconomic outlook for the global economy, with a particular focus on the European situation. Chapter 2 focuses on energy policy, and emphasises that the case for a genuine European energy union is even stronger than the case was for a monetary union in the 1980s and 1990s. Chapter 3 analyses the evolution of regional disparities in Europe, highlighting that both the decline and the recent increase in disparities were driven by uncoordinated national policies. Finally, Chapter 4 looks at the contentious issue of European migration. It highlights that a commitment to free mobility, a simultaneous commitment to a generous welfare state, and enlargement of the EU to include members much poorer than existing ones, creates problems and tensions.

Chapter 1
Macroeconomic Outlook

Despite a slowdown in momentum in many industrialised countries, the world economy managed to remain in recovery mode last year. It is expected to gradually gain some further momentum in 2015.

In contrast to most industrialised countries and despite interest rate hikes, the emerging economies continued to grow moderately during 2014. The underlying economic dynamics were very heterogeneous across the emerging markets. Whereas the pace of expansion in India and many economies of East Asia accelerated significantly, Latin America witnessed a substantial decline in growth. Overall, the emerging economies will this year achieve growth rates roughly comparable to last year. On the one hand, many of them will benefit from the continuing recovery taking place in the industrialised world. On the other hand, several emerging economies are facing a marked flattening of their population growth, which reduces potential growth, while for oil-exporting countries such as Brazil, Russia and many economies in the Middle East, the strong decline in oil prices means a loss of national income.

Cheaper oil prices are supporting the slow, but steady acceleration in the advanced economies. In the United States in particular, the upturn is expected to continue. The US recovery is more advanced than in the euro area and is underpinned by the improved asset position of households, a well-capitalised banking sector and a still very expansionary monetary policy. Whereas the business sector in the United States has clearly regained confidence in the future outlook of the US economy and has increased its investment activities substantially, firms in Europe remain reluctant to invest. The US government has used the economic recovery to reverse the increase in public consumption, and in that sense has demonstrated clearly anti-cyclical behaviour. In the euro area, on the other hand, the role of the public sector has increased substantially during the crisis, and there are no signs that this is going to be reversed any time soon. On the contrary, the pressure to implement austerity and structural reform programmes has decreased in the last two years; with public consumption on the rise again in the euro area as a result. Progress in the crisis-afflicted countries to improve their international competitiveness by ultimately reducing relative price levels will remain slow and hampered by the sporadic resurgence of political uncertainty.

Continued robust growth in the United States and the United Kingdom will allow for monetary policy to become less expansionary in both countries. Monetary policy in the euro area, however, is still moving in the opposite direction. Although it has helped to dispel uncertainties related to the viability of the monetary union and the stability of the financial system, which should have created incentives for firms and households to invest, actual investment dynamics have remained flat to date. Numerous international conflicts, as well as renewed discussion of a potential Greek exit from the euro area, are counteracting the monetary stimulus provided by the European Central Bank.

Besides the sharp fall in oil prices, the recovery in the euro area is also being reinforced by the depreciation of its currency. While plunging oil prices are benefitting energy producers and consumers, the currency depreciation mainly supports firms with competitive positions in international markets. Partly due to differences in competitiveness, the pace of economic recovery will vary across Europe. Among the larger economies, Spain in particular is likely to grow significantly faster than the euro area average, while France and Italy are likely to see only slow growth. The latter two countries have been suffering from similar structural problems for years and have lost price competitiveness since the introduction of the euro. Their shares of world trade have decreased markedly as a result.

The weak economic recovery in Europe will also be supported by the structural reforms already implemented in some crisis-afflicted countries. Moreover, the reduced consolidation efforts are supporting the business cycle. These efforts, however, imply a significant risk to stability at the same time. Public debt levels remain high and, as the recent re-emergence of suspicion towards Greece shows, renewed doubts about their sustainability could lead to a new escalation of the euro crisis.

Falling oil prices have triggered a further decline in inflation rates in the euro area. Although this is certainly supporting economic developments, it also entails a risk. The longer low inflation rates persist, the greater the risk that inflation expectations will lose their anchor. This could subsequently create further downward pressure on inflation. In a still to be considered extreme scenario, the euro area could slip into deflation, which would place a heavy burden on growth. Currently, however, long-term inflation expectations for the euro area still appear to be quite firmly anchored.

Chapter 2
The European Energy Conundrum: Power Failure

European energy policy is currently poorly coordinated between the member states of the European Union, although substantial gains could be achieved through enhanced cooperation both at the European and the global level. The argument in favour of a European energy union – a genuine common energy market with common regulation – is even stronger than the case that was successfully made in the 1980s and 1990s for a monetary union.

The difficulty of formulating a forward-looking energy policy arises from the difficulty of comparing different types of risk and drawing appropriate policy lessons. There are at least four different perceptions of risk, and, while all are clearly present, they tend to be seen in quite contrasting ways in different European countries, and consequently produce varied and mutually incompatible responses from national political authorities: the risk of increased CO_2 emissions leading to climatic change; the risks of a nuclear disaster; threats of a cut-off of imported energy (gas or oil) supplies; and the likelihood of a network breakdown.

The greater the diversity of supply, and the more market alternatives exist (including different forms of energy), the more resilient the energy economy becomes against unanticipated events, including attempts to blackmail energy users. For these advantages to materialise, however, the interconnectivity of national energy markets has to be improved dramatically, while regulatory policies with regard to the different energy sources need to be harmonised across the countries of Europe.

Chapter 3
European Regional Disparity: Borders Strike Back

The original premise of the Single Market was that the promotion of economic integration brings prosperity to the European Union, reduces income disparities across member states, and by reducing differences between member states and within regions, it enhances social and political cohesion within Europe. The instruments to promote "economic and social cohesion" are primarily left to the member states and lower levels of government. Only a small set of supranational policy instruments exists in the form of EU cohesion policies directly motivated by the effects on regional and national income inequality of the European economic integration process.

The evidence seems to suggest that the policy was successful as there was a substantial reduction in disparities over time both in terms of labour productivity (as measured by GDP per employee) and unemployment rates until the crisis. However, closer inspection of the data leads to a somewhat different conclusion. Regional disparities in labour productivity declined up until the mid-2000s, but subsequently increased throughout the euro area's economic crisis. Moreover, disparities within countries changed relatively little, their initial decline and subsequent rise being primarily due to changes in disparities between countries and, to a much lesser extent, due to changes between regions within countries. This suggests that whatever contributions EU cohesion policy made to the convergence process, country-specific factors, including policies, played a more important role. The evolution in unemployment rates reveals a similar pattern. Disparities in regional unemployment rates declined as of the late 1990s and up until the crisis. Moreover, polarisation in the labour market (the number of regions with much lower and much higher unemployment rates than the European average) also declined. Since the outbreak of the crisis, however, regional disparities in unemployment rates have been increasing, and regional labour markets have become more polarised. Again, the disparities within countries have changed relatively little over time. Unemployment disparities altered primarily due to changes in unemployment rates between countries.

We argue that the evidence on the evolution of disparities before and after the crisis suggests that uncoordinated national economic policies were likely to lead to a fall in regional disparities first, and to a rise later. This occurred despite the presence of supranational redistributive policy instruments. The process started in the 1990s when the announcement of the euro improved expectations in the EU's relatively poor periphery that these countries would converge rapidly to the income levels of the rich EU core. As a result, capital flowed from the capital-rich core to the capital-poor periphery. This capital outflow depressed wages in the core and the corresponding capital inflow raised wages and employment in the periphery. The capital flow also led to falling disparities both in terms of labour productivity, and unemployment across regions. The nature of the capital flow, however, suggests that this primarily occurred due to falling disparities across countries, while disparities across regions within countries remained roughly the same. Depressed wages in the core made it more likely that a labour market reform would be carried out in the core (in Germany in particular), while rising wages made it less likely that a similar reform would be carried out in the periphery. Reform in the core and the lack of it in the periphery eventually led to divergence. Firstly, it led to price divergence as prices in the periphery were rising faster than in the core. Secondly, it led to divergence in labour productivity, which grew more slowly in some periphery countries than in the core. Finally, once the financial crisis hit Europe, the core and the periphery reacted asymmetrically, reinforcing the divergence among regions that had started years before the crisis and that had been driven not by regional, but by country specific factors such as national policies. The lack of coordination in policy choices reversed the regional convergence of the European regions firstly in terms of labour productivity some years before the crisis, and secondly in terms of unemployment rates after the crisis broke out. This underlines the importance of policy coordination in such matters as labour market reform too.

Chapter 4
Migration in the European Union: Too much of a good thing?

The European Union is committed to the principle of the free movement of people within its frontiers, which is central to the concept of EU citizenship. But this principle has given rise to concerns caused by the inclusion of more Eastern European countries with much lower wages. Many people in Germany, Britain, the Netherlands, Austria and other "old EU" members, particularly those with low skills in precarious low-wage jobs, who are threatened by unemployment and disadvantaged in housing markets, fear the consequences of the unlimited movement of workers from the East. They fear that their wage and job prospects may be undermined by the employment of immigrant workers at lower salaries; that incoming migrants may push up rents and property prices; that migrants may impose greater burdens on the welfare state, particularly if they (the migrants) have lower skills and wages than the indigenous population, are more prone to unemployment, and likely to pay lower taxes. The debate about migration and public policy has become highly charged as a result.

There is a sense that the scale of migration has increased in recent years. But migration data provides a mixed picture. The net flow of migrants into Germany was very high in the early 1990s – more than 15 migrants per 1,000 inhabitants in 1990 following the collapse of the Soviet Union, but subsequently declined, until a resurgence in 2009 following the financial crisis. Spain and Ireland had very large inflows in their boom years in the early 2000s, which have turned into significant outflows in recent years. Illegal immigration led to a sudden up-tick in migration into Italy in 2013 and 2014. Compared with these experiences, net immigration into the UK since 1990 has not been remarkable. However, gross flows have increased. From a gross inflow and outflow of around 200,000 persons per year in the 1970s and 1980s (a period in which the UK largely had a small net outflow of migrants), the gross inflow rose to over 500,000 per year and the gross outflow to around 300,000 in 2013, giving a net inflow of over 200,000 persons a year. The rise in gross flows may be contributing to people's sense that communities are changing around them and the unease felt by parts of the population. This disquiet is being compounded by the EU's lingering recession, prolonged austerity policies, and years of stagnating, or actually falling, net-of-tax wages.

The economic effects of migration are clearest in the labour and housing markets, taxes and public spending. They depend on the skills, occupations and ages of migrants relative to the existing population. Immigration from outside the EU is generally restricted in terms of its scale and by the type of immigrant admitted, typically with a preference for highly educated professionals. Free movement in the EU draws a relatively young, unskilled, low-wage migrant flow to the more generously redistributive Northern old-EU member states. Projected net inflows based on current policies are predicted to lower dependency ratios and partly offset population falls, in Germany for example, up to 2080 and beyond.

Evidence from many empirical studies suggests that labour markets can better absorb migrant flows, with smaller changes in unemployment rates and wages, than is generally supposed. The immigration of relatively highly skilled workers actually raises the wages and employment of less-skilled workers, and raises profits. The immigration of low-skilled workers has modest impact effects, reducing wages and increasing the unemployment of unskilled indigenous workers in the short run, but these return to normal fairly quickly. Absorption is quicker in boom times and slower in recession, which partly accounts for current troubles.

The immigration debate tends to focus on those countries that are net recipients of migrants, but migration also matters for countries that are net sources of migrants, such as Poland. It is often supposed that net emigration may cause the loss of a country's brightest and best, subjecting it to a brain drain. Poland's experience challenges such a view. Between 2004 and 2008, when there was a mass exodus of young workers to the UK and Germany, Poland's unemployment rate halved. Subsequently, economic growth took off and many earlier migrants returned, often with new skills and ideas. Migration seems to have worked as a useful shock-absorber in Poland's transition to EU membership.

In the economic literature on the subject migration is often portrayed as imposing a burden on a welfare state, which acts as a magnet (the welfare magnet) for the poor and causes "welfare tourism". There is evidence that more generous welfare benefits attract more migrants, but the effect is small relative to the effect of the wage gap, employment prospects, and the existence of a group of earlier migrants from the same country or region, who provide a supportive social network for new migrants in the country of destination. There is, however, evidence that a more redistributive state attracts relatively less-skilled, lower-wage migrants. There is also evidence that migrant populations make more use of the welfare state than native populations. This evidence points to a conflict between the generosity of welfare states, the principle of social inclusion and the free movement of people.

To mitigate this conflict, we suggest strengthening the insurance principle in social insurance. This would involve making more benefits dependent on contributions, adopting strict criteria of availability for work as a condition of receiving benefits, and using other active labour market policies to help poor and unemployed people into work. A home country principle for welfare benefits might be introduced to replace the current residence principle, under which people would receive benefits at the rates provided by the states in which entitlement was built up. The EU can also mitigate the problem by fostering the economic development of poorer members via structural funds and inducements to institutional reforms. The problem of high migration could then prove a temporary concern. Migration flows may reverse when wages and job prospects improve in the source economies, as seen in the case of Poland. The EU may have to compromise, and balance this trio of mutually incompatible goals for some years.