Andreas Dombret: We can work it out – or can we? Current challenges in Brexit talks

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at an event of the Atlantik-Brücke at the Travellers Club, London, 8 November 2017.

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1 Introduction

Ladies and gentlemen,

It's a great pleasure to be with you in London, which for me has always been the embodiment of both British and international spirit.

Just a few miles from this building, 52 years ago, on 20 October 1965, the Beatles recorded their hit "We Can Work It Out" at EMI Studios, later renamed Abbey Road Studios.

This song is about the difficulties in repairing a damaged relationship. The legend goes that Paul McCartney delivered the up-beat mood, concentrating on the possibility to work it out – before John Lennon added the rather sceptical voice. Thus, the attitude of the song swings from positive to negative. To me, this clash of messages describes the current state of the Brexit talks better than anything else.

Currently everyone is asking whether the EU and the UK can work it out. Yet, in a way, it's too late: the train has already left the station. The UK will leave the EU, and that will include a full-blown exit from the single market and the customs union.

But on another level, we can still work it out, as we can still find an agreement that achieves the two big goals: a stable and friendly political alliance as the foundation for close cooperation in foreign and security matters, and economic cooperation that allows for an efficient division of labour and trade.

From an economic point of view, the question then is: can we still work out a deal of close cooperation with little in the way of friction? Or will we break up entirely and trade on quite prohibitive terms?

I remain optimistic that we can achieve a good deal for both sides, and I remain committed to this outcome. But what does that mean?

For me it means two things. First, there is no need to panic: even the worst-case scenario is manageable from an economic viewpoint. Yet, it will have serious effects on our economic process.

Thus, and this is the second point, if we want a strong economic partnership that's based on a sound political partnership going forward, both politicians will need to work out the best possible terms for economic cooperation; and businesses have to prepare meticulously.

Today I will talk about the current challenges on the road ahead. I will begin by outlining the consequences of Brexit and explain why a disorderly Brexit may mean substantial losses for the UK. The disorderly exit, as I will go on to show, is unfortunately not that improbable given the difficult current state of negotiations. That's why firms and politicians must prepare for a disorderly exit, too. I will focus on the financial sector to highlight what that means. Nevertheless, I will close with an optimistic outlook on the terms of our future cooperation

2 What if we don't work it out?

But, first let's take a look at what's at stake. What are the economic consequences if we don't work it out?

Well, economic impact analysis is anything but an exact science, but we can sketch some likely scenarios. Seeing the writing on the wall, the UK government has apparently begun to realise that a hard – that is, a disorderly – Brexit without a new agreement would have serious repercussions for the UK economy.

This impact will come via two main channels. The first is the trade and investment channel. Exporters will lose out as a result of the restricted access to the single market, and supply chains may suffer substantially.

The second channel is the migration channel. The UK's access to highly skilled workers from abroad could take a severe hit. I recognize that migration has played a big role in the Brexit vote – but, especially today a failure to attract highly-skilled workers via migration could have a detrimental impact on future UK growth.

The economic impact on Europe will be limited by comparison. Take Germany for instance. The UK is an important export market, accounting for 7% of German exports. But that's only 2% of value added to the German GDP. Therefore, Brexit will most likely not result in a major setback for the German economy. Bundesbank simulations confirm that even a hard, disorderly Brexit would be manageable from Germany's viewpoint.

To sum up: the costs of Brexit will most likely be much higher for the UK than for the remaining EU, though a disorderly exit would, without doubt, substantially disrupt economic cooperation on both sides – just think of the transnational supply chains.

And these consequences were not transparent to those who voted to leave the EU. In contrast, many voters held the EU responsible for wage stagnation, job loss, precarious job conditions or a lack of rural development. In the end, they protested by voting to leave the EU.

The frustrating thing is that the UK's exit from the EU will not help to overcome these issues. In fact, economic disintegration may even worsen the situation. That's why national policies on both the European continent and in the UK as well as EU-27 policies must take those who have lost out through economic change seriously and find tangible – not emotional – solutions.

3 Can we still work it out?

This will be a challenge that runs in parallel to the Brexit negotiations, and it is likely to be a long-term challenge. At the moment, it also looks as if the Brexit negotiations are going to be a drawn-out, very long-term process – progress so far has been quite disappointing.

In June this year, the EU and the UK agreed to settle the divorce arrangements first, before entering into talks about the future relationship. These issues are the divorce bill in respect of the UK's outstanding liabilities, the future status of EU citizens living in the UK and vice versa, and the border between the Republic of Ireland and Northern Ireland. Yet, to this day progress on the three issues has been thin on the ground – they are far from being settled.

The only logical consequence following the EU summit three weeks ago was to conclude that progress was insufficient to embark on the second phase of negotiations. The EU-27 leaders were united in their assessment that talks about the future relationship – that is a free-trade agreement and a transition period – could not yet be started.

In addition, however, they chose a far-sighted communications strategy. They made clear that the questions surrounding the divorce – while showing disappointing progress – were actually quite solvable and that talks about the future relationship could be initiated as soon as December, at the next EU summit. This is far-sighted because it strengthens Prime Minister May's quite difficult position at home, where she has to tread a fine line between the extreme camps of the "leave-now-without-any-deal" Brexiteers and the "remain-as-close-as-economically-possible" supporters.

But we have to be careful, as there may be a hint of method in the UK's political turmoil. As we know from international negotiation theory, a leader can use domestic dispute as a negotiation resource, arguing that she cannot move any further because she has no room for manoeuvre at home. That's why it was necessary for EU leaders to call for the UK to deliver soon in order to move on to phase two in December.

In sum, then, the state of negotiations has to be taken seriously – but there is no reason to panic. Why not?, you may ask, as the outlook seems quite dramatic.

There are two reasons. First, the process we are witnessing is not that unusual for complex political negotiations – they take time, and in the beginning both sides typically weigh up their options and their opponents first. Thus, it is often the case in such negotiations that concrete results only become visible shortly before the deadline.

That it takes time is also quite sensible, seeing as a lot is at stake. The decisions taken will influence UK-EU relations for decades; moreover, they will have a lasting impact on global supply chains and geopolitical constellations.

The second reason why we need to keep calm is that the UK government is apparently ready to compromise. While Prime Minister May's speech in January was widely perceived as indicating a hard Brexit – (quote) "No deal is better than a bad deal" (unquote) – her tone and stance have softened in the meantime. This was clearly signalled in her Florence speech.

We now know that the UK government aims to strike an ambitious free-trade deal and reach a customs agreement. In exchange, they are prepared to offer permanent residence for EU citizens and a clear budgetary commitment regarding their liabilities.

Overall, therefore, the chances of reaching a deal might be better than they appear at the moment.

4 Hope for the best, but prepare for the worst

Given this calm assessment of mine, some may conclude that firms could simply sit back and wait. Nothing could be farther from the truth. Let me explain why, by focusing on the financial services sector. What will the impact of Brexit be on financial institutions?

Financial institutions should prepare for the worst case – that is, a "no deal" scenario – with a disorderly exit of the UK in March 2019.

As daunting as it seems, this "no deal" scenario is – if we take a positive view – luckily, quite clear; there will be no surprises. WTO rules will apply, as the UK will be a third country. With regard to banking, the relevant EU regulations and directives will necessitate a licence from an EU supervisor.

Therefore, banks are well able to prepare for this scenario and so make the worst case manageable. The necessary preparations certainly mean costs and a heavy administrative burden for banks, and they are complex and time-consuming.

Yet, despite these costs, it would be irresponsible to speculate on one particular outcome of the talks – such as a possible transition period – and adopt a wait-and-see strategy based on that educated guess.

Let me be crystal-clear. Preparations should already be well underway; if not, they must start now! Banks must establish at least basic entities in the EU – and, vice versa, in the UK – before it's too late. In many cases, that means applying for new licences and a great deal of paperwork.

While I am concerned about the state of preparations at some banks, I am at least as worried about the current position at other firms. For them, the pressure to prepare for the worst – and to do so now – may be even greater.

As I said, the "no-deal" scenario represents an event with clear terms – with no hidden surprises – but, of course, there will be no surprises only if a company thinks this scenario through and asks itself: how would it affect us, our customer relations, our product offerings, our supply chains, and in terms of regulatory approval, and so on?

Think of it as a Brexit stress test. If – and only if – you prepare meticulously, you won't be caught out by the "no deal" scenario. So, the motto must be: Hope for the best, but prepare for the worst. The potential repercussions of inaction are huge. Firms have to act now!

5 Friends after the break-up? Terms of future cooperation

Supervisors are playing their part to support preparations. We are taking a strict, yet at the same time pragmatic approach. What do I mean by that?

Our aim is to make the transition as smooth as possible. We are providing a clear point of contact for banks, explaining our supervisory approach and offering guidance with the licensing.

Here is one example: when EU supervisors examine a bank's internal model used to calculate regulatory capital requirements, they could proceed – for the time being – from the findings of the Prudential Regulatory Authority. Similarly, the PRA could build on the verdict of the EU's Single Supervisory Mechanism. For that to be viable, both the PRA and the ECB or the Bundesbank would need detailed information on each other's decisions. Close, responsible cooperation would have to be in place between supervisors.

But no bank should put its money on supervisors' mercy. We take our mandate seriously – there will be no blank cheques. We will not accept shell corporations – we will license only if banks build risk-appropriate risk management functions in the EU.

That's why it would be so important to work towards a meaningful free-trade agreement that integrates services in a pragmatic manner. There could be an agreement that safeguards a high regulatory standard without imposing undue processes. But first, negotiations would have to move to the second phase.

6 Conclusion

Ladies and gentlemen, I am optimistic that we still can achieve an orderly Brexit, with a solid future relationship between the EU and the UK.

However, the current negotiations must gain in speed – if the British government can find a constructive approach that unites the country and enables progress on the divorce issues, we might see substantial acceleration.

But even then, it remains a highly challenging undertaking to reach an agreement in a timely manner. And let us not forget that a disorderly exit will remain an option until the very end.