Andreas Dombret: Between integration and reform - current developments in the euro area and Germany

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bombay Stock Exchange (BSE), Mumbai, 31 October 2017.

* * *

1. Introduction: Quo vadis Europe?

Mr Chauhan

Mr Steinrücke

Ladies and gentlemen

It gives me great pleasure to be back in Mumbai, and it is an honour to be speaking at the Bombay Stock Exchange.

The Bombay Stock Exchange is prospering, with its BSE Sensex reaching all-time highs, beyond 33.000 points. I am hopeful that this is a sign of India's economy growing in a strong and broad fashion in the future, after some recent setbacks.

Talking about economic setbacks and recoveries: I have been asked to talk about the economic situation in the euro area and in Germany. I am happy to do so, and will also take the opportunity to discuss their economic future in light of the current political situation.

Wherever I go these days, people ask me: Where is Europe heading? Will the EU recover? Or will it eventually break up? Brexit and the rise of populism have raised doubts about the Union's future.

In this debate, one side is calling for the EU to disintegrate substantially, or at least to go not any further with integration. In the other corner are EU proponents. They think that the answer to the political and economic problems is more integration, not less.

I think both views are not balanced enough. Neither more, nor less integration are per se solutions to the problems that Europe is facing. We must instead take a closer look at the problems at hand and solve them with problem-oriented reforms.

In my talk, I will explain to you that the economies of both Germany and the euro area are currently doing quite well. Yet I will highlight the fact that important fundamental problems have not been dealt with either at all or at least not sufficiently. I will argue that this is an important explanation for the current political troubles in the EU. To counter these political tensions, we need problem-oriented reforms in the euro area as well as in the individual member states. I will outline important directions for such reforms.

2. The German and euro area economy: Better…

Let's start with the current economic situation in the euro area. Until recently, despite extensive monetary easing, the pace of recovery since the financial crisis has been disappointing. Lately, however, there have been clear signs of a broad economic recovery.

Recent figures show a sound GDP growth of 0.6% for the second quarter of 2017. Unemployment stood at 9.1% in July, well down from its peak of 12.1% in 2013.

Moreover, both the IMF and the ECB staff have recently upped their growth expectations for the euro area.[1]

At the same time, the healthy upswing of the German economy is continuing: 2017 will be the fourth consecutive year of GDPgrowth outpacing potential output.

Growth has gained further momentum and the upswing has become more broadly based. Thus far, the major drivers have been consumption and housing investment. Recently, industrial activity, exports and business investment have also made significant contributions to growth.

Looking ahead, the very high level of confidence among firms and households suggests that the upswing will continue not only into the second quarter of 2017, but also beyond.

A very positive effect of the economic upswing has been the substantial reduction in unemployment.

3. …but not yet good

With regard to the Euro area as a whole, however, a recent study has shown that the labour market is in worse shape than the official job figures suggest, with workers unlikely to see real increases in pay because of the level of underemployment.[2] A measure of "slack" in the labour market indicates that about 15% to 18% of the euro area workforce are without jobs or would like to work more – which is nearly double the official unemployment rate. Underemployment is even growing further in weaker labour markets, such as those in France and Italy.

The still weak labour market in many regions of the euro area is one of the most severe ongoing repercussions of the recent financial crisis and an indication that the recovery is not yet strong enough. This is particularly true with respect to the high level of underemployment among young people and in peripheral regions.

Thus, while the euro area economy looks increasingly healthy on average, it becomes clear on closer inspection that a lot still remains to be done to move onto a sustainable, integrative path of prosperity.

This is also one of the reasons why populist extremists are still making electoral gains.

4. The political landscape: More populism in sight?

When we look at the German general election five weeks ago, however, although a populist party came in third, things need a more differentiated explanation – only half of the populist supporters were economically disaffected. I will come to that in a moment.

In my eyes, though, the positive outcome is one of government stability: Chancellor Merkel's conservative Union has remained the largest force in parliament.

But she faces the difficult task of forming what has been dubbed the Jamaica coalition with the business-friendly Free Democratic Party and the Green party. The negotiations have just begun and are challenging. But I am confident that an agreement can be reached and that German political stability will stay intact. And that the German economy's strong growth momentum will also remain intact, which, in turn, will be a strong basis for continued growth of the euro area economy.

Yet this election reveals a deeper, inconvenient truth – that people are not convinced that politicians have found sustainable solutions for longer-term social cohesion. This is mirrored in the first far-right party entering the Bundestag since 1949: Alternative for Germany, or AfD for short. It is now the third-biggest party in the Bundestag, having received almost 13% of the popular vote.

About half of the party's voters are economically disaffected – people without jobs, people with declining real income and people fearing future losses.

This is the economic side of why protectionism and populism have enjoyed support in Germany. The AfD, like many other populist parties, blames the economic malaise on globalisation and European integration – and are demanding that they be reversed.

These simple explanations offer intuitively appealing solutions to Europe's problems. But they overshadow the mid-term economic challenges, which need to be tackled urgently, however.

If we do not solve these mid-term challenges, populist influence might well grow – and that would put global and European cooperation at risk. These unresolved problems could become the roots of serious political conflict.

Can this really become such a problem? I have one word for that: Brexit.

In June 2016, UK voters decided to leave the EU – they had been told that they would be able to save their money and put it to better use, and that they could once again control their destiny in the global economy, all without any negative consequences. Unfortunately, the campaign was built on false anti-EUinformation. These intuitively appealing anti-European sentiments did find support – to a substantial degree – among economically disaffected citizens.

Where are we now? Brexit is definitely happening, and it is more and more likely to be a hard one – by which I mean that there will be a complete exit rather than a partial one. The UK and the EUwill go their separate ways in March 2019. After we agree on how to separate, we will start to negotiate the terms of our future partnership. At the moment, it is possible that we could start this second phase in December of this year – this is the guidance of the EU Council, but for it to happen substantial progress has yet to be made on several fundamental issues such as the rights of EUcitizens in the UK after Brexit.

Since negotiations have been going rather slowly, there may be a transition period of two years from 2019 to 2021 – during which the old rules would still apply and the terms of the new partnership could be implemented. What kind of economic partnership this will be has yet to be determined. If we do not find a solution, the EU and the UK will trade under rules set by the World Trade Organization – which is in nobody's interest, but could be particularly harmful to the UK economy. I hope that all parties involved will be able to negotiate an economic partnership that underscores the close political amity between the UK and the EU.

5. Neither less, nor more – but better: Reforms are needed

Brexit shows that less integration is not the solution to the root causes of our economic problems.

But a simple case of more integration is not a solution either.

One thing should be put first: The EU appears stronger today than it did a year ago. This was reflected by Commission President Jean-Claude Juncker's State of the Union address on the 13th of September, and in French President Emmanuel Macron's plan to reform the EU, as set out in his speech on the 26th of September. I agree with them that a strong EU is in the best interest of all Europeans and that it can play an important role in international relations. More integration may thus be warranted.

But I think that we should get the order right: first reform, then the next steps towards more integration.

This is especially true with regard to the European monetary union. The euro area will remain vulnerable, as long as its fundamental stumbling block remains unchanged: its asymmetric institutional design. Member states surrendered sovereignty in monetary policy matters to the ECB, but retained ownership of their fiscal and economic policies.

This creates two big challenges: first, a common monetary policy for economies that are at different developmental stages – like France and Greece – and at different stages of the business cycle. Second, the moral hazard that arises when governments borrow too much in order to take advantage of lowered interest rates as a result of averaging in the currency union.

We need solutions to both problems. For the first, no simple, realistic solution is available. The economic convergence of the euro area will take time. Far-reaching structural reforms need to be undertaken in countries in order to narrow the gap to the best-performers with respect to competitiveness.

The second problem – excessive borrowing by governments – could, in theory be much more easily solved. However, the necessary political reforms have made little progress so far.

Formally, the EU has a set of fiscal rules that restrict public lending – the Stability and Growth Pact. Yet these were regularly violated before the financial crisis, without any meaningful consequences. In response, the EU reformed it, but the discretionary scope was actually expanded even further.

The European Commission, albeit foreseen as the guardian of the Stability and Growth Pact, has already exploited scope on several occasions and invariably interpreted the rules very generously in doing so. Some euro-area countries have been breaching the rules for nine years now.

What is needed to strengthen the fiscal rules is a simple and transparent design and implementation of the rules.[3] An independent institution taking over responsibility for fiscal surveillance from the Commission would be a key step towards a less political approach. One promising way would be to strengthen the role of the European Stability Mechanism (ESM) in fiscal surveillance.

However, if member states retain their fiscal autonomy, the sustainability of public finances needs further safeguards than rules alone.

It is therefore essential that the binding force of the rules be additionally shored up by the disciplining effect of the market. In other words, interest rate levels and thus financing costs have to be realigned more closely with the risks in government budgets.

For this essential function of a modern market economy, we need investors and stock exchanges such as the Bombay Stock Exchange, as they are the economic equivalent of political checks and balances.

The only way to achieve that, however, is to give the no bail-out clause in the Maastricht Treaty more credibility again. Investors have to perceive a more credible threat of losing money if they buy bonds from governments that have unsound public finances. One proposal put forward by the Bundesbank thus envisages changing the contractual terms for sovereign bonds in the euro area by introducing an automatic maturity extension for them as soon as the issuing government applies for an ESM programme.

Up to now, a large part of the assistance loans have ended up being used to pay off the original creditors. This means that the original creditors, such as banks, are then let off the hook – at the expense of taxpayers.

In contrast, extending maturities would leave them on the hook, and they could still be held liable if a later debt restructuring were necessary.

To sum up: Neither less nor more integration at any price is a panacea for the problems in our economies.

And that is why, not only the euro area, but also the member states have to tackle reforms sooner rather than later.

Let me focus on the German case, and point to two challenges: first, we need to face our demographic challenges ahead; second, we need to ensure that those who lose out from globalisation and digitisation are compensated.

One major challenge for the German economy is the foreseeable ageing and shrinking of the domestic population and its impact on potential output growth in the medium term.

In view of the shrinking domestic labour force, it can be assumed that Germany's potential growth will drop below one percent in the next decade.

We need to mitigate this effect by encouraging more women and older people to participate in the labour force. What's more, we will probably be forced to think about raising the statutory retirement age.

A second important task is that we need a fairer market economy – to encounter the fears of people moving down to a lower layer of societal strand.

We need to strike the right balance between two types of policies: those that foster the competitive dynamics of market economies, and those that ensure the social cohesion that is necessary for market economies and indispensable to democratic societies.

The most obvious tools are fiscal policy instruments that serve to strengthen the social security system, which provides financial compensation to individuals such as those who are unemployed.

At least as important as the provision of financial compensation is making sure that people are capable of helping themselves. To that end, we need better education and higher qualifications: countries need to promote equal access to high-quality primary, secondary and tertiary education. What is crucial to educational success in 5 to 50 years is that we increase public spending on qualified personnel. Moreover, active labour market policies shall support the jobless in their efforts to qualify for other professions.

6. Conclusion

Ladies and gentlemen

The euro area's economy has made it through the rain and is now under relative sunny skies. Yet clouds still hover over the less-than-complete recovery – a lot remains to be done.

The Germany economy, on the other hand, has been in the sun for quite some time now, and even the short term outlook is quite promising. Yet, serious medium-term risks loom.

A vital euro area requires more reform: The monetary union must be reformed – but it is not a matter of simply more – or less – European integration. Instead we need problem-oriented reforms of its institutional design.

Moreover, member states must embrace reform. For example, Germany has to face the demographic challenges, and its economic policy has to strike the right balance between fostering the competitive dynamics of market economies and ensuring the social cohesion that is necessary for democracies.

I am confident that this is possible – but policymakers have to take their responsibility to reform very serious.

Thank you for your attention.

---

[1] GDP projection by IMF: 2017: 2.1% (+0.2 pp); 2018: 1.9% (+0.2 pp); GDP projection by ECB staff; 2017: 2.2% (+0.3 pp); 2018: 1.8% (+0.0 pp); 2019: 1.7% (+0.0 pp).

[2] European Central Bank (2017), Assessing labour market slack. ECB Economic Bulletin 2017 (3): 31–35.

[3] Deutsche Bundesbank (2017), Design and implementation of the European fiscal rules, Monthly Report, June 2017