Andreas Dombret: What's going on in Europe?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Hong Kong Monetary Authority, Hong Kong, 16 January 2018.

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1. Introduction

Dear Norman Chan

dear Eddie Yue

dear colleagues

It’s a pleasure for me to be invited back to the Hong Kong Monetary Authority. I value very highly the excellent cooperation, not only between the Hong Kong Monetary Authority and the Bundesbank, but also more generally between our two countries. This contributes to the strong friendship of Hong Kong and Germany.

In my remarks today, I will give you an overview on what’s going on in Europe.

Some of you may have become used to quite negative news from the European continent, as we not only endured the global financial crisis but also witnessed how it triggered the euro area crisis. As a result, the last ten years were something of a dry spell for the EU’s economy.

But things have actually changed for the better of late: the economic recovery is gaining momentum and has spread to all EUcountries. Today, I will paint a positive picture of the current development and will also talk about the positive outlook.

Yet in my remarks I will also focus on the two big challenges the EU faces, namely Brexit and euro area reform. My main point is that we now have a vibrant economic situation that gives us an opportunity not only to manage but to master these challenges such that the recovery becomes a sustainable story.

2. Finally, a broad-based recovery of the EU economy

Until last year, the economic recovery following the financial crisis was rather disappointing – and that despite extensive monetary easing by the European Central Bank. Entering the second half of 2017, however, growth momentum began.

Recent figures for the third quarter of 2017 show a sound GDPgrowth of 0.6%, quarter on quarter – after 0.7% in the preceding quarter. Euro area unemployment stood at 8.8% in October – well down from its peak of 12.1% in 2013 and the lowest level since January 2009. And a recent study by Ernst & Young expects 1.8 million new jobs to be created over the course of 2018.

What is important is that the upswing has become more broadly based – across countries as well as sectors. And this is also reflected in the positive economic sentiment. In December last year, the European Commission index reached a 17-year peak to record the highest value since October 2000.

And at the same time, inflation is slowly rising. The Eurosystem staff macroeconomic projections forecast annual HICP inflation of 1.5% in 2017, 1.4% in 2018, 1.5% in 2019 and 1.7% in 2020. There is some indication, then, that the volume of expansionary monetary stimulus could be lowered.

The euro area recovery is in considerable part driven by the healthy upswing of the German economy, which is ongoing: 2017 was the fourth consecutive year in which GDP growth outpaced potential output. And the Bundesbank expects a further rise of 2.5% for 2018, while growth in 2019 is seen at 1.7%.

3. A solid outlook for the EU economy

Coming back to the euro area and looking ahead, the very high level of confidence among firms and households suggests, moreover, that the upswing will continue well into 2018. The outlook for the euro area's economy is quite solid. This is in considerable part due to the robust projection for the world economy. The World Bank recently estimated that growth will be 3.1%; this means that the world economy's growth potential will be fully or almost fully reached for the first time since 2008.

The strongest driver of global growth will be the East Asian economies, China in particular. The World Bank sees emerging markets growing by 4.5% in 2018 and by 4.7% in 2019.

The global and emerging market growth has positive effects on the euro area economy as well. And I am convinced that the strong ties between the euro area and Asia, notably between Germany and Asia, will contribute to the success stories of both Asian and European countries. With this in mind, we should further deepen our political and economic relationships. And this should be based on the principles of free trade and market economies, while leaving some room for legitimate differences in rule-setting.

Both the IMF and the ECB staff recently upped their growth expectations for the euro area.[1] According to the December 2017 Eurosystem staff macroeconomic projections, the annual real GDP is set to rise by 2.3% in 2018, 1.9% in 2019, and 1.7% in 2020. Compared with the September projections, the outlook for GDP growth has been revised upwards substantially.

The Eurosystem expects the economic expansion to continue, as private spending and consumption growth are reinforced by lower deleveraging needs and better labour market conditions.

Furthermore, the recovery in business investment is supported by improvements in corporate profitability and the very favourable financing conditions. At the same time, euro area exporters are benefiting from the ongoing global economic expansion.

These figures give some comfort as to the EU's economic future. And I personally am confident that this trend can and will continue. However, challenges are looming: two particularly serious ones are Brexit and euro area reform. The current, upbeat trajectory has to be harnessed as we set about mastering these historical challenges.

4. Brexit looming

The first challenge, Brexit, began in June 2016, when the majority of UK voters decided to leave the EU. Where are we now? Brexit is definitely happening, and it is more and more likely to be a hard Brexit – by which I mean that there will be a complete exit rather than a partial one. The UK and the EU will go their separate ways.

Since December of last year, there is a better chance of reaching a sensible agreement before the deadline of March 2019. The EUCouncil agreed in December on the Brexit divorce issues: basic compromises were reached on three fundamental questions, namely the rights of EU citizens in the UK after Brexit (and vice versa), the border between Ireland and Northern Ireland, and the UK's financial contributions to the EU budget over the coming years.

This compromise allows us to move forward to negotiate the terms of our future partnership. But let's keep in mind that substantial progress has yet to be made on the details of the three separation issues I just mentioned.

Now, 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 no solution is found, the EU and the UK will trade under rules set by the World Trade Organization – which is in nobody's interest, but is likely to be particularly harmful to the UK economy, while the economic impact on Europe will be limited by comparison. Take Germany for instance. The UK is an important export market, accounting for ca. 7% of German exports. But this implies only 2% of value added to the German economy.

My hope is that all the parties involved will be able to negotiate an economic partnership that underscores the close political amity between the UK and the EU.

With a view to future economic relations, we must work hard to reach a deal that, on the one hand, minimises frictions in trade and supply chains. In that context, I also think that a substantial transition period is in the interest of both economies. On the other hand, however, this deal must also give the UK and the EUthe freedom to develop their own agendas in economic policy and rule-setting – this would ensure the possibility of institutional diversity, where each society can develop rules according to its own specific, historically grown circumstances and current preferences.

5. Euro area crisis and reform

Mastering Brexit is probably the biggest mid-term challenge facing the European economy, and we all need to take a pragmatic approach. Much is at stake. Yet as is always the case in life, problems and challenges never come alone, but in groups, or at least in pairs. The second big economic challenge we need to focus our attention on in 2018 is the reform of the euro area. This is also emphasised by the weight that this topic has in the current negotiations to build a new government coalition in Germany. I will come back to this in a moment.

The euro area will remain vulnerable as long as one fundamental stumbling block remains in place: its asymmetric institutional design. Member states surrendered sovereignty in monetary policy matters to the ECB on the one hand, but retained ownership of their fiscal and economic policies on the other.

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

We need answers to both these problems. For the economic convergence of the euro area will take time. Currently, the potential German coalition partners are debating quite sensible approaches on how to foster social inclusion, limit a race to the bottom in tax policies, and foster the convergence of the euro area economies. It's too early to judge these positions.

The second problem – excessive debt, and high borrowing by governments in particular – could, in theory, be solved much more easily. However, the necessary political reforms have seen little progress so far. But here, again, the recent proposals of the potential German coalition partners are promising. The creation of a European Monetary Fund seems to go in the direction that we, the Bundesbank, have been advising for quite some time.

Formally, the EU has a set of fiscal rules that restrict public borrowing – the Stability and Growth Pact. Yet these were regularly violated before the financial crisis, without any meaningful consequences. In response, the EU reformed the Stability and Growth Pact in 2005, but the outcome was to expand the discretionary scope even further.

The European Commission, despite its role as guardian of the Stability and Growth Pact, has already exploited its scope on several occasions and interpreted the rules rather generously in doing so. Indeed, 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.[2] The transfer of responsibility for fiscal surveillance from the European Commission to an independent institution would be a big step towards a less political approach. One promising measure would be to strengthen the role of the European Stability Mechanism, ESM for short. Thus far, the ESM has been tasked with providing financial assistance to euro area countries experiencing or threatened by severe financing problems.

However, if member states retain their fiscal autonomy, the sustainability of public finances will need further safeguards beyond 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, therefore, financing costs have to be realigned more closely with the risks in government budgets.

The only way to achieve that, however, is to restore the credibility of the no bail-out clause in the Maastricht Treaty. 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 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 taxpayers' expense.

In contrast, extending maturities would leave the original creditors on the hook, and they could still be held liable if debt restructuring became necessary at a later point in time.

6. Conclusion

To sum up, the European Union has entered a period of broad-based, stable economic growth and, having done so, has overcome the economic repercussions of the financial crisis and the euro area crisis.

Yet it would be a huge mistake to consider our mission successfully accomplished. It is a solid basis on which the EUneeds to build its efforts in 2018 to tackle not only the political challenges it faces but also the two biggest economic challenges in the shape of Brexit and the reform of the euro area.

We must do all we can to achieve a close and friendly political and economic partnership between the UK and the EU after Brexit – anything else is in no-one's interest.

With regard to the euro area, it is crucial that we improve the asymmetric institutional design to prevent another euro crisis.

If we take these challenges seriously, the euro area will become an economic success story.

Thank you for your attention.

[1] GDP projection by IMF: 2017: 2.1% (+0.2 pp); 2018: 1.9% (+0.2 pp).

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