Embargo: 6:30 PM Pacific Daylight Time

Dr Andreas Dombret
Member of the Executive Board
of the Deutsche Bundesbank

What's going on in Europe? – A view from the Deutsche Bundesbank

Speech at the World Affairs Council and American Council on Germany,
San Francisco
Monday, 11 July 2016

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

Table of contents

1 Introduction

Ladies and gentlemen

It is a great pleasure for me to be here in San Francisco with you and with these two distinguished organizations.

You know, when we agreed on the title and the date of this event, I was expecting to give a talk on the economic situation in the euro area and its implications for monetary policy. This was because – like many – I was convinced that the United Kingdom would ultimately decide to remain in the European Union.

As you know, events took a different course. At the end of June, the British people decided to leave the European Union. This decision is certainly a

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

turning point for Europe. Since Belgium, France, Germany, Italy, Luxembourg and the Netherlands founded the European Economic Community in Rome almost sixty years ago, European integration has only been going in one direction: towards deeper integration. Now this process has hit its first major roadblock.

I am deeply convinced that the decision to leave the EU will benefit neither the United Kingdom nor the rest of the EU. Take terrorism, climate change, international security or migration. In my view it is the wrong decision to try to solve global problems with national policy. The idea of the European Union remains as relevant as ever.

There is a real danger that Brexit might also sway public opinion across the EU on European integration and add fuel to the current anti-EU sentiment in some member states, which ignores the Union's benefits.

But the vote does not only reflect discomfort with the shared sovereignty that membership in the European Union brings with it. The EU has become a proxy for fear of immigration, open borders and, more generally, globalisation. This mood is also evident outside the European Union. If Brexit ends up feeding these currents, it may have implications beyond Europe.

The European project was also a lesson from the wars that devastated the world in the 20th century. It was in this very city that the Charter of the United Nations was signed in 1945. And it was the same spirit that led Belgium, France, Germany, Italy, Luxembourg and the Netherlands to sign the Treaties of Rome in 1957.

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

Ladies and gentlemen, the full consequences of Brexit will probably be only fully evident in some time to come – all the more because formal relations between the United Kingdom and the EU will only be decided through a long negotiation process that has not yet started. The key question in these negotiations will be whether the United Kingdom will remain a member in the single market or not – and if so, under which conditions.

Only after this question is settled will we be able to better assess the full consequences of this vote – economic and political. There is a strong case for negotiating co-operatively, but there must be no rebates on the obligations that come with participation in the single market.

The decision of the United Kingdom to leave the European Union requires a political response. This is not the core business of a central banker. So today, I will talk about the implications of Brexit for the economic outlook and for monetary policy. And I'll touch upon the potential longer-term implications for European integration.

2 Economic consequences of Brexit

2.1 Immediate financial market reaction

Mark Twain once said that October is one of the "peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February."

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

Measured against this wisdom, the reaction of financial markets to the Brexit news was by and large orderly. The news obviously came as a surprise – there is no other explanation for the steep drop in the pound sterling of 11% immediately after the referendum. But there was obviously no panic:

Investors have bought government bonds in an attempt to hunker down their money. For traditional safe-haven countries like the United States, Germany and Japan, this has brought down long-term interest rates even further. The steep increase in the long-term interest rates of peripheral euro-area countries immediately after the referendum reversed itself in the following days. On balance, long-term interest rates for Italy and Spain declined – and all in all it is obvious to me that there is no euro-area break-up scenario dominating capital market sentiment.

Stock prices dropped sharply on the day after the referendum. However, the situation had calmed down already in the afternoon.

Only shares of financial institutions have dropped strongly and still remain significantly lower, not only for UK banks but also for banks in the euro area. This is a sign that the uncertainty about the possible implications of the Leave vote is primarily affecting the banking sector. In my view it's the short-term consequences of a possible economic slow-down and the longer-term consequences of Brexit for banks' business models that are weighing on investor sentiment.

However, most banks have taken the possibility of a Brexit sufficiently seriously and prepared carefully. Supervisors asked them in a timely manner to

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

assess the risks associated with their holdings of stocks, bonds and foreign currency. And banks had to engage in emergency planning. Thanks to stricter capital and liquidity regulation, banks are in better shape today than at the start of the financial crisis in 2007.

Additionally, immediately after the referendum, the ECB joined other central banks in declaring that it would stand ready to supply liquidity should the need arise. Up to now, no liquidity provisioning has been necessary, however.

These measures certainly helped to avoid stronger financial market reactions. But this doesn’t imply that the financial markets have already found their new equilibrium. I cannot rule out further movements in prices and shifts of money from one asset class to another. But, we can be carefully optimistic that – with regard to financial markets – a panic reaction to Brexit is now rather unlikely.

2.2 Economic outlook

Further ahead, it is foggier. The economic consequences of Brexit are still uncertain.

The UK decision to leave the EU comes at a time when the economy in the euro area is on the path of a slow, but continuous recovery. The experts of the Eurosystem expect the economy to grow by 1.6% this year and 1.7%

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

next year, mainly on the back of domestic demand which is benefiting from low oil prices and a very expansionary monetary policy.

However, these forecasts do not include the consequences of Brexit. In fact, one of the downside risks to the projection has now materialised – and the above-mentioned forecast seems to be a bit too optimistic.

The impact on medium-term economic growth will depend strongly on expectations concerning the long-run economic consequences of the referendum, which in turn will hinge on the outcome of the exit negotiations. The chain of causality runs from the single market to productivity: The more the access to the single market is restricted, the more trade will be inhibited and the more productivity will be curbed – both in the UK and the EU.

Before the referendum, the International Monetary fund had warned that if established trade relationships broke down, this could have serious regional and global consequences. It has also pointed out that uncertainty created until an exit is fully negotiated could dampen investment.

Hence, much depends on whether this period of uncertainty can be minimised. Negotiations about the future relationship between the UK and the EU should be speedy and sensible. Neither party has an interest in re-erecting trade barriers.

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

In the meantime, the depreciation of the pound sterling we have seen since the referendum provides some relief. It counteracts the uncertainty hanging over the economic outlook. So this means that the immediate consequences for the economic outlook may not be quite that dire. The same may even hold for the euro area, for the euro has also depreciated somewhat against the US dollar and the yen.

In any case, while the impact of Brexit on growth will be negative, fears of a reduction in growth by, say, 0.6 percentage points in 2017, as predicted by Consensus Economics, seem exaggerated to me.

3 Implications for monetary policy

Ending the uncertainty arising from the exit negotiations is a political task. Given the current set of economic indicators, I do not see the need for any monetary policy response to the outcome of the referendum.

This is all the more the case as monetary policy in the euro area has already been very expansionary for quite some time. Unlike the Fed, for example, the Eurosystem is still expanding the size of its bond holdings. Some measures, such as the ECB's Corporate Sector Purchase Programme (PSPP), have only begun as recently as last month. It is therefore not clear to what extent a further loosening would stimulate the economy.

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

The ultra-loose monetary policy in the euro area is a consequence of the very low inflation rates. Over the last two years, it was mainly the decline of the commodity prices that kept inflation low. This holds in particular for the price of oil. Changes in commodity prices will at some point automatically cease to have an effect on inflation. They will “wash out of the inflation rate,” as central bankers like to put it.

But at the moment, low commodity prices are not the whole story. Low inflation rates are also a result of a subdued domestic price pressure. The “core” inflation rate – which excludes commodity and food prices – is also low.

For this reason, an expansive monetary policy stance is currently warranted – which doesn’t mean that one cannot disagree on specific unconventional instruments for monetary policy easing. The Bundesbank has always been – and in fact is still – critical with respect to purchases of government bonds by the Eurosystem central banks.

When I am abroad, people often ask me why I am having concerns with regard to the purchase of government bonds by the Eurosystem, even though the Fed, the Bank of Japan and the Bank of England are using this instrument.

The answer lies in the institutional set-up of the euro area. This set-up is unique and not comparable to that of a single state. Although euro-area countries have decided to share a common monetary policy, they haven’t mutualised fiscal policy. Every member state remains responsible for its own fiscal policy. To limit governments’ inherent incentive to incur debt, however,

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

fiscal rules were decided on and fiscal bail-outs by other member states or by the Eurosystem were explicitly excluded by the European Treaties.

Although sovereign bond purchases by the Eurosystem are not forbidden per se in such a decentralised set-up, they risk leading to a dangerous commingling of monetary and fiscal policy as the Eurosystem could then become the biggest creditor to the euro-area member states. If governments adjust their policies to the very low level of financing costs by delaying structural reforms or fiscal consolidation – and this is what OECD studies on the willingness to reform and current indicators on the fiscal policy stance in the euro area are telling us – the Governing Council could come under political pressure in future to maintain its ultra-loose monetary policy even if its price stability objective suggested exiting from this policy.

This risk of fiscal dominance is what troubles me because it could make it more difficult for monetary policy to fulfil its primary objective of price stability.

4 Reforms for a more stable euro area

Ladies and gentlemen, the Leave vote in the United Kingdom has led many to think about its political consequences. Some politicians – rather predictably in my view – immediately called for deeper European integration. But this deeper integration should, on the one hand, not come at the price of more shared liability without more shared sovereignty. And in any case, it would have to be ensured that the common decisions are taken in a stability-

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

oriented manner. On the other hand, the Brexit vote must in no case serve as an excuse to retard reforms or even turn back achievements in European integration.

Proposals for further integration were already on the table prior to the referendum. Many of them contain proposals for more shared liabilities but ignore the issue of common decision-making. This middle path will not be enough to stabilise the euro area sustainably. In my opinion, what the currency union needs is a synchronisation of liability and control.

Recent years have shown that the combination of 19 different fiscal and economic policies with a single monetary policy can lead to a situation in which member states have to mutually bear the consequences of individual member states' economic policy decisions.

The seemingly endless emergency summits at which member states bickered about the shape of rescue funds may have been one reason why the image of the European Union has suffered.

They illustrate a misalignment of liability and control in the euro area. This problem was anticipated already during the negotiations of the Maastricht treaty that launched the single currency. The idea was to use a combination of market discipline and additional rules to restrict governments' propensity to expand public debt.

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

The Treaty contained a no-bail-out clause that prohibits member states from assuming each other's debt. Investors rather than tax-payers were intended to shoulder the risks of their investments.

In addition, the Treaty contained restrictions on public debt levels and fiscal deficits in order to ensure that each member state could cushion a recession with its own fiscal policy without losing access to financial markets.

Unfortunately, politicians obviously found it hard to difficult to adhere fully to the no-bail-out rule when financial markets lost trust in the sustainability of public finances of some member states.

This was because banks in these countries were loaded up with sovereign bonds. A sovereign default would thus have put financial stability in the whole euro area in danger.

As a comedian from Austria once put it: "Europe consists of countries that refuse to be ordered to follow those rules that they themselves came up with."

Since the outbreak of the financial crisis, things have only become worse. There are now countries in which the fiscal deficit has been in excess of the limits set by the rules for seven years.

And the application of the rules has become more and more politicised due to an increased scope for interpretation by the European Commission. The European Commission is interpreting its role in two ways: as the guardian of the Treaties, on the one hand, and on the other hand, as a political actor

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

which seeks to balance the different interests of the member states. This has clearly not helped to make the rules more binding.

So over time, the misalignment of liability and control that was entailed in the constitutional set-up of the euro area from its very beginning has become even worse.

In fact, it requires bold steps to establish a consistent institutional set-up for the euro area.

One such step is to jump to a full political and fiscal union. Common decision making would then go along with common liabilities.

But even back when the Maastricht Treaty was signed, politicians did not think this option was deliverable. And, in the light of the debate in Europe today, it does not seem to have become more feasible today.

But there is another option for aligning control and liability. It would require returning liability to the member states, where control still resides. It is at least as important to reinstate market discipline over member states' fiscal policies.

To make this decentralised way credible, at the end there has to be the possibility that member states can become insolvent.

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

The sovereign debt crisis showed us, however, that this requires an end of the so-called sovereign-bank nexus as the insolvency of a member state must not be allowed to endanger financial stability in whole euro area.

This cannot be achieved with a single measure. But there is no getting around one particular measure: To end the preferential regulatory treatment being granted to sovereign bonds.

Unlike for corporate bonds, financial institutions do not have to hold equity against potential losses on their government bond holdings. Sovereign bonds are still regarded by regulators as risk-free.

The sovereign debt crisis in the euro area has definitely shown that this assumption does not hold. If the preferential treatment of sovereign bonds on bank balance sheets is ended, this will force investors to take a closer look at the risk profile of sovereigns before making their investments. Capital markets could then resume their function of disciplining government fiscal policy.

This is why the exemptions granted to sovereign bonds are now being debated in the Basel Committee on Banking Supervision.

5 Final remarks

Ladies and gentlemen, I do not want to stretch your attention any further. As some wise person once said: There should never be too many words be-

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

tween the beginning and the end of a speech. I hope I have not violated that piece of advice too blatantly today.

I have covered many topics – some of them only briefly. But it was my intention to provide some food for discussion.

As a last remark, I want to thank you for your hospitality. Please be assured how much I enjoy being here in San Francisco. Citing one of your most famous inhabitants: “I’ll be back.”

Thank you very much.

* * *

Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de