Presentation of the EEAG Report "What Now, With Whom, Where To – The Future of the EU"

Spain needs to reform its pensions system even at the cost of future cutbacks in other areas, warns the President of the ifo Institute

- Clemens Fuest singles out youth unemployment and the public deficit as the Spanish economy's main weaknesses during the presentation of the EEAG Report on the European Economy 2018
- The study predicts that Spain will expand by 3% in 2018, outperforming the rest of the top five EU economies and the euro-area average – which it estimates at 2.5% – with a more balanced growth mix compared to the pre-crisis years
- It expects Spanish unemployment to drop to 15.2% while noting that this is still far above the European average. Inflation rates, meantime, are forecast to hold near last year's level of 1.5%
- The authors do not see the Catalonia crisis as having dampened economic activity across the country as a whole
- The rapid enlargement of the European Union is viewed as a double-edged sword: on the one hand increasing familiarity, reducing negative stereotyping and dismantling barriers, but on the other strengthening suspicion and eroding trust
- The EU, the report warns, could undermine trust in its own effectiveness if its recommendations to member states lack political ownership and legitimacy at the national level.

Madrid, 9 May, 2018.- The Spanish economy is enjoying a sustained and balanced recovery with a robust performance overall. However two weaknesses stand out: an unacceptably high youth unemployment rate and an excessive public deficit. This is the snapshot of our country's juncture offered by the President of the ifo Institute, Professor Clemens Fuest.

On the subject of the recently announced increase in pensions, he sees it as an important political decision but one with clear budgetary implications: "Spain is undergoing a demographic shift and needs to implement reforms to ensure a sustainable pension system. And that, of course, will do little to improve the deficit

situation. If expenditure persists at these levels, there will have to be cutbacks in other areas."

In Spain, Fuest points out, pensions have become a lifeline for families affected by unemployment. For this reason, he adds, the reform must be structural in nature: "It is essential to keep in mind the whole system of transfers, particularly the protection available to society's younger members."

The German economist was visiting the BBVA Foundation in Madrid to present the **"EEAG Report on the European Economy 2018: What Now, With Whom, Where To – The Future of the EU"** prepared by the European Economic Advisory Group at the ifo Institute in Munich (CESifo)**.** President of the ifo Institute and one of the report's authors, Fuest is also Director of the Center for Economic Studies at the same institution, and Professor of Economics and Public Finance at the University of Munich.

The report projects that Spanish GDP will grow by 3% in the present year, 0.1 points less than in 2017, due to a mild slowdown in domestic demand. Even at that, the Spanish economy will outperform the euro-area average (2.5%) and the rest of the top five economies in the European union – Germany, France, Italy and the United Kingdom.

By component, continued job creation and favourable financing conditions should continue to support private consumption and business investment. The unemployment rate should fall to 15.2%, which, the report notes, is still well above the European average. Inflation, finally, should remain at a similar level to last year's 1.5%.

Looking back on 2017, the report highlights the fact that Spanish growth remained strong and robust, and that the political crisis in Catalonia did not have a significant negative impact on overall activity. Spain, it continues, outperformed most other EU countries for the third consecutive year with a growth rate of 3.1%. Both domestic and external demand contributed to this outcome, underlining a more balanced growth pattern than in the run-up to the Great Recession.

Most components contributed strongly, in the view of the report's authors. Strong job growth supported household income and consumer spending. Business investment, supported by stronger confidence and improved profit margins, continued to rise. Construction investment increased, reflecting an improved labor market and favorable financing conditions for households and non-financial corporations. And, finally, strong demand from trading partners and structural reforms helped to improve competitiveness and support export growth.

Macroeconomic conditions and outlook

The global economy, the report states, 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 (with world growth forecast to reach 3.2%).

Output gaps in the euro area and the United States are expected to be closed soon. The Chinese economy and the Japanese economy expanded strongly, both fueled 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 demonetization, with the withdrawal of 500 and 1000 rupee notes, and a reform of the VAT system.

The low interest rate environment of recent years, the report continues, 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 U.S. 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, in the view of the analyst team. Flat yield curves have been reliable empirical predictors of imminent economic downturns. Not only that, they warn, interest rates increases can trigger excessive loan defaults and major distortions on financial markets, as they did when they were too hastily implemented in the past. 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 probable impact of future crises.

The likeliest scenario, the report concludes, is that the global upturn will continue for a while, then gradually slow down as factors of production become increasingly overutilized in North America and in European countries that have been experiencing relatively strong growth after the crisis.

How to build trust between suspicious minds

The report also looks beyond the macro figures to review the political and economic juncture in the European Union, with the focus on trust, which it describes as one of the most important elements holding societies together. Trust, it continues, 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, in the view of the European Economic Advisory Group.

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, the report continues. Globalization 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.

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.

Addressing the goal of how best to build such trust, the report examines the two formulas most widely used in the European convergence process: plural arrangements ("clubs" of countries) that ease issues coordination among heterogenous states; and convergence processes that over time reduce heterogeneity.

The 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 geopolitical 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.

The authors draw an analogy between supranational groupings of countries and "clubs" that provide facilities to their members and exclude non-members. In both cases, they point out, 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 report concludes, therefore, that 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 to join a single convoy

of European states, but there were and still are good reasons for one such convoy to be formed.

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, the report's authors contend. 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 favored 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.

In concluding this section the authors acknowledge that it might be helpful to give the European Union additional competences in areas where national economic policies generate large spill-overs. The danger, however, is that this could blur responsibilities and allow national politicians to blame Europe for poor results primarily caused by the shortcomings of national policies. The European Union, they warn, 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.

The full report can be downloaded from the BBVA Foundation website: www.fbbva.es