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Europe at the Crossroads

Intereconomics was established in 1966 and has carried the subtitle ‘Review of European Economic Policy’ since 2001. I joined as Editor-in-Chief in April of this year and thank my predecessor Brigitte Preissl, the editorial team and our authors for making Intereconomics an influential, independent and international platform for European economic policy debate and a bridge between economic researchers and policymakers. Numerous outstanding economists, including Nobel Prize winners, Ministers and EU Commissioners have contributed to Intereconomics and enriched the debate centered on the continuously evolving economic policy challenges in Europe.

Today many economists see Europe at a crossroads. It can either fulfil the European project, complete the monetary union and form a fiscal union or it can revert to a Europe of small and probably less influential nations. Many researchers share the view that the adoption of the euro created an incomplete and fragile currency union and that this comes at a cost including the impossibility of using exchange rates as a stabilising tool.

According to the impossible trinity, autonomous monetary policy is impossible under capital mobility and fixed exchange rates. Still, the establishment of the Economic and Monetary Union (EMU) rules out any stabilisation through monetary policy or even realignments of nominal exchange rates.

But there might be a need for adjustments of (real) exchange rates particularly in the presence of asymmetric shocks or after longer periods of inflation differences and real exchange rate divergence. In a currency union, a nominal exchange rate adjustment can only be substituted by an internal de-/revaluation. The theory of optimum currency areas suggests that country characteristics, such as mobility of labour or labour market flexibility, might reduce these adjustment costs. Yet it remains debatable whether linguistic barriers in Europe hinder labour mobility, whether the migration outflow that took place during the Eurocrisis helped to stabilise Southern Europe or whether the outflow of talented people could be regarded as a brain drain that further contributed to divergence.

According to the latter view, migration amplifies asymmetric shocks so that Germany benefitted and Southern Europe lost twice during the Eurocrisis: first, by the asymmetric shock, and second, by the asymmetric effect of the migration outflow on potential growth and implicit debt. Looking into the past, after the creation of a currency union in 1990, Germany faced a comparable situation: East Germany absorbed a large amount of capital imports, while providing the West with exports of human capital. In the German fiscal union, imbalances between East and West Germany were compensated by fiscal transfers.

In the absence of a fiscal transfer mechanism, deficit countries have to reduce imports, prices and real exchange rates; yet there is no consensus as to whether surplus countries should help reduce the adjustment costs with accompanying inflationary policies. Some scholars argue that increasing real exchange rates through inflationary policies is not desirable in surplus countries such as Germany. Others argue that there is a deflationary race to the bottom where European countries compete against each other to reduce their real exchange rate in order to gain competitiveness while countries with higher wages, prices and deficits carry the burden. Internal devaluations can be achieved with social and labour market policies, as well as through fiscal devaluations and a shift in the tax burden from production to consumption. But beyond positive effects on the national current account, these policies might have negative effects on the current account in partner countries and are apparently far from popular. The *gilets jaunes* in France are just one recent example of the political tensions that appear in the aftermath of a shift in the burden toward consumers.

The absence of monetary policy and exchange rate adjustments could in principle strengthen the role of fiscal policy as the last remaining stabilising tool. However, the institutional design of the EMU with its fiscal rules explicitly prevents the applicability of fiscal policy. This basically gives rise to a more general impossible trinity, that a member country of a monetary union with no transfer or bailout mechanism does not have any stabilisation policy at the national level.

On the surface, since the cost of the current institutional design appears to be higher than expected, populist parties have called for reversing the process of European integration. But reversing integration is costly, too, as Brexit has shown. And it is questionable whether disintegration reinstates autonomy and welfare-maximising policies.

In small open economies, two more impossible trinities arise in other fields of public finance: redistribution and allocation. First, against the background of capital mobility and tax competition, a small open economy cannot use redistributive taxes because capital-owners might choose to live or invest in countries with low taxes. Tax competition in Europe basically implies a leftward shift of the Laffer curve, making it more likely to appear on the right hand side of this curve. Second, small open economies do not provide a welfare maximising amount of public goods if these goods generate international spillovers and are used by consumers abroad. This could apply to public transportation, infrastructure, research, security and environmental policies. Spillovers reduce the adequacy of national policies. Allocating competencies at the EU level would be a solution to solve these trilemmas.

Taking into account both the increased cost of maintaining the fragile status quo as well as the costs of disintegration, completing the monetary union and developing a fiscal union appears to be particularly beneficial. The division of competences between the EU and its Member States and the harmonisation of policies – e.g. regarding taxation – could be renegotiated at the same time. Does it make sense that the small countries in Europe have autonomous foreign, environmental or defense policies? Is it reasonable to allocate these tasks at the national level, against the backdrop of the growing global conflict between the US and China? Are there economies of scale if we reallocate tasks from the regional to the national or EU level? But if there are local information advantages, does it make sense that tasks remain at the national level, or should they be dispersed to the regional level?

The question of whether to proceed with the European project and complete the monetary union or live with the fragile and incomplete currency union and eventually go back to ostensible national sovereignty is the crossroads Europe faces in the 2020s. Intereconomics will accompany these and other emerging challenges of European economic policy in detail. In this issue, for example, Margit Schratzenstaller, Åsa Gunnarsson and their colleagues focus on the necessity for tax harmonisation in the EU. In the 'Forum' section of our journal, authors examine various issues of the European integration process from different perspectives, comparing and contrasting case studies, models and theories to offer applicable policy recommendations that will lead the broader discourse and help shape the future of the European Union.

Gabriel Felbermayr discusses the consequences of different exit strategies for the UK. Brexit demonstrates that disintegration is not only of theoretical interest. Because the creation of the EMU as well as Brexit can be regarded as unique policy experiments, it is of crucial importance for researchers and policymakers to understand and discuss these case studies. Natural experiments in economics are rare occurrences and Europe, with its many Member States, is full of them. Intereconomics will continue to observe and contribute to the ongoing debates surrounding integration and disintegration as well as institutional reforms in Europe and its Member States to better understand the evolving situations, the policy implications and how they apply to individual nations. This discourse is of crucial importance not only for researchers, but also for policymakers and citizens of Europe. It will soon be completley available for all to join: starting in 2020, Intereconomics articles will be 'Open Access' and free online.

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