Philip R Lane: The eurozone after Brexit

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Euro50 Group & CIGI Breakfast Meeting, Washington DC, 9 October 2016.

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It is a pleasure to speak to this joint Euro50 / CIGI meeting on the topic of the implications of Brexit for the euro area. I will focus on the economic and financial dimensions, leaving to others to discuss the political issues.

In the period immediately following the referendum, the capacity of banking systems and financial markets to absorb the unexpected result can be attributed to several factors.

First, it was clear that the Bank of England and other central banks (including the European Central Bank and the eurosystem more generally) had taken the necessary precautions to ensure that banks would have sufficient liquidity to overcome any short-term disruption in funding markets. The improvement in underlying resilience as a result of the substantial increase in capital ratios for European banking systems over the last several years was also an important factor in ensuring an orderly market response to the Brexit news.

Second, it was also well understood that the central banking community would respond appropriately over time to any shifts in macroeconomic conditions that might be generated by the Brexit fallout. Indeed, the Bank of England's Monetary Policy Committee (MPC) loosened its policy stance in August 2016, while the broader decline in euro area yields might be attributed to beliefs that Brexit could represent a headwind for recovery in the euro area, prolonging the phase of accommodative monetary policy. In turn, the prospect of slower recovery and "lower for longer" interest rates helps to explain the decline in bank equity values that has occurred post-Brexit.

Third, the substantial decline in Sterling since the referendum provides an important stabilising mechanism by which the adverse implications of Brexit for the UK's terms of trade are mapped into international relative price adjustment. By the way, it is important to put the recent movement in the Sterling-euro exchange rate into context: it partly just unwinds the sustained appreciation of Sterling that took place between early 2013 and early 2015.

Looking ahead, the design and timing of the new relationship between the UK and the EU remain quite uncertain. It is reasonable to expect some volatility in financial markets and macroeconomic variables as the negotiations move along, with harder versions of Brexit likely to be associated with more substantial re-assessments of growth prospects and asset prices for both the UK and the EU.

Given the especially close ties between the UK and Irish economies, the Central Bank of Ireland has adjusted its 2017 growth forecast from 4.2 percent to 3.6 percent as a result of Brexit, while also calling out further adverse Brexit-related developments as a specific downside risk.

Let me turn to a longer-term perspective, with a particular focus on the evolution of the European financial sector. To the extent that some relocation of financial activity from the UK to the EU (and/or to other regions) will be triggered by Brexit, it is important to bear in mind several factors.

First, the EU system of financial regulation and supervision is grounded in a common framework, as expressed in the various EU directives and regulations.

Second, this applies a fortiori in the euro area banking sector, given the lead role of the ECB's Single Supervisory Mechanism (SSM) in authorising and regulating banks. Accordingly, the locational strategies of financial firms should not be driven by regulatory considerations but should rather reflect the typical determinants in the economic geography literature: availability of skilled labour and suitable office accommodation; quality of public infrastructure; relative

cost levels (both wage and non-wage components); national education, legal and tax systems; language and cultural factors; and relative attractiveness in relation to "quality of life" indicators.

Third, Brexit reinforces the urgency of making progress in relation to the Capital Markets Union agenda. To the extent that the new longer-term UK-EU relationship will make it more difficult to rely on London as a location for euro-denominated capital markets activity, fostering scale economies and harmonisation in the EU financial system is essential in order to develop the deep and liquid euro-denominated markets that are required if the EU is to reap the benefits from a more balanced financial system, in which the availability of equity and bond funding provides an important alternative to bank-sourced funding for corporates.

In summary, Brexit is a disruptive event that has adverse implications for both the UK and EU economies. At this point, the focus of policymakers has to be on negotiating a new UK-EU settlement that can allow both the UK and EU to prosper over the long run. For central bankers, the transition towards the new arrangements has the potential to be a source of volatility and will require continuous monitoring and risk assessment.