Joachim Wuermeling: How stable is Europe? Taking stock of the latest developments in politics and the financial markets

Speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the American Council on Germany, New York City , 4 May 2017.

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1. Introduction

Ladies and gentlemen

Ten years ago, back in spring 2007, the US subprime bubble was bursting. In May 2007, there were some early signs foretelling the escalation of the crisis in summer 2007.

Many of us remember August 2007, when interbank interest rates skyrocketed and money markets dried out. It was at this time that the crisis spilled over from the subprime mortgage sector to the money markets, with the Lehman bankruptcy in September 2008 marking the start of the banking crisis.

Back in those days, some in Europe tended to take the high ground. In 2007, ten years ago, the situation in the European financial sector appeared to be generally stable. Many in Europe were shaking their heads about the imprudence that had led to the emergence of the US subprime bubble.

While the impact of the US financial crisis started to subside from 2009 onwards, this was precisely the point at which the euro crisis took hold. The belief that the crisis could be avoided in Europe proved premature.

The negative economic impact of the euro crisis is certainly one of the key reasons why Europe is facing serious headwinds to its most ambitious project: European integration. Populism has reached worrying levels and is accompanied by growing scepticism towards many forms of transnational cooperation. I should point out, by the way, that this is not solely a European phenomenon.

In my speech today, I would like to touch upon the economic outlook for Europe and what it may imply for monetary policy. I'm also going to shed some light on recent political developments and share my views on Brexit.

2. Economic outlook and monetary policy

The euro area is in fairly good economic shape. Last year, macroeconomic growth rates were positive in all euro area countries except Greece. With a growth rate of 1.7%, GDP in the euro area rose more quickly than production capacity last year; the output gap is gradually closing. The latest growth projections for the coming years are promising as well. In March, the Eurosystem slightly upgraded its expectations for economic recovery in the euro area: real GDP is now expected to grow by 1.8% this year, 1.7% next year and 1.6% in 2019.

Unemployment has been falling in many euro area countries. In the euro area as a whole, the unemployment rate is now less than 1 percentage point above its average in the pre-crisis years after declining to 9.6% last year.

The economic upswing and improved employment data in the euro area are likely to drive up price pressures gradually. Inflation rose more sharply at the start of the year than anticipated in the December projection. In February, HICP hit a four-year high of 2.0%. However, this increase was largely attributable to base effects and higher energy prices. On Friday, Eurostat published its most recent estimate: the inflation rate is expected to hit 1.9% in April. Meanwhile, core inflation is currently estimated at 1.2%. According to the March forecasts, it will slowly increase as the euro area's economic recovery continues. It is expected to reach 1.8% at the end of the forecast horizon in 2019.

Considering these numbers, an accommodative monetary policy remains appropriate. It goes without saying that opinions differ with respect to the right degree of monetary accommodation. Of course, views also vary regarding the point in time at which the price outlook will have firmed enough to justify a change in communication and, ultimately, in the monetary policy stance. Let me share three thoughts on this issue.

First, the Bundesbank has always been critical of government bond purchases by the Eurosystem central banks as they lead to a dangerous commingling of monetary and fiscal policy.

Second, as inflation has increased, the real interest rate has declined even further. The effects are comparable to a central bank rate cut. Hence, monetary conditions in the euro area will be looser even without any further central bank action.

Third, the risk of a deflation scenario in the euro area is extremely low. Financial market participants seem to have a similar take on it: according to the respondents to the Survey of Professional Forecasters, the probability of the inflation rate turning negative in the next five years is in the region of only 2%.

Against the backdrop of robust growth and inflation rates, public discussion regarding an exit from the ultra-loose monetary policy has already started. That said, as you might already expect, I did not come to New York to comment on the timing of the exit. It's up to the ECB Governing Council to decide when and how such an exit will take place.

I do, however, want to shed some light on the issue of which operational options will be available to the Eurosystem when the Governing Council decides that the time to exit has come. A key factor in this context is the sequence of actions by which the normalisation of monetary policy will be achieved – by first increasing the interest rate level or by scaling back non-standard monetary policy operations. The latter would be reflected in the balance sheet more directly.

This issue might sound very familiar to you – the Federal Reserve System was confronted with a similar issue a while ago. It stopped buying large quantities of assets in October 2014 and, since then, it has kept the size of its balance sheet constant, buying just enough to replace maturing securities. The Fed has stated that it will not begin shrinking the central bank's balance sheet until normalisation of the federal funds rate is well underway.

As for the Eurosystem, the ECB Governing Council is to decide upon the sequencing of such measures. From an operational point of view, I believe that neither increasing our set of interest rates nor abandoning individual non-standard monetary policy measures presents special challenges.

We do have to consider, though, that the Eurosystem has introduced a considerable number of non-standard measures since 2007 – the expanded asset purchase programme is the most recent and the largest measure so far. But other measures, such as the fixed rate full allotment policy, targeted longer-term refinancing operations and the reduced requirements for eligible collateral – to name just a few – have played important roles as well.

The comprehensive package of non-standard measures has a highly expansionary impact when viewed as a whole. Doing away with any one single measure would leave the impact of the remaining measures unaffected; in other words, the monetary policy stance would not become restrictive, simply less expansionary.

Please do not ask me when the time to normalise will come. As I have already mentioned, this decision will be made by the Governing Council. However, in my view, it is important to signal the financial markets, sooner rather than later, of the steps that are likely to be considered in connection with the asset purchase programme in 2018 – this goes beyond the calendar-based forward guidance that has already been provided up to December 2017.

I believe that, when the time to exit arrives, there will be a gradual and prudent scaling-back of non-standard monetary policy operations. It’s hard to imagine any other approach if we want to avoid market tensions. But even if non-standard measures were to be brought to an end earlier or at a quicker pace than expected, there would still be a considerable amount of excess liquidity in the system for quite some time. This will hold, in particular, for as long as the targeted longer-term refinancing operations are outstanding (which is until 2021) and the reinvestment policy adopted under the asset purchase programme is maintained.

Of course, the Eurosystem could decide at a certain point in time to absorb excess liquidity by means of targeted liquidity-absorbing operations – if, for instance, it is deemed necessary to steer money market rates to values considerably above the ECB deposit rate. Let me make two last comments.

First, I advise market participants in the euro area to be prepared for the considerations I just discussed – both operationally and from a balance sheet perspective.

Second, I believe that, from an economic as well as from an operational point of view, there is no predetermined order when it comes to scaling back non-standard measures. But, as I have mentioned before, the Bundesbank has always been rather critical of euro area government bond purchases as they blur the distinction between monetary and fiscal policy. In my view, the intended effects of these purchases are diminishing over time due to the rise in the unwanted side effects arising as a result. Thus, ending the public sector purchase programme would certainly be in our sights once the Governing Council decides that the time to exit has come.

3. 2017: an important election year

The markets are not only focussing on the monetary decisions to come. In 2017 and over the course of 2016 as well, public attention has been shifting from one election to another throughout the western world. In a way, this is a healthy development: markets had been moving politics since 2008. It appears, however, that 2016 was the first year in which politics moved the markets again.

Following the Brexit referendum, the US elections and the referendum in Italy in 2016, 2017 is being, and will continue to be, shaped by elections in Europe. There will be elections in Norway and the UK, but neither is key to the cohesion of the European Union. In terms of Brexit, it currently seems that we no longer need to discuss if, but rather how, the UK will leave the Union.

Far more interesting will be the elections in those countries which, for many observers, are regarded as core countries of European unification. We saw the outcomes of the elections in the Netherlands in March. We are currently awaiting the second round of the French presidential election. In Germany, two important state elections will be held in May 2017 and the federal election in September 2017. At the moment, we can observe a swing in the voters’ mood. We have seen a rise in the success of populism in recent years, culminating in the astonishing decisions of 2016 and their aftermath. But the popularity of political populism now appears to be waning, and was not successful for example in case of the Netherlands.

4. Brexit: a chance to refocus on European strength

Given the UK government's formal declaration to withdraw from the European Union, Brexit has now entered a new and decisive phase. This applies, in particular, to the future role of the UK's financial sector as the financial hub of continental Europe.

At the current stage of negotiations, nobody knows what form any future interdependencies will take. While the UK's withdrawal from EU is highly regrettable, its exit could be associated with the substantial loss of rights to conduct business in the European Union.

Most people agree that London's major role as financial capital cannot be replaced within a short timeframe. However, some argue that the uncertainty surrounding Brexit will lead to a substantial shift of banking services out of London. This relocation of sensitive and important infrastructures needs careful planning. Hence, market participants will most likely not postpone decisions until the negotiations between the EU Commission and the UK have been finalised.

I do not expect that Brexit will have negative repercussions for the financial centres in continental Europe. Given the economic weight of the world's largest common market, home to 500 million citizens, and the importance of banks for businesses in the euro area, there might even be a net positive effect for the financial centres in the EU.

Incidentally, you may have noticed that a lively competition between financial capitals in the EU has started. In the wake of Brexit, it is becoming ever-clearer that at least some business may have to move to continental Europe. Some of you have already made, or are about to make, decisions on where to relocate your business in the EU. I am convinced that, in the years to come, an even closer network of European capital marketplaces – maybe with the centre of gravity in Frankfurt – will provide added value to global financial markets. All capital marketplaces together linked by a strong single currency, a balanced European legal framework and a profitable and resilient financial industry in a capital markets union will be of increased global relevance.

Let me share another thought with you: the British referendum – and the refugee crisis – were a wake-up call to work harder on convincing ideas for the future design of the European Union and for the division of labour between the European Union and its member states. Recent developments have made it very clear to everyone that we need to put more effort into creating a realistic vision for Europe that its citizens will support.

Discussions on the future set-up of intra-European relationships and the relationships with our partners abroad have been gaining momentum recently. This debate will help to improve the architecture of Europe. People currently appear to be rediscovering the advantages of close political ties and of an integrated economic area with a common currency. If the member states work in concert, the European Union can act as a major economic player and will be in a better position to influence further globalisation.

Today, there appears to be no majority for deeper European integration. There is a belief, however, that we should consolidate our achievements and improve the finer points. It is necessary to reflect on how we benefit from Europe, the European Union and the euro.

For many EU citizens, the 60th anniversary of the European Union as a peace project was a chance to express their support for a democratic European Union. For the first time in years, we are now seeing demonstrations in favour of the European Union and not against the "bureaucracy in Brussels". Frankfurt marks the epicentre of a movement called the Pulse of Europe, as part of which citizens are gathering on a weekly basis and expressing their belief in the fundamental idea of the European Union and its ability to be reformed. This movement is intended as a countermovement to the negative and destructive voices that are often heard in public. The Pulse of Europe has spread to other German and European cities.

During my years in the European Parliament, I learned that Europe has never been an easy issue. Quite the contrary, it is a complicated and demanding project. But I am convinced that it is a project worth fighting for. Thus, I believe the European declaration of Rome is right when it says: “We have united for the better. Europe is our common future."

Thank you for your attention.