John Iannis Mourmouras: Implications of the UK vote to leave the EU – a view from the South

Panel intervention by Professor John Iannis Mourmouras, Deputy Governor of the Bank of Greece, at the Bank of Italy-OMFIF Main Meeting, Rome, 22 September 2016.

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Intervention in a panel meeting with Lord (Norman) Lamont, former UK Chancellor of the Exchequer, Ambassador Antonio Armellini, and Philip Middleton, Deputy Chairman, Ernst and Young, OMFIFAdvisory Board, moderated by Fabio Pannetta, Deputy Governor, Banca d'Italia, at the Banca d'Italia-OMFIF Main Meeting in Rome (Italy) on 22 September 2016.

Disclaimer: Views expressed in this speech are personal views and do not necessarily reflect those of the institutions I am affiliated with.

Ladies and Gentlemen,

It is a great honour for me to take part in such a distinguished panel. On this very important matter of implications of the UK vote to leave the EU, I would like to focus on a couple of issues: Firstly, on the potential effects of Brexit on the dynamics of European integration and indeed offer a southern point of view and, more particularly, make five points from the South on the Brexit vote. Secondly, I will examine the implications of Brexit on what central banks do in terms of monetary policy, including the ECB.

1. A SOUTHERN VIEW ON BREXIT'S IMPLICATIONS FOR THE EU

The European Union is currently facing crises on multiple fronts (anaemic growth, high unemployment, persistently low inflation close to deflation, a debt crisis, an ongoing migrant crisis), but Brexit represents the biggest medium- to long-term challenge of all.

Point number 1: A deeper look into some European failures that influenced the Brexit vote

Euroscepticism is now a strong sentiment in Europe. Populist, authoritarian parties are in government or in a ruling coalition in nine (9) countries of the EU. This is an alarming figure. Referendums in Italy and Hungary, and national elections next year in the Netherlands, the Czech Republic, France and Germany, are expected to reinforce this eurosceptic mood. Eurocrats should take note of this reality.

Beyond the obvious economic concerns which triggered the UK vote to leave the EU, everyone agrees that the EU needs to address the issue of its democratic deficit and accountability. This is obviously not resolved with a European Parliament that maintains two seats: a real seat in Brussels and a symbolic seat in Strasbourg, costing the EU, and thus European taxpayers, €114 million per year. The EU is perceived as a sclerotic and costly organisation that fails to adapt to the changing circumstances in a world of rapid upheavals. At the same time, persistent austerity policies – quite often ill-designed – adopted in Southern European countries increase the rejection of the European project even in countries such as Greece or even Italy, which had always been pro-integration and where public opinion was always in favour of the EU.

In addition, it has long been argued that the European Union remains a 'market without a state'. This quote perhaps summarises the debate on European integration over the last 40 years at least. The most frequent complaint regarding the way the EU works is that it is governed by an elite of unelected technocrats through several independent European institutions and bodies (including the ECB).

In light of the above issues of democratic deficit and accountability, Europeans are increasingly disenchanted with the EU, as shown by the rise of populist, authoritarian parties. Support for populist political parties with eurosceptic credentials has been rising, that is, parties which are by nature more Eurosceptic and less oriented towards reforms, which of course the South badly needs. As a result, this is a major downside risk to debt sustainability in this part of the euro area.

Point number 2: Mushroom of referenda and political contagion

For continental Europe, Brexit represents a shock to the institutions and norms that underpin markets, albeit different from the euro break-up fears of 2012, the global financial crisis of 2008 or the bursting of the high-tech bubble of 2001. The origins of previous financial crises can be located in multiple factors that are linked with the financial system and the economic cycle, respectively: imbalances in trade or capital flows between EU Member States; a combination of decades-long excessive borrowing, risky investments, and lack of transparency in the financial sector; and the speculative mania around the shares of so-called “dot-com” companies and the subsequent collapse of the speculative bubble. The risk is not financial contagion, like in 1998. Instead, it represents a contagious political development. No matter whether we have a full-blown or a light Brexit, the political risk for the continent is that referendums may mushroom across Europe in a tug-of-war between populist forces and the political establishment and elites. Brexit has the potential to unleash centrifugal forces, leading perhaps to a breakup of the euro, especially if such a referendum were to be held this time in a major eurozone country. Perhaps such a referendum is more likely in a southern eurozone country.

Of course, democracy is the very foundation of our civilisation, but sometimes even well-intentioned initiatives can produce unintentional consequences (as we have seen with the UK vote).

The public not only in Europe (but also on this side of the little pond) seems to have lost confidence in the political and economic establishment to come up with visionary solutions that are also pragmatic and improve things for most people.

In 2017 we will be celebrating 60 years of European integration. Europe has emerged as a standard-bearer of freedom, democracy, the rule of law. So we should not be complacent about populist parties using the refugee issue as a key fear factor for European voters and turning it into a major campaign theme to tell the EU to keep out of migration and human rights issues. It is particularly worrying to see Member State governments turning the EU into the enemy for domestic purposes. The agreed-upon migrant relocation scheme is founded on solidarity, the very basic principle of European integration that has helped the EU become the major trading bloc around the world that is has become.

Point number 3: Duality and the way forward for the EU

The theoretical debate about the EU’s post-Brexit future has seen three predominant scenarios: an EU that falls apart/disappears, an unchanged EU that continues to muddle through trying to cope with its underlying problems or an EU that integrates further, or at least some Member States moving forward, some others choosing to stay back. One idea that has circulated a lot in the context of the Brexit debate – which I concur – that a balance between national sovereignty and European solidarity and prosperity may be found in duality, i.e. two “Europes” coexisting in a broader European construct, independently from one another. One would be a political union (either taking the form of a federal state or a confederation of nations) to complete the EMU and beyond, which is the vision of the EU’s founding fathers (Jean Monnet, Robert Schuman, Altiero Spinelli). The other would be based on market liberalisation, forming an outer rim of a new European construct, in which Britain could obviously play a leading role, if it so wishes.

For Southern European countries of course, the 1-billion-dollar question is the following: if this dual architecture becomes a reality in the EU (definitely not likely before the German elections) will the South of Europe be part of a "new eurozone" [a proper fiscal union, with a banking union , a defence and a political union], or will it be left behind in a secondary, outer circle of countries? This is something I would not like to speculate about here today, and to be frank with you not ever! But it's not a matter of wishful thinking, it's a matter of tough realism.

Point number 4: Coup d'état in Turkey – Migrant crisis

Clearly, Brexit is an issue for the whole of Europe and Southern Europe will not be immune to the implications of Brexit, for instance because of tourism, external demand, etc. However, coming from one of the countries located on the EU's external border, which has received massive influxes of refugees from war-torn countries such as Syria (we have all seen the pictures of boats washed ashore in Lampedusa, Gibraltar, or the Greek islands of Northern Aegean), it would rather be an omission on my behalf not to discuss the more urgent problem for Southern European countries right now, which if it escalates further in the next 6-12 months may affect the rest of the EU and eventually present an existential threat to the European Union itself. Migration needs to be recognised as a major policy issue that will play a critical role in shaping the EU's future and it is definitely an issue that should not be underestimated. We have seen last fortnight's election results in Berlin and three weeks ago in the German Chancellor's own constituency (Mecklenburg-Vorpommern) with the anti-immigration, right-wing (AfD) party gaining significant ground. It is urgent to tackle the migrant crisis and the linked labour mobility issue.

I am particularly worried about recent developments in Turkey following the attempted coup and the impact this will have on the migrant crisis, as a major challenge for the EU's future. Against the backdrop of an escalating migrant crisis, the UN Declaration adopted two weeks ago in New York which calls for a more equitable sharing of the burden for hosting the world's migrants and refugees becomes even more relevant. Take, for instance, the recent EU deal with Turkey, which has promised to accept migrants back to its territory in exchange for financial aid. That was based on a premise that Turkey was a safe country for refugees. Lots of international analysts cast doubts on this after the latest bout of political instability and the heavy crack-down on suspected dissidents in the military, the judiciary and even higher-education in our neighbouring country.

Point number 5: The British reform benchmark to be followed by South-eastern Europe

Despite Brexit, the UK could be used as a reform benchmark by South-eastern European states to be emulated in a number of ways. According to the OECD, the UK has the least regulated labour market and is second to the Netherlands as the least regulated product market in Europe. The UK also has low taxation (a corporate tax rate of 20% and there is speculation that this will go down to 15% as an incentive to foreign firms to stay in Britain after Brexit).

South European countries would stand to gain a lot by starting to resemble Britain in a number of areas, including the attraction of FDI, public sector accounting, transparency, rule of law and strong institutions including an efficient public administration plus credible government financial management. This should be the agenda for the whole of South Europe in the years to come, with or without adjustment programmes, namely using the UK as a benchmark, except one thing: Brexit!

2. IMPLICATIONS OF BREXIT FOR CENTRAL BANKS[1]

a. Less (?) monetary policy divergence

The Brexit vote triggered a broad-based reassessment of the future path of monetary policy globally. With improving headline growth still perceived as fragile in most advanced economies, and inflation still persistently low, the distinct response from major central banks to the Brexit uncertainty can be described as dovish: policy rates would stay “low for longer”. The Bank of England cut the policy rate by 25 basis points (it is now 0.25%), and expanded the government bond purchase scheme by £60 billion, bringing the total to £435 billion. It also established a new corporate bond purchase program of £10 billion, and launched a new Term Funding Scheme that will provide funding for banks at rates close to the monetary policy rate. Forward interest rates for December 2017 quickly dropped to the new level of the policy rate, reflecting the view that a quick policy reversal was not expected.

Following the Brexit shock in the US, a 2016 rate rise is not fully priced in the market with the implied probability of a Fed rate hike in December 2016 to be around 55% today. The Bank of Japan in its last policy meeting launched a novel kind of monetary easing as it set a cap on 10-year bond yields and vowed to take action to overshoot its 2% inflation target. Its decision demonstrates that central bankers are still willing to experiment with new monetary policy ideas, as inflation remains too low. Some observers characterised this shift as probably the biggest innovation in monetary policy since the introduction of negative deposit rates by the Danish central bank in the summer of 2012!

Finally, at its latest GC meeting, the European Central Bank (ECB) announced that it will extend its QE programme beyond March 2017 if needed.

So far, there is some encouraging evidence from the ECB’s ongoing QE programme. In more detail: Loan growth continued to recover gradually. Lending to companies grew by 1.9% year-o-year, while household lending grew by 1.8%. A significant improvement has also been observed in Eurosystem banks’ composite cost of debt financing, which declined in July to a new historical low, after broadly stabilising in the second quarter of 2016. Also, banks reported a further net easing of credit standards on loans to enterprises in the second quarter of 2016, suggesting a continued improvement in financing conditions for corporate loans. Across the largest euro area countries, overall terms and conditions eased across all larger countries except for Germany. In most of the large euro area countries, in particular, France and Italy, banks continued to report a narrowing of margins on average loans in net terms. Margins on riskier loans widened in net terms in Spain and Germany. Furthermore, composite lending rates on loans to euro area NFCs (corporate loans) and households (i.e. mortgages) fell by around 100 basis points. The reduction in bank lending rates was especially strong in vulnerable euro area countries, indicating reducing fragmentation in euro area financial markets. Over the same period, the spread between interest rates charged on very small loans (loans of up to €0.25 million) and those charged on large loans (loans of above €1 million) in the euro area followed a downward trend. This indicates that small- and medium-sized enterprises have generally been benefiting to a greater extent than large companies from the decline in lending rates.

b. QE vs. negative rates

Staying in the eurozone and taking as a given fact that we will move towards more accommodative monetary policy in the months ahead, a more open question is: which policy instrument will be used? More QE or further negative rates? This is the essence of the monetary policy debate in the eurozone today.

Clearly, there are limits to persistent negative rates, namely the underlying question is how far and for how long they can actually go. There are a number of concerns including banks’ profitability, how negative rates may act as an anaesthetic to euro area governments especially in the euro area’s southern periphery, taking into account that the fiscal space gained from lower debt service costs may result in a slower implementation of necessary fiscal and structural reforms.

Policy rate cuts to negative levels have generally been reflected in corresponding declines in money market rates and short-term government bond yield. In turn, the fall in bank wholesale funding costs has helped lower lending rates, but to varying degrees across countries. In addition, there are concerns about the political and institutional feasibility of negative rates as their long-term effects are still unknown. Most importantly, their effectiveness is put under question during a recession, if this were to emerge in the near future.

I would personally, in my professorial hat, prefer to see more QE rather than further negative rates. If this is the case, the next question is where could more QE in the eurozone come from? In other words, does the ECB have the tools for more QE stimulus?

Well, there are several options. From changing the parameters of the current QE programme like, for instance, buying bonds below the deposit rate, increasing the 33% issue share limit, dropping the capital key allocation, or even adding new securities to the pool of eligible assets such as bank bonds or equity.

c. The limits of central bank actions: a role for governments?

In closing, it is worth reminding the words of President Mario Draghi , who said recently: “[low interest rates]… are not the problem. They are the symptom of an underlying problem, which is insufficient investment demand, across the world, to absorb all the savings available in the economy.” Along the lines of the previous caveat by President Draghi, one could add, for instance, that in countries with fiscal space, and/or at a eurozone-wide level, extra spending on infrastructure investment especially in today’s environment of extremely low long-term rates would clearly increase low demand in the eurozone, enhance its potential trend growth rate, make the task of monetary policy much easier and finally contribute to public debt sustainability in many countries. In other words, the time has come to use policy tools other than monetary policy, including fiscal and structural ones.

Thank you very much for your attention.

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[1] A more detailed account on this can be found in my HABA-New York speech (October 2016).