Andreas Dombret: In and out, up and down – the future of Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the German Chamber of Commerce and Industry, Tokyo, 15 June 2016.

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1. Introduction

Ladies and gentlemen

It is a great pleasure for me to be with the German Chamber in Tokyo. Thank you for inviting me back.

In my remarks today I would like to take a closer look at European issues. Starting with the economic outlook for the euro area and Germany, I will then touch on the topic of monetary policy. After that, I will discuss how the European monetary union can be made more stable in the future.

The most exciting event in Europe this month is, without doubt, the European football tournament. But there is also a political issue which will also be thrilling. It is the UK referendum on 23 June, in which Britain will decide whether it will remain in the European Union or go it alone.

If the UK were to exit the EU, Germany would lose a close ally that shares its market-oriented economic view. Indeed, I am in no doubt that the European Union has benefited from having the UK as a member. The EU is stronger today because of Britain's contribution to it. And the European economy is more open and more dynamic as a result of Britain's commitment to open and flexible markets – a position which is very much in tune with the Bundesbank's, I might add.

But not just that: A Brexit might also sway public opinion across the EU on European integration and add fuel to the current sentiment that is opposed to deepening the Union. And in this regard, the mere fact that a Brexit is even being debated might itself cause some damage.

It is clear to me, however, that the risk of a Brexit is weighing primarily on the UK economy and only to some extent on the rest of the EU. While projections assessing the economic impact of Brexit are fraught with uncertainty, I would agree with the bulk of economists who say that UK membership is fruitful for both the UK and the rest of the Union. That being said, a "leave" vote next week would also take its toll on the prospects for the economy in the euro area.

In its most recent World Economic Outlook, the International Monetary Fund argues that a Brexit has the potential to do "*severe regional and global damage by disrupting established trading relationships*". And I agree with the IMF when it writes: "*Negotiations on post-exit arrangements would likely be protracted, resulting in an extended period of heightened uncertainty that could weigh heavily on confidence and investment, all the while increasing financial market volatility.*" To keep such risks in check, it would be important – were Britain to vote to leave – for the UK and the rest of the Union to proceed quickly, and without animosity, to a constructive discussion framing their future relationship. Introducing trade barriers can certainly not be in the interest of either party.

2. Economic outlook: Between recovery and new challenges

On that note, let me now turn to the state of the economy in the euro area and in Germany. Having got off to quite a good start in 2016, the euro area economy is expected to see a resilient, ongoing recovery, supported by low energy prices and the accommodative monetary policy stance. The latest Eurosystem macroeconomic staff projections predict that real GDP will grow by 1.6 % in 2016 and by 1.7 % in both 2017 and 2018. This means that aggregate economic capacity utilisation in the euro area as a whole may get close to normal levels by the end of the projection horizon.

Germany's economy, meanwhile, experienced a strong surge in growth in the first quarter of 2016. Real GDP was up 0.7 %. Aggregate capacity utilisation climbed to a multi-year high, boosting the willingness of German corporates to step up their investment again. Private consumption and buoyant construction activity were the main forces driving economic growth, but, in contrast to the end of last year, renewed stimulus was coming from exports and foreign investment as well.

While the economists of the Bundesbank expected the German economy to lose some traction in spring, the solid underlying cyclical trend will probably remain intact. According to our June 2016 economic forecast, the German economy is predicted to expand by 1.7 % this year, by 1.4 % next year and by 1.6 % in 2018. Adjusting for the number of working days makes the growth rates even more uniform, and they are higher than the estimated increase in potential output, which is running at about 1.4 % per year. The utilisation rate is therefore continuing to rise, and it is expected to be significantly up on the long-term average at the end of the projection horizon.

However, unlike the short to medium-term economic outlook, the longer-term growth expectations for the German economy are not only rosy. We shouldn't let the upbeat projections for the next few years lull us into a false sense of security. Germany's long-run outlook, like Japan's, is also being clouded by demographic developments and their negative implications for potential growth. So if we want to keep our economies wealthy, we will need to address the root causes of declining prosperity and implement growth-enhancing measures.

The huge influx of refugees to Germany, which peaked last autumn, may dampen the impact of demographics to some extent, as refugees generally tend to be younger than the population at large. However, to limit the burden surrounding the current wave of migration, it is the precondition that the new arrivals integrate smoothly into the labour market.

3. Options and Limits of Monetary Policy

Monetary policy cannot increase potential growth – that's for sure. Its effect on real economic activity is limited and temporary. So the most important contribution monetary policymakers can make to growth is to guarantee low and stable inflation.

Inflation in the euro area is currently very low – too low, monetary policymakers say. According to its definition of price stability, the ECB Governing Council aims to keep inflation rates below, but close to, 2 % over the medium term.

However, the last time euro-area inflation was close to 2 % was in early 2013. It has been following a downward trajectory ever since, and over the past 18 months it has been hovering around zero.

The sharp fall in energy prices is the main reason why inflation in the euro area has been in the doldrums over the last 1½ years. Its effect on headline inflation is usually only short-lived, however.

But the decline in energy prices isn't the only thing that is pinning down inflation. Domestic price pressures as measured by the core inflation rate, which is the inflation rate with the most volatile components like energy and food stripped out, is also low. And if inflation is persistently weak, it becomes a headache for monetary policymakers. For if inflation stays too low for too long, there is a mounting risk of de-anchoring inflation expectations. Lower inflation expectations can ultimately translate into weaker wage growth, diminishing domestic price pressures further still. If such second-round effects occur, that makes it even more difficult to maintain price stability.

Against this background, an accommodative monetary policy stance is certainly justified for the time being. Currently, deflation seems less probable than ever. And let me also emphasise that there is no evidence of second-round effects so far. According to the latest Eurosystem staff projections, inflation is expected to rise again, to 1.3 % in 2017 – driven to a large extent by upward base effects in the energy component –, and to 1.6 % in 2018.

That being said, this is why the Governing Council decided on no further measures at its latest meeting, all the more so as a comprehensive set of measures was adopted only recently in March. That set of measures included, amongst others, lowering policy rates and upping the volume of monthly asset purchases. Only now are some of these measures being implemented. As of June, the Eurosystem has started purchasing bonds of non-financial corporations, and on 22 June the first operation in a new series of targeted longer-term refinancing operations will be conducted.

The Bundesbank has repeatedly stated that purchases of euro-area government bonds are not "just another" monetary policy instrument. Central bank purchases of government bonds make for a dangerous combination of monetary and fiscal policy. The central banks are becoming the euro-area countries' biggest creditors. For a significant share of sovereign debt, government financing costs have become decoupled from capital market conditions. If governments become accustomed to the favourable funding terms and don't use this time to reduce their large accumulation of debt, this may later put pressure on the central banks to put off tightening the monetary reins until a later date for the sake of their country's public finances.

I am also aware of the fact that many savers are frustrated by the low interest rates. And of course, these concerns are perfectly understandable. Their safe investments are providing them with either very little or no return at the moment. If you factor the inflation rate into the equation, however, the situation does not seem quite so bad. At present, the inflation rate is so low that the real interest rate on savings deposits is above zero. This means it is currently still higher than it was in the 1970s. To take another example, between 2011 and 2014, the real interest rate was actually negative.

Of course, monetary policy has contributed to the unusually low level of long-term interest rates. Not only the forward guidance, but also the purchase of long-term bonds – issued by sovereigns, banks or enterprises – aimed at lowering long-term rates. But long-term interest rates are not only determined by monetary policymakers. They are also a reflection of nominal growth expectations, and if potential growth is slowing, it has a depressing impact on the real rate of return. Making our economies more prosperous would therefore pave the way for higher real interest rates. There are plenty of growth-enhancing measures – like strengthening competition in product markets or making labour markets more flexible – and all of these measures go beyond the central bank's sphere of influence.

This is not to say that the central bank doesn't care about the plight of savers. Quite the opposite, in fact – monetary policymakers protect savings from devaluation through inflation, in part by deciding on an appropriate monetary policy stance while remaining independent. Over the long term, this is also in the best interests of savers. But we shouldn't forget that citizens are not just savers. They are also taxpayers, workers and borrowers – and from this perspective, low interest rates are not always a bad thing.

It is also true, however, that ultra-accommodative monetary policy entails risks and side-effects, and these will continue to grow the longer money remains cheap. Therefore, the low-interest-rate policy must not prevail for any longer than is absolutely necessary from the perspective of price stability.

There is a risk, for example, that politicians will start to rest on their laurels because of the short-term stimulus provided by this accommodative monetary policy. Although a central bank may be able to temporarily even out weak demand in the short run, it is not able to permanently raise its economy's longer-term growth trend. However, the repeated deterioration in global growth prospects suggests that when it comes to the slowdown in the global economy, we are actually dealing more with supply-side rather than demand-side problems. And there is little that monetary policy can do about these.

4. Monetary Policy is no Panacea: Reforming European monetary union

The recent monetary policy measures are geared to maintaining price stability in the euro area as a whole. Unconventional in nature though these measures may be, they should not be seen as crisis measures like those taken in the wake of the Lehman Brothers collapse, or after the euro-area crisis erupted. That being said, weak economic conditions and low domestic inflationary pressure are also, to some extent, an outcome of the euro area crisis.

This crisis, which is actually a combination of at least three kinds of crisis – a sovereign debt crisis, a banking crisis and a balance of payments crisis – has been troubling European policymakers for more than six years now. Solidarity among governments combined with bold fiscal and monetary policy measures helped to contain the crisis and prevent it from escalating.

However, some of those measures have thrown the balance between action and liability out of kilter. While fiscal policy has essentially remained a national domain, liability has increasingly been transferred to the European level. In that state, however, monetary union becomes inherently unstable because the incentives are not aligned. The balance between action and liability therefore has to be restored if EMU is to regain a more stable footing. But how can this be done?

In theory, two options are viable. The first would imply a more centralised EMU design with formalised elements of common liability. Such a great leap in European integration towards a fiscal union would, however, mean constraining national sovereignty in fiscal affairs and transferring the respective control rights to the Union level. Such an initiative would need sufficient political backing and – in some countries – electoral approval. To be honest, I doubt this to be a realistic endeavour in the foreseeable future.

The second option for realigning responsibility and control would be endorsing the original framework of the European monetary union, but fixing the shortcomings exposed by the crisis. The original framework, which was agreed in the Dutch city of Maastricht nearly 25 years ago, can be described in a nutshell as follows: Shared responsibility for monetary policy; national responsibility for fiscal and economic policymaking.

Important precautions were put in place to prevent unsound fiscal policies from damaging the stability of the single currency. Those were the “no-bail out” clause, the ban on monetary financing and the deficit rules specified in the Stability and Growth Pact.

The problem is that these arrangements failed to prevent the sovereign debt crisis from erupting, and, unfortunately, market discipline did not help, either. The “no-bail out” clause, which prohibits a member state from assuming liability for another one’s debts, was expected to enhance market discipline. But as it turned out, it simply wasn’t credible enough. At least, markets did not adequately price in the risk of sovereign insolvency. What is more, the preferential treatment of sovereign borrowers encouraged banks to step up their lending to governments. That ultimately paved the way for the disastrous sovereign-bank nexus. As the crisis unfolded, many banks, notably in the euro-area periphery, raised their exposures to domestic government bonds. By doing so, they tied their fate even more closely to that of their national governments and made it almost impossible to restructure public debt.

Making the “no-bail out” clause more credible is therefore key when it comes to strengthening a decentralised EMU design. What we need, then, is a procedure for restructuring debt in an orderly manner. This is where the Bundesbank has proposed an automatic maturity extension for all bonds, which would be activated whenever a government applies for fiscal support from the European Stability Mechanism (ESM). Automatically extending maturities would allow the sovereign in question to tackle its fiscal challenges while preventing investors from bolting. If it turns out that the ailing country really is insolvent, legacy creditors could then be held liable.

Clearly, achieving a stable monetary union with a decentralised design is not an easy task, but it can be done if politicians are willing to implement the institutional reforms needed to strengthen individual responsibility.

Another project which will reduce fragmentation is the capital markets union, which is currently in the making. Creating a single market for capital across all 28 EU member states by removing barriers to cross-border investment will make a key contribution to improving the absorption of macroeconomic shocks and lessening the impact of heterogeneous economic developments. The creation of a capital markets union could stimulate growth in the European Union substantially. Not just that: it could also boost the stability of European monetary union. Integrated capital markets foster private risk sharing, which is a far more important shock absorber than public risk sharing. Since equity has a much greater capacity to absorb shocks than debt, fostering equity markets should be the particular aim of the capital markets union.

5. Conclusion

Let me conclude.

During my speech I pointed out several pivotal decisions that lie ahead for Europe.

In the next week, we face the challenge that the next step in the EU's history may well be not one of union, but one of separation. Although it is neither the time nor the place to enter into this political debate, I really hope that the majority of the UK electorate will share our view that most of the current challenges Europe is faced with need a European and not a national answer.

I am confident about the prospects for the euro-area economy, since the moderate recovery remains intact – being supported not least by the monetary policy of the ECB. Eight years on, euro area GDP has finally recouped the losses it sustained in the crisis.

However, on a disaggregated level, the picture is still mixed. Some European countries are continuing to feel the after-effects of the crisis. The German economy, by contrast, has made a brisk recovery, and its prospects for the next two to three years are upbeat. That, however, is no reason to be complacent. The long-term growth outlook for Germany is clouded also by adverse developments like the demographic impact of an ageing society.

Prosperity in Germany and Europe depend, in part, on the lessons we learn from the recent crisis in the euro area. The European monetary union, as it currently stands, is not sustainable – at least not as a stability union.

Ladies and gentlemen, the existing challenges in Europe call for reforms – deep and comprehensive reforms. We must now all work together in solving current cases and thereby never forget what the European Union has been since its beginnings – namely a project for maintaining peace for our continent and beyond.

Thank you for your attention.