Andreas Dombret: Opt-in or opt-out? The future of the European Union in light of the UK referendum

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Atlantik-Brücke, Hamburg, 23 Juni 2016.

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1. Introduction

Mr Schwenker

Mr Kracht

Ladies and gentlemen

Yet again, Europe finds itself at a crossroads, at least it does from the UK's perspective. 41 years on from the UK referendum in which the country came out in favour of becoming a member of what was then the European Economic Community, the people of Great Britain and Northern Ireland are, as I speak, once again voting on the "European question".

Though this decision is quite clearly one for the UK alone to take, voices in all quarters have been sounding a note of caution right up to the last minute. One very notable example is the IMF's Christine Lagarde, who recently underscored the many benefits that the European partnership brings for the UK after an IMF paper sketched out a distinctly bleak future for a post-Brexit UK economy. Echoing Ms Lagarde's remarks, Federal Reserve chair Janet Yellen warned that a UK vote to leave the EU could have "significant economic repercussions".

UK voters alone will now have to make of these scenarios what they will. Now is neither the time nor the place to pass judgement on the decision to hold a referendum or the pros and contras of the respective standpoints from a UK angle.

I will instead look at matters from a European vantage point and invite you to discuss what today's referendum means for the European Union. In doing so, I will take a look at both the direct challenges we will face in the event of a Brexit and the long-term outlook for the EU.

2. Standing firm in the face of uncertainty: the direct repercussions of a Brexit for the EU

Ladies and gentlemen, half of the UK's exports go to other EU countries. 46% of foreign direct investment in the UK comes from the EU; the other way around, the figure is 43%.[1] Thanks to the UK's long-standing membership of the EU, its economy now enjoys closer ties than ever before with its European partner countries. Figuratively speaking, a Brexit, then, would set in motion highly complex divorce proceedings and herald a protracted spell of uncertainty.

What a Brexit would mean in practice depends to a large extent on what's hammered out in Brexit negotiations. While the mechanics of leaving the EU are now codified in Article 50 of the Treaty of European Union, that article only maps out the process and preliminary two-year timeframe within which an agreement is to be negotiated between the Union and the withdrawing member state.

Both sides would undoubtedly be interested in maintaining the existing trade links. But at the same time, there should be no doubt that the EU should resist any efforts by the UK to cherry-pick the most advantageous terms.

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1 C Fuest, Der Brexit ist ökonomisch irrational (in Wirtschaftswoche, 27 May 2016).

A glance at the agreements that exist with other countries makes it plain that sharing a market always means sticking to a common set of standards as well. The European Free Trade Association (EFTA) for Iceland, Liechtenstein and Norway, for instance, is tied up with membership of the European Economic Area (EEA). But this also means applying the full set of EU legislation, a notable component of which is the freedom of movement – an issue that “Brexiteers” have cited in the run-up to the referendum as one of the reasons why they think the UK should leave the Union. By contrast, the alternative model used by Switzerland, which is not part of the EEA, does not initially envisage the country having freedom to access the common market. In all likelihood, individual arrangements which grant access won’t be possible without concessions. And with a jungle of contractual small print to contend with, time constraints will mean that the negotiating parties will be unable to repeatedly redraft proposals in their efforts to hammer out an agreement.

So it’s anything but certain how the legal situation will ultimately pan out. The terms of the EU Treaty would remain in force during the negotiation period. But businesses on both sides of the Channel would be unable to forge out any longer-term plans as long as these conditions haven’t been clarified – so planning uncertainty is bound to be costly. And it’s very much up in the air whether the spell of uncertainty will be over after two years or whether the negotiating parties will have agreed by mutual consent to extend the negotiating period.

Putting aside the tall order of gauging the economic fallout of a Brexit decision, there is naturally another question which arises from a European angle and for me personally as a central banker – given that a “leave” vote might spark a turbulent market response, how far will Europe’s banking and financial system remain stable and continue to function properly?

Financial markets have already started to price in a Brexit scenario, and heightened volatility and climbing risk premiums are coming to the fore in the lead-up to the referendum. It’s a safe bet that markets will remain in turmoil if the UK chooses to leave the EU.

For example, the pound is open to exchange rate risk, as it could devalue again strongly should there be a vote to leave the EU. Effects can also be expected on the stock markets. In particular, British bank shares could come under pressure if the markets expect a Brexit to push up banks’ wholesale funding costs to the detriment of their profitability. Seeing as the financial sector accounts for a much greater share of the UK economy, at 6.7%, than it does in the rest of Europe,[2] UK bank shares will be at the epicentre of market jitters. So it’s not surprising that Mark Carney, governor of the Bank of England, has spoken out, as part of the BoE’s monetary and financial stability mandate, on the repercussions of a Brexit and points to the likelihood of negative short-term effects.[3]

That’s why European supervisors wasted no time in urging euro-area credit institutions to precisely quantify and continuously review their forex, credit, equity and bond market risks, simulate scenarios and draw up “contingency plans”. The vast majority of banks have treated the Brexit scenario with the seriousness it deserves and are rigorously prepared to face the aftermath – in some cases, their preparations have required a great deal of time and effort. The same goes for central banks, too, of course. They’re ready to face up to the real risk of a “leave” vote. As things stand today, I think the risk that might emerge, say, from a theoretical UK rating downgrade or a possible revaluation of the UK property sector is manageable overall, but of course, no one really knows for sure.

As for the EU, a Brexit would also cause some fallout in the medium term. European banks based on the continent operate in the UK market and have branches in London. The UK capital is also home to a great number of non-European institutions which use the EU’s

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2 Financial and insurance activities expressed as a share of UK GDP; the equivalent for the EU as a whole is 4.7% (source: OECD.Stat).

3 Bank of England Inflation Report Q&A (12 May 2016).

passporting regime to conduct business in any other EU country – that makes London a hub for the entire European market.

If the UK voted to leave the EU, institutions in Germany and the other EU countries that operate branches in the UK would face the prospect of losing access to this passporting regime or seeing it be changed. This would force institutions to either convert their London branches into standalone subsidiaries and to apply for them to be licenced by the Bank of England or shift their operations out of the UK and into the euro area – two immensely costly options, might I add. But saying that, it is also true that if the UK opts to leave the EU, we will have to wait for the outcome of post-referendum negotiations before anything can really be said on the EU's passporting regime that will stand up in court.

But for financial centres elsewhere in the EU, the Brexit scenario opens up a number of opportunities over the medium term. Also, a larger number of foreign banks look set to switch from the UK to mainland Europe – and that's something that might even benefit the Frankfurt financial centre. London's pulling power as a venue for European bond and forex trading would shrivel. For even today, supervisors take a critical view of the fact that euro trading is based mostly in London, and therefore outside the euro area. This criticism would intensify if the UK chose to leave the EU, of course. The same can be said for clearing business and central securities depository services, at least for euro-denominated business – supervisory authorities will need to be a lot more tolerant if this business is to be allowed to be conducted not just outside the euro area but outside the EU as well. If truth be told, that's a level of tolerance I can barely imagine.

Looking at the medium-term horizon, the European Union also needs to consider how, given the close links between financial agents in the UK and continental Europe, it intends to safeguard financial stability in Europe if a more national brand of regulation and supervision is reintroduced on the other side of Channel. While UK banks aren't currently affected by the Single Supervisory and Resolution Mechanisms of the banking union, they do need to comply with the Single Rulebook.

Incidentally, the European Banking Authority plays an important role in this regard. Not only does the EBA ensure a harmonised interpretation of the rules, it also promotes interaction and dialogue on supervisory practices in the member states. And as I'm sure you all know, it is currently headquartered in London. So if the UK voted to leave the EU, the EBA wouldn't only have to find a new home; it would also have to rebuild the prudential cooperation with the UK from scratch.

So a "leave" vote throws up a vast number of planning issues and raises considerable uncertainty. But even if the electorate came out in favour of "remain", there would still be some loose ends to deal with in the relationship between the UK and the rest of the European Union. Just consider, for instance, the question as to how the revision of the EU rules that were agreed in the event the UK remains in the EU actually affects economic and political dynamics within the EU.

3. Strengthening crisis resistance: the long-term outlook for the EU

Ladies and gentlemen, the outcome of the referendum is something that Britain will have to resolve on its own – it is not something we will be able to influence. What we can influence, though, is the EU itself, and its ability to function. And this is where I see the far more consequential issues affecting Europe's future.

For the UK referendum should be understood less as the result of the anticipated benefits of exiting – earlier on, I gave you an insight into some imponderables and risks of leaving the union – but more as the outcome of widespread dissatisfaction with the European Union. And, should the UK vote to remain in the union, the referendum will most likely not represent a resounding commitment on the part of Britons to the EU.

In addition, as we all know, dissatisfaction with the EU is not a purely UK phenomenon, but instead has grown significantly in many member states. Support for Eurosceptic parties is mounting. A UK vote in favour of Brexit could also launch a movement in other member states to look into ways of leaving the EU. Moreover, even if the UK votes today to remain, we cannot expect underlying attitudes towards the European Union to change overnight.

Motives for dissatisfaction may partly be found in domestic politics. On the other hand, however, a search for causes also needs to include the European Union's specific actions, such as how it has dealt with refugees, the euro crisis, and the general cost-benefit considerations of harmonised rules and an "ever closer union" – at this juncture, I will not go into detail on individual topics, as that would be beyond the scope of my mandate.

What reverberates everywhere, however, is the question of whether the European Union is capable of taking decisions effectively and efficiently. The EU has yet to demonstrate its ability to deal with diversity – cultural or economic – and to channel it in the right directions. Let me explain this now in view of the euro area and outstanding reforms.

The challenge of channelling diversity in the right directions has come up quite prominently in monetary union. In a large economic area, it is quite natural for individual regions to evolve in a variety of different ways; owing to the structures of their economies and societies, they will not respond to change in the same way. The underlying question is this: how can the system as a whole respond to such asymmetrical shocks? Put differently: how can the EU be made more crisis-resistant?

In a single monetary area such as the euro area, there are no more exchange rates to adjust; therefore, other channels are needed to cushion imbalances, such as adjustments to prices in the factor markets, sufficient labour force and capital mobility, or also, of course, a stability-oriented economic and fiscal policy.

Despite a variety of efforts at harmonisation, there are still 19 different sets of economic and fiscal policy in the euro area. Yet these states are not all necessarily addressing their respective structural problems in an appropriate manner because EU-level sanctioning mechanisms are either non-existent or, to put it mildly, being underused. It has also occurred in the past that, in dealing with their structural issues, governments have fobbed off part of the negative fallout of national policy measures on the rest of the euro area. Over the course of the euro crisis, this became clear in connection with sovereign debt.

Other policymaking areas, too, are exposed to the threat that other member states will be forced to pay the consequences for individual member states' policy errors. The European Union is consequently increasingly being viewed as a synonym for a lack of will to reform and as a dumping ground for national risks.

Let me frame the reform problem this way: Europe is facing the challenge of overcoming obstacles to reform along the route to a sustainable and coherent community order. There is certainly more than just one solution. The option of reforming the common economic and financial framework towards stronger European liability, however, is predicated upon transferring more national sovereignty to the European level. If we look at the discontent about "ever closer union," it appears as if this option is currently a political non-starter. However, another way for the European order to ensure synchronicity between actions and liability for their consequences is that these consequences are borne where the vast majority of scope for action is located: by national decision-makers. This means that they need to take responsibility for their actions and have convincing incentives to eliminate the structural problems.

I would like to illustrate this now by citing two topical areas of financial reform: first, sovereign debt, and second, European deposit insurance. Both reforms are related to the nexus between sovereigns and their domestic banks. And, in both cases, as obviously apparent as the problem is, enthusiasm for reform still remains to be demonstrated.

The excessively close sovereign-bank nexus is a primary example of a factor which can make sovereign debt a structural problem, as it can engender an unhealthy mutual interdependence. It is precisely the large stocks of sovereign bonds on the books of domestic banks which is creating dependencies.

The Bundesbank was one of the first to point out the role of the preferential regulatory treatment of government bonds as a key aspect of the problem. Banks are currently not required to set aside any capital against loans to euro-area sovereigns, unlike loans to enterprises or households. Nor are there any caps or ceilings on their lending to these borrowers. Banks therefore have, at least in the short term, a huge incentive to invest in government bonds. Sovereigns likewise benefit over the short term since they can easily obtain funding through the artificially inflated demand for government bonds – yet at the same time this lessens the pressure to reform, to consolidate government finances and achieve debt levels which are sustainable over the long term.

The crisis showed more than clearly that even euro-area government bonds may be exposed to risk. This is why, in my view, risk-based capital requirements need to be extended to cover banks' on-balance-sheet lending to sovereigns.

I also believe it still makes sense to limit banks' exposures to individual sovereigns – much like the large exposure limits for private-sector borrowers. That way, even if these borrowers were to default, banks would still have enough capital at their disposal.

If the preferential regulatory treatment of sovereign debt were done away with, this would also increase investors' incentives to take greater account of the differing risk profiles of the individual states, which in turn would thus strengthen the disciplinary function of capital markets. Countries that pursue unsustainable policies would then face rising risk premiums.

Where political action needs to be taken is known – however, the EU now needs to demonstrate that it is, in fact, willing to act.

There is a similar political constellation regarding the topic of deposit protection. Under the European Commission's current proposal, existing national protection schemes – which are already operating under standards which have been harmonised across Europe – will gradually be replaced by a European deposit protection scheme.

Although we have a Single Supervisory Mechanism in Europe under which banks are supervised according to uniform European guidelines and harmonised rules, as well as a Single Resolution Mechanism to go with it, the financial situation of the supervised institutions hinges on the state of the economy, as well as, of course, the legal framework of the affected country. Insolvency, for instance, is still governed by a patchwork of very different national regimes. Rushing all too madly to introduce a European deposit insurance scheme would not only create an unfair situation in which some banks would be more likely to dig quite deeply into the shared pot; it would also tend to reduce the pressure on member states to conduct reforms.

Let me once again reiterate the guiding theme of my foregoing remarks: there is an in-built conflict between short-term relief and the balance between actions and responsibility for their consequences, and thus also the basis for a rules-based order that can function in the long run. It is not only at the EU level but also, and in particular, member states where unpleasant structural reforms have to be undertaken in order to make the EU less vulnerable to crises. Time is of the essence and, given the challenges we are facing in the EU, should not be wasted.

4. Conclusion

Ladies and gentlemen,

at this hour, the UK's future in the EU is balanced on a knife edge. We won't have to wait longer than tomorrow to learn how the UK has voted: whether it wishes to remain a member of the EU or to leave. However, we should not worry only about the immediate impact of the referendum – be it “Brexit” or “Bremain”. What will be more decisive over the medium to long term, however, will be to find good solutions to the problem of chronic dissatisfaction with Europe’s institutions. We have to confront the detected deficiencies in a decisive manner. Europe must demonstrate its ability to conduct credible political reforms.

This task is necessary irrespective of today’s referendum in the United Kingdom. Should the UK vote to leave the EU, however, one thing is certain: Europe’s political landscape will be missing a voice of caution and a proponent of stability and the market economy. That is something I would highly regret; however, it is my hope that Britain’s known penchant for pragmatism will prevail this evening.

Thanks you very much for coming, and I would now be pleased to join you in a discussion.