Europe's Policy Trilemmas: Considering the Economic and Monetary Union

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An Interview with Kriyana Reddy
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***Brown Journal of World Affairs*:** I would like to begin by talking a little bit about your "trilemmas"—the three main challenges that you see the Economic and Monetary Union facing today. Could you describe what those three challenges are specifically?

Marco Buti: The euro was born out of solving Mundell's trilemma, which is that you can't have at the same time free capital mobility, fixed exchange rates, and an independent monetary policy. So how did the founding fathers of the euro solve the Mundell trilemma? By pulling together monetary sovereignty with a single monetary policy and a European Central Bank and by ensuring that the other two elements were also addressed properly. This gave them shared monetary sovereignty, a single currency, and free capital mobility within a single framework.

Now, with the experience that we have gained with the Economic and Monetary Union (EMU) before and after the financial crisis, I think other crucial trilemmas have come to the fore. First, one cannot continue to have such a low inflation rate while at the same time expecting weak countries in Europe to improve competitiveness and reduce public debt. These countries need their inflation rate to be lower than the euro area average to improve their competitiveness but high enough to help reduce the burden of their debts. So it is important to have policies lifting inflation toward the 2 percent target, which is the objective of price stability set by the European Central Bank (ECB). This can also not be done alone by the ECB. In this environment, you need a more proactive fiscal policy to help achieve a more balanced policy mix. Second, it is difficult to ensure the generous welfare states that are typical of the European social model while keeping public finances under control when growth is very low. So one has to foster more structural reforms to help generate more resources in order to keep public finances under control and at the same time have sufficient resources to sustain the welfare state. Finally, from a more political viewpoint, it is important to go in the direction of having institutions which build their legitimacy not on one of the individual member states but on the wider European polity. The European dimension of policymaking has to be increased. These are the three elements that should inspire the future direction of European integration, particularly in the currency union.

I do not see the currency union breaking up under any circumstances.

***Journal*:** You previously noted that the EMU was developed in part as a political mechanism for German integration. If the EMU were to fracture or dissolve, do you believe that could seriously jeopardize the unity and security of Europe? Or, in another sense, has the EMU maybe fulfilled its initial political objective?

Buti: When the decision was made to move to a single currency, to economic and monetary union, we had a double objective: on the one hand, we wanted to guarantee the proper functioning of Europe's single market. The feeling in the 1980s was that it would not be possible to do so with different currencies, because of the so-called "competitive devaluations" of the time. So in order to guarantee a free circulation of goods, services, capital, and people, one would have to have a zone of monetary stability in Europe. This was the economic objective. The second objective, which is the one you alluded to, was to anchor Germany—which after the fall of the Berlin Wall and reunification had become much bigger than any of the other member states—to a stronger Europe by bringing it into a single currency area. This was the more political objective. I think both elements have to be kept in mind when one looks forward. Many countries, but European ones in particular, had a very tough time during the crisis, and a lot of political capital has been invested in keeping up the monetary union. Now the time has come to make some politically difficult choices to complete the EMU's architecture.

Important steps have been taken in the past years to strengthen the eurozone. I would refer, for instance, to the creation of the anti-crisis mechanism, the European Stability Mechanism, and the establishment of the Banking Union. I think Germany and others who have been more skeptical about the single currency have realized that we need to go beyond the initial Maastricht projects. So choices have been made, albeit reluctantly, to strengthen the monetary union and to continue to share economic and monetary sovereignty. Looking forward, I do not see the currency union breaking up under any circumstances. We had a very tough discussion last year, in summer 2015, when the issue of Grexit [Greek exit] came to the fore. Even though Greece is only a small country, the fear was that by having Grexit one would break the fundamental unity of the currency union, so a lot of effort was deployed in order to ensure that the integrity of the currency union would not be called into question. I think that, since then, there has not been a single participant in the EU, even Germany, that would call into question the integrity of the eurozone. We will continue to operate under the current configurations.

One often forgets that even though the currency union underwent severe stress during the crisis, it always maintained its appeal. We had new countries joining, even during the crisis: Slovakia and the three Baltic countries. For these new member states, entering the heart of Europe was also a political and historical decision to be anchored in the West, especially in the face of dangerous developments on the eastern front with Russia.

***Journal*:** Speaking more to the political aspect of the current state of the union, with regard to the social welfare model and the compromises you have to make in terms of protecting social welfare, you also note the resilience of countries. And so, I wanted to discuss the issue of poverty, especially in regard to the welfare systems. Since the first eurozone crisis and Brexit, many people have become skeptical of the eurozone at large, and one of the issues that plays into that is growing poverty in a lot of the member countries. Why do you think that the eurozone is unable to keep up with the welfare demands of its member countries?

Buti: The European social model is distinctive and has features which make it unique in the global economy. In Europe, we care much more about fairness than simply efficiency, and the European welfare state is one of the features that really characterizes European countries. Now the European welfare state has come under stress during the crisis, and the kind of fiscal restrictions that member states have imposed in order to reduce public debt and control deficits have reduced the scope of the welfare state. At the same time, there is no political appetite to move to a U.S. model of the welfare state, which is much leaner and less generous. It is true, nonetheless, that the welfare state must evolve in order to meet the new needs that have emerged more prominently during the crisis. Here what is particularly relevant is not only the increase in poverty, which has happened in a number of member states, but the income stagnation experienced by the middle class. If one considers indicators of poverty and private deprivation, Europe continues to do considerably better than the United States. In Europe, it is more the fact that middle-class incomes have not been growing in the past several years that has put stress on welfare and political systems. This is essentially because those earning the middle income are also the median voters who determine the political destiny of governments and parliaments. We need to fundamentally rethink the functioning of the welfare state in Europe in a way which adapts much more to the challenges of globalization and skill-based technological progress, which tend to prevent a big chunk of the workforce from benefiting from the fruits of growth, undermine the security of the middle class, and fail to ensure a secure future for younger generations. I think this is one of the big challenges that we have in front of us.

***Journal*:** You refer to the "stagnation trap," the lack of compromise between having a strong fiscal policy and being able to rethink and remold this social welfare state to adapt to what Europe is facing now. Are there any specific structural reforms that you think the EMU should pursue in order to get closer to this goal?

Buti: Structural reforms have a bad name because they are usually associated with increasing hardship and insecurity. For instance, if you implement labor market reforms, you decrease the protection of workers. If you implement reforms that reduce the generosity of the welfare system and pension reforms that reduce entitlements, replacement rates, etc., workers feel less secure. So structural reforms are usually characterized as sacrifices, and this makes them very unpopular. I think we should put much more emphasis on what we call "structural reforms 2.0," which aim to equip people much more with the right entitlements when they come into the labor market. This means better education, skilling and reskilling, continuous training, and investment in human resources in general—all those reforms which increase the adaptability of people and economic agents to the various shocks in the economy, to the rapid development in technological progress, and to globalization. I think focusing on entitlements, not only financial but also in terms of human capital, would be the way to go, and this would also alleviate the anxiety in the population at large when they hear about structural reforms. This is the next frontier for structural reforms.

***Journal*:** I'd like to move to the second trilemma, which really centers on the idea of a conflict between inflation and competitiveness in some of the "peripheral" or weaker countries in the union. Could you talk about the conflict and where you see the EMU going in terms of resolving it right now?

Buti: Several peripheral countries in the EMU have attempted to simultaneously regain competitiveness and reduce their stock of debt. Now, how do you do that? In order to increase competitiveness, you need to have your labor costs growing less than those of your competitors. This is one way to regain competitiveness besides investing in quality products. But cost competitiveness requires you to have lower inflation than your neighboring countries. When it comes to reducing debt, both public and private, a key way of doing this is to have a prudent fiscal behavior and more inflation, which reduces debt via the denominator. So for these countries, inflation needs to be both high enough to bring down debt and low enough to improve competitiveness. How do you solve this dilemma? The only way is to have inflation high enough at the aggregate level of the euro area so that inflation at the country level can be lower—to improve competitiveness—but still positive to help reduce public debt.

In recent months, Europe has had almost zero inflation—while the definition of price stability, according to the Central Bank, is a medium-term inflation rate in the proximity of 2 percent. This means that at the present juncture you cannot solve the conflict of objectives that I indicated before. So what to do? The only way is to continue with expansionary monetary policy, but one cannot leave the ECB alone in pursuing higher inflation. One needs to have a more active fiscal policy to help sustain demand and inflation. Of course, this must be done in a way that does not jeopardize the long-term stability of public finances, which means that you need a more active fiscal policy in the short term, but control of the budget in the longer term. So it should be like Saint Augustine: "Make me chaste, but not yet." This would be the way to achieve this balance, this intertemporal coherence. This can be achieved via reforming entitlements so that expenditure outlays in the longer term remain sustainable, and by strengthening national institutions in charge of fiscal surveillance.

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***Journal*:** How politically feasible do you think these reforms are, maybe in a given country—Italy, for example? Do you think that there's a political feasibility of seeing these types of reforms materialize?

Buti: Sometimes there is a perception of Europe as being trapped in "Eurosclerosis," with nothing happening. This is not correct. If one looks at the indicators of structural reforms, such as those published by the OECD on product market and labor market regulation, you can see that European countries have passed quite a lot of reforms in the last few years. And evidence shows that countries under greater stress have actually done more reforms than countries in better conditions. This is also because when countries have their backs against the wall, they find the political courage to make the reforms. So countries under stress have actually done, or are doing, a lot of the reforms that they need. Some of these countries, Spain for instance, are now reaping the benefits of these reforms and are actually growing very strongly at over 3 percent. Some countries like Ireland, having fixed their banking systems, are also growing very strongly. Italy has started reforms but still has more to do. I think a key issue for countries like Italy—but also for virtually all the countries in Europe, or at least the vulnerable ones—is improving the efficiency and effectiveness of public administrations. Because it is not only a question of making the right laws, it is also about enforcing them too. What we have seen in the past few years is that many countries adopt the legislation and the reforms, but then fail to follow through with all the subsequent administrative procedures that are needed. Sometimes they adopt the law, but the enforcement steps needed afterward to make an actual difference in everyday life are not followed up on completely. This is a question of not only political will in general but also of the efficiency of public administrations in carrying through reforms.

***Journal*:** Considering aggregate demand and increased growth and growth rates, you have obviously noted that aggregate demand may well remain low in the foreseeable future partly due to demographic trends in the eurozone, but you have also said there is room for increased growth and growth rates. So, how do you compare these two tendencies? Or, how do they reconcile with each other?

Buti: First of all, if one looks at aggregate demand, the key component that is weak is investment. If one looks at the investment gap from before the crisis to today, it is still very sizeable. What is important is to create the right conditions for boosting investment, both private and public. Public investment was slashed during the crisis because governments needed to cut the budget deficits and public investment is much easier to cut than other types of spending. It is essentially because the vested interests behind public investment are weaker than those behind other components of public spending. In the future, what we have to do is reallocate public resources more toward public investment. Public investment here is material investment, such as infrastructure, and also immaterial investment, such as R&D, innovation, and so on. This will help on the demand side because investment is a component of demand, but it will also affect the supply-side and potential growth because it will add to the capital stock of the economy.

What is very important is not only public investment, but also private investment. We are currently working on the implementation of the so-called Juncker Plan, the Investment Plan for Europe, in order to create better conditions for boosting investment in the private sector. The Plan has three components: financial incentives, help in identifying viable projects, and reforms to improve business environment. Putting a lot of emphasis on investment provides a better chance to revive aggregate demand in the short term and contributes to higher potential growth in the longer term. Clearly, demographic developments imply that since we are getting older and older, potential growth will go down in the future. To prevent this, it is also key to think about a new immigration policy, which will help to integrate new migrants into the labor market and enable them to contribute to the wealth of the society.

***Journal*:** In terms of immigration, there are many political hues to the implementation of the policy, not just in Europe but also around the world. Moving toward the politics of trade now, would you say that the rise of politicians such as Donald Trump, and also the rise of politicians on the European right, has impacted you or your position? How are economic policies affected and how should they be affected by this sort of popular sentiment nowadays that's so dominated by these anti-trade, quasi-isolationist impulses?

Buti: Look, we are facing in Europe very much this type of pressure, and we are facing it very directly because in a sense the European Union is perceived by many as globalization at the regional level, rather than as a joint response to globalization. We have integrated so much in Europe between countries that these tensions are felt even more here than in the rest of the global economy. Now I think one has to acknowledge—and we have not done it sufficiently in the past—that economists are right in pointing to the overall gains of trade, but that they have not sufficiently put the emphasis on the distributional impact of trade. This implies that even if the society as a whole gains, there are sections of the society that lose. Usually those who gain are the silent majority—the consumers—and those who lose are very concentrated interests which make a lot of noise and complain very loudly. I think one has to acknowledge that there is a distributional conflict here. To address it, one should make sure inclusiveness is factored into the new directions of trade policy even more than what has been done so far. Europe has just signed a free trade agreement with Canada, the Comprehensive Economic and Trade Agreement (CETA), and I think this is truly part of the new generation of trade agreements where this issue of inclusiveness is taken more into account.

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Let me put the issue in a more general manner. When you deal with the distributional impact of trade, you have three dimensions. The first dimension is the pre-market—it's the issue of endowments, namely financial endowments and human capital endowments. So before you go to the market, if you have a very good education you are in better shape to face global competition. Then you have the second dimension, which is trading in the markets, and here is where trade enters directly. And the third dimension is the post-market. If you have unequal distribution of resources coming from the functioning of the market operation (trade), then the system of taxes and benefits and the working of the welfare state can be used to correct any negative impacts. I think what we need to do is to work on each one of these three dimensions. We have to work more on the pre-market one, on the issue of endowments; we need much more emphasis on education, investment, human capital. Second, on the market functioning, one will have to see and take into account the impact of trade on the distribution of resources. And the third element is the functioning of the tax and benefit systems in order to address some of the unwelcome distributional consequences of the functioning of markets. In short, I think we need to be more innovative in the future on each one of these three dimensions.

***Journal*:** Ensuring the success of that kind of innovation also relies on the cooperation of the member states. Touching on Brexit from this past summer, politically speaking a lot of times the question is, "Are these policies politically feasible?" What kind of forecasting did that decision have in terms of, "Yes, there is a growing sentiment of isolationism?" Do you think other countries will follow suit?

Buti: Yes, Brexit has been a shock because it is the first time that there has been a reversal of integration in Europe. We have always gone forward, and we have never gone back. Brexit implies that there's one of the member states that has legitimately decided not to continue to share sovereignty with the rest. I think, at the same time, Brexit has highlighted the fact that when you come to fundamental choices in terms of migration policy, social security, anti-terrorism, and defense policy, the national dimension is not the adequate one. "Regaining control" was one of the main slogans for Brexiteers. However, I think that once we start proceeding with the divorce, it will very quickly become apparent that they will not regain meaningful control in a globalized marketplace. For Europe, which is made up of a number of small-ish countries, the national level just isn't able to stand up to developments in the global economy. I think that in the future the only choice that I see as rational, even though it is politically difficult in the face of populism, is to keep pooling sovereignty and deciding together. This is the only way for European countries to have an influential role in global governance and shaping the global economy.

***Journal*:** You have mentioned the optimism you have for the unity and security of Europe going forward and the idea that this balance of transnational sovereignty and domestic sovereignty can happen. From your position, what are you looking forward to for the eurozone in the next decade or so?

Buti: The crisis caught the eurozone in the middle of the river. It hit just a decade after we created the Economic and Monetary Union, which if you look at historical parallels, is a very, very short time. We were definitely not prepared for a shock of such historic proportions. We have been building and reforming the institutions in the meantime—fixing the engine while flying—and I think we are now in a better position to make the final extra steps that are needed to complete the Economic and Monetary Union. Our challenge is to bridge different perspectives, such as the German perspective, which puts more emphasis on, say, national responsibility and avoiding moral hazard, and the French/Italian perspective, which puts more emphasis on solidarity and sharing sovereignty. I think each one of these perspectives individually taken is not viable and is not sustainable in the longer term. We need to find the common bridge between these two views, which in practice means coupling risk sharing with risk reduction. I would see in the next 10 years the Economic and Monetary Union being strengthened along both these dimensions.

***Journal*:** That is a very optimistic outlook. You mentioned the resilience of Europe so far, and that really on the time horizon, it has not been so long just yet, and with time the union is going to grow.

Buti: A key ingredient in all this is leadership. When the Economic and Monetary Union was established, there was the combination of Kohl and Mitterrand, together with Delors as the President of the European Commission. We will need to have the same political courage that was shown at that time in order to make the extra steps that are now needed. I do not think that the response to populism, the inward-looking attitude, should be to follow those populist movements into the low ground, because there they will always win. They can always build a higher wall. So, instead, what I think is needed is to make a positive case for Europe that shows our citizens that the response to fundamental threats now on security, on anti-terrorism, on general defense, on protection of borders, and on orderly migration policy cannot be done by individual countries alone—even by a Germany or a France. The minimum dimension in global governance, then, is the eurozone or the

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EU. And if you look at these phenomena from the European perspective, it is not too hard to master them in an orderly fashion. But the response cannot be simply "close the borders" and have a defensive attitude. I would hope that in the next 12 months, when there is a string of elections in member states, there will be, especially from mainstream parties and political movements, sufficient courage to frame the case for Europe in a positive way and not only defensively or as an attempt to limit the damage of pressure from populism.