

Andreas Dombret: The euro area navigates rough seas - where is Europe heading?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the parliamentary evening at the Bundesbank's Regional Office in Hamburg, Schleswig-Holstein and Mecklenburg-Vorpommern, Hamburg, 7 June 2017.

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1. Introduction

Ladies and gentlemen

I am delighted to be here this evening to talk to you about the future of the euro area. Here in Hamburg, Germany's largest sea port, it seems quite fitting to ask where Europe is heading.

These days, Europe's reputation is suffering somewhat – uncertainty and political risks are casting a shadow on Europeans' self-image. Against the backdrop of Brexit and an apparent resurgence of nationalism and populism, politicians and the general public alike are starting to ask: "Where is Europe heading?"

The European Union is facing criticism on all fronts at present. Why is this? What are the roots of the seemingly ever-increasing levels of euro-scepticism and reform fatigue? What lessons can and must we learn from the dissatisfaction of large numbers of people? How can we counter calls for more nationalism and less Europeanism?

I believe we must deal constructively with euro-scepticism. This involves finding areas in which we can start making improvements.

I am emphatically not talking about making intellectual U-turns. What really matters is bringing about a change of course and sticking to it. And that is why it is equally important to take an unbiased view of the chances of successful reform in Europe.

2. Navigating rough seas – European and global challenges

Ladies and gentlemen, the result of the US presidential election and the unexpected Brexit decision in the United Kingdom are just two examples that show that many of the general public's reservations and concerns have been underestimated for too long. And yet, in Europe, too, a tendency to revert to nationalism is not a completely new phenomenon. Even when the EU was being established, many member states had misgivings about transferring sovereignty to international institutions. And these concerns come to the fore again every time powers at the European level are expanded.

But we should not be under any illusion – over the last few years, protectionist policies have gained more political traction than in the past. Protectionists believe that trade barriers will bring jobs back as well as boost growth and employment. They see stricter trade and immigration controls as the answer to people's concerns.

However, they fail to recognise that it is precisely the opening-up of trade that improves a country's competitiveness by facilitating the division of labour, which enables countries to exploit their own individual competitive advantages. This allows goods to be produced at low cost, which increases consumers' purchasing power. Ideally, this stimulates demand; prosperity, investment, and, ultimately, employment increase as a result.

One thing is clear: isolationism brings no benefits, offers no stability and does not lead to prosperity. The belief that protectionism is the better alternative is merely an illusion.

Nonetheless, scepticism regarding the European project has grown. Of course, some of the criticism aimed at the euro area is justified. Unfortunately, closer European cooperation also produces undesirable side-effects.

Without a doubt, there are major benefits to the single European market. But, at the same time, it obviously creates redistribution effects which can cause the regional loss of jobs or wage stagnation. And these effects tend to undermine many people's trust in the European Union.

The European project must therefore be judged on the extent to which it benefits all its citizens. On the one hand, economic and socio-political action needs to be taken in this regard – but I won't go into further detail about that today. On the other, however, there is also a fundamental need to overhaul the regulatory framework in Europe. Parts of this framework need to be adjusted and parts need to be completed in order to provide a stable footing for the European project in the long term.

Only stable institutions and a reliable regulatory framework can create confidence. We saw the opposite of this during the European sovereign debt crisis, when a lack of confidence in the euro area led to a crisis which was by no means confined to individual countries.

Even though many necessary reforms have been initiated and the euro area has been made significantly less vulnerable to crises, we have not yet reached our goal. We still need to press ahead with the right reforms in order to strengthen people's trust in the institutions of the EU, which would also take some of the wind out of the sails of populism. So let's now consider where we could start making specific institutional changes.

3. The euro area – room for improvement in the status quo

The sovereign debt crisis made one of the euro area's problems glaringly obvious – previously, the financial markets appeared to assume that, should individual euro-area countries experience financial difficulties, the European community would bail them out, even though the EU treaty prohibits mutual liability. As a result, doubts as to the soundness of individual governments led to doubts regarding the euro area as a whole. It is therefore extremely important that, in the future, it is possible for over-indebted states to default. For one thing, this would significantly limit the extent of future crises; for another, it would reduce the likelihood of the European community of states having to intervene.

Until then, however, we still need to overcome a few obstacles. One major obstacle is the strong nexus between banks and sovereigns. It means that insolvent banks can pose a threat to the solvency of entire governments, and vice versa.

Banks are not required to back bonds issued by European governments or other OECD countries with capital, and can hold unlimited quantities of them on their books. In theory, a bank's business could therefore consist entirely of bonds issued by a single state. This rule creates a troubling risk concentration.

To sever this unhealthy link, we need to make just one simple change. In future, banks must back the government bonds they purchase with sufficient capital. In short, the existing rules need to be improved to ensure that both creditors and borrowers consider the risks more carefully when lending or borrowing.

However, this reform won't be enough on its own to resolve the euro area's underlying problems. Another starting point for reform would therefore be to intensify the coordination and integration of economic policy within the euro area. Without an integrated economic policy, it is difficult for the economies in a currency union to converge.

Implementing deficit ceilings for government debt is another area in which progress needs to be

made. All member states should adhere to these ceilings – in no way should they be seen merely as recommendations. The onus here is clearly on politicians. Central banks can apply pressure, at most.

4. Where is Europe heading?

Now, there will be some who say that these reform proposals sound too ambitious given the current state of Europe. But there are signs that the EU is indeed both willing and able to reform and that, overall, it is making progress. I would therefore like to bring three points to your attention.

First, it goes without saying that you can think long and hard about the need for reform – even the finest minds will achieve nothing if the political will is lacking. It is on this very issue that we seem to be seeing a turnaround. For instance, it appears possible to win elections with a clearly pro-European stance. We recently witnessed this in France.

The finance ministers of France and Germany have also announced an initiative designed to strengthen the euro area. Furthermore, we are hearing claims from France that it is on course to comply with the deficit ceilings for general government debt in future. To me, this is wonderful news.

Second, the European economy is also providing a boost. Following a prolonged period of weak economic developments in the euro area, we now find ourselves on a solid upward trajectory. The euro-area economy grew by 0.5% in the fourth quarter of 2016 and the first quarter of this year, respectively. The euro area's economic recovery has thus firmed, with even the mounting uncertainty in the wake of the Brexit vote and the outcome of the US presidential election doing nothing to alter that fact.

The tides are also turning in our favour with respect to the unemployment rate, with unemployment in the euro area falling consistently. Although, at 9.5%, the unemployment rate is currently higher than the pre-crisis average, it has been declining steadily since 2013 – while the finishing line is undoubtedly still a way off, we are on the right track.

But how are economic developments now affecting politics in Europe? First, populist movements that oppose multilateralism, free trade and the euro play on factors such as the fear of weak economic growth and rising unemployment. In other words, positive economic developments take the wind right out of sceptics' sails. Second, a turning manoeuvre can be performed far more successfully after picking up a little speed.

And I cannot neglect to mention a third ray of hope for Europe: we have recently implemented major reforms. By that, I am referring to the EU's banking union.

The banking union was approved in May 2014 and has standardised banking and financial supervision in the euro area. Though still in its infancy, it is one of the most sweeping reforms to be implemented following the euro-area crisis.

In the euro area, we were able to see that the costs of the crisis were felt not only by the countries that caused them. However, given the existence of risk-sharing in the euro area, it is vital that these risks also be jointly managed. The regulation and supervision of the financial markets could therefore no longer remain a matter of national responsibility.

It was for that reason that the Single Supervisory Mechanism, the SSM, was established as the first pillar of the banking union. Within a very short space of time, 85% of assets held by European banks were placed under the supervision of the ECB.

All systemically important financial institutions in the euro area are now overseen by the ECB's

joint supervisory teams and the national supervisory authorities. These teams are headed by a member of staff from the ECB. Important actions and decisions are determined jointly with the national supervisory authorities and carried out by joint staff. Put differently, the ECB cooperates closely with national authorities such as BaFin and the Bundesbank in the SSM.

By contrast, smaller institutions that are not deemed systemically important are still overseen by national supervisors. The SSM demonstrates how European and national authorities can complement each other and work together efficiently.

What the banking union also shows is that Europe is capable of reform today. With that in mind, I do not believe that we need a new Europe; instead, we need to concentrate on improving the one we already have.

5. Conclusion

Ladies and gentlemen, where is Europe heading?

I was invited here today to shed light on this issue. But I'm afraid I must disappoint you: I don't have the answer to this question. At the end of the day, Europe is everyone's decision – a decision that we all have to make.

As we have seen, the EU is facing major challenges: from the sovereign-bank nexus and the possibility of sovereign insolvencies to the integration of European economic policy. Confronted with the threat of populism, we must work with even greater determination to improve the European system. While this will not always be easy, Europe is worth the effort. Nevertheless, we ought to be optimistic about the years to come.

We are no longer going to stumble from crisis summit to crisis summit. We can see political commitment to change. We can see that the euro area is in good economic shape. And we can see that, thanks to the banking union, reforms are continuing to be implemented in the EU. The future of Europe is not as grim as some would have us believe.

I hope that the US election, the Brexit decision and euro scepticism will provide the impetus needed for major reforms and motivate us to work tirelessly for a better Europe.

The European Union is an anchor in rough seas. For more than 70 years, peace and stability have reigned over our European continent. Let us never succumb to the temptation to take this for granted.

Thank you for your attention.