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With Trump, despite Brexit: How to rescue the EU

Statement

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The spoken word shall apply

1. The European Union in an existential crisis

Europe has frequently been in crisis since its integration process began 66 years ago. At such times, there has often been a lack of imagination about what the next step might be. There were also periods when things ground to a halt. But there has never been a truly existential crisis like the one we are experiencing today. A reversal of European unification, which has appeared unimaginable over the course of the past 66 years, threatens to become reality in 2017 – at least, the probability has never been so high. Now we must contend with what once appeared unthinkable.

Looking back at 2016, we can see that the foundation of common understanding in Europe has weakened:

- The Brexit referendum presented facts in an entirely new dimension. Those who felt that they had lost out from globalisation directed their rage and their seeming powerlessness against Londoners and therefore, indirectly, against the Brussels elites. The planned exit of the United Kingdom will not only stop integration in the EU moving forward, but will actually reverse it.
- Once the disquiet surrounding Brexit plans had subsided somewhat, and the greatest worries about an economic rupture had faded away, Donald Trump was elected US President. Much like the Brexiteers, Trump relied on a post-factual populism strategy which fed on popular dissatisfaction with globalisation and the elites. His election added fuel to the fire in Europe.
- Finally, the failed Italian referendum about the (sensible) restructuring of its political system additionally weakened an already vulnerable Europe. Since Italy was a founding member of the EU and, as a major country, has the capacity to destabilise the European Monetary Union, it is a worrying setback to Europe when it falters.

From our perspective at the beginning of 2017, it is clear that Europe faces a high risk of being torn apart. This year's European election calendar could seal its fate. The 17 million citizens of the Netherlands will vote in elections on 15 March, with the anti-Europeans of the Freedom Party currently ahead in the polls. In France, the first round of the elections on 23 April and the run-off on 7 May will elect a new President. There too, anti-Europeans in the form of the Front National wield a strong influence. New elections are also expected in Italy, where the Five Star Movement remains strong despite the latest turbulences and the disappointment with the M5S' mayor in Rome.

The nihilism expressed by those who reject Europe offers no solutions, but appears at the same time to be attractive to many voters. Frustrations about national problems are often directed against Europe. One such right-wing election result in one of these core European

countries will be enough to herald the end of European integration.

Brexit and Trump are putting pressure on the European Union, which has already been placed under considerable strain by Putin and the refugee crisis. Right-wing populists are challenging the EU from within, because they believe this approach will bear fruit. The EU is therefore faced with the great challenge of preventing further disintegration and establishing new legitimacy.

- On the one hand, there are three concrete areas of action that must be implemented: setting Brexit on the right track, avoiding a renewed escalation of the Euro debt crisis as a result of turbulences in Greece or Italy, and correcting the ultra-expansionary course in monetary policy. (2. – 4.)
- On the other hand, and very fundamentally, the European Union must find a new perspective on integration – one which leads the way out of the alleged conflict between Member States and the EU. Integrated Europe must not only demonstrate its ability to act with openness and strength on the continent, but also defend the principle of open markets in the world in the face of advancing protectionism. (5. + 6.)

In addition, peace in the European Union is at stake. The populists are not giving any indication of what order they want. At any rate, a return to nation states which are not bound to each other will lead us straight back to the potential for conflict that has been all too familiar in the past.

2. Keep Brexit on course: Prevent EU disintegration

It is important to set the right course for Brexit. The EU should negotiate fairly with the UK, preventing the Brits from cherry-picking in order to halt further disintegration as others look to follow their example. The basic principles of integration - the four basic freedoms - must not be compromised.

The United Kingdom wants to leave the internal market and the customs union, but at the same time ensure broad access to EU markets with a comprehensive free trade agreement. This was made clear by Prime Minister Theresa May in the speech she gave last Tuesday. However, it is doubtful whether the EU would stand for this. For a long time, London has thought that German industry would be a source of pressure for generous negotiation with Britain due to the former's large goods surplus with the UK. Some think that internal market access can be retained despite a limitation on immigration and a breakaway from the European Court of Justice. This way of thinking is an illusion, as the latest survey of nearly 2,900 German companies goes to show:

- According to the survey, more than nine in ten German companies do not believe their business activities for 2017 and beyond will be strongly impacted by the upcoming Brexit. Only two to three percent of the companies surveyed foresee significant impacts on investments or employment. These are very much small-scale figures.
- They claim that the largest negative effects will be on exports to the UK. But on average, only one tenth of the companies feel they would be strongly impacted by a devaluation of the British pound. Even for the larger firms with over 500 employees, which have a more international focus than SMEs, only 20% responded by saying that they would be strongly impacted. Just 2 to 4 percent of these larger firms expected clearly negative effects on investments and employment – a negligibly small number.
- If we cast a glance at the category of minor Brexit effects, we can see higher proportions of companies expecting negative effects. Once again, this particularly applies for exports to the UK. Nearly 30% of all the companies surveyed felt that they would be slightly impacted. For the large companies with more than 500 employees, about 40% expect a slight exchange rate-induced impact on exports; this was true of

about 26% of SMEs.

- Quite remarkably, however, 22% of the companies expect slight benefits, and 2% significant benefits, for their business activities due to diversionary effects, at the British economy's expense; this means that current EU buyers of British goods would no longer buy in the UK following Brexit due to new EU import barriers, but will buy products from German companies instead.
- Rather unsurprisingly, industrial companies expect to be affected to a greater degree by Brexit than service providers.

Brexit will cause more harm to the British than it will to the German economy and the rest of the EU: in a meta study carried out last spring, we worked out that British prosperity could suffer a longer-term decline of up to ten percent or more. And even though Brexit will not leave the German economy entirely unaffected, the unity of the EU will be more important than any possible lazy compromises to secure German exports.

In London, it's time to put these illusions aside. Theresa May's speech was overdue, but still left a lot of issues open. It was nothing more than an inevitable first move in what will be a long series of negotiations. There is an inherent threat of selecting another economic model, primarily intended to salve the UK's own peace of mind given its eroded industrial base and its renunciation of the "financial passport". We will see how quickly the country can address its WTO status. This will not yet result in a new economic model. Even a low-tax nation must ultimately create a workable economic structure.

The same applies to all: short-term or one-sided economic advantages don't achieve much. Political primacy is what counts.

3. Do not let the Euro debt crisis escalate again

A second short-term task for the EU is to prevent the Euro debt crisis from re-erupting in 2017, which could happen in Greece or Italy.

With regards to Greece, the EU must help to secure the upturn that has begun and to adequately ensure the implementation of reforms at the same time. A return to growth is expected for 2017, since the economic slump in the past two years was on a lesser scale than initially feared.

But risks remain. If larger problems occur in concluding a second reform audit as part of the third aid programme, uncertainty could develop due to the threats facing the country such as sovereign bankruptcy and an exit from the Euro. Significant debt repayments are expected in the coming months, and above all in July, and these are payments which Greece may not be able to repay without further subsidies.

Euro partners were irritated with Greece in December as a result of Greece's special payments to low-income pensioners which had not been agreed beforehand. But there is good reason to believe that the second review will take place so soon that the problems will not create further disturbance:

- Both sides are likely to have an interest in preventing escalation, as was the case in the rather quiet first review that took place early last summer.
- The imminent liquidity bottlenecks leave the Greek government with little room for further manoeuvres like it made in December.
- European partners and the ECB are currently planning debt relief measures, a further reduction in capital exchange controls and the acceptance of Greek government bonds into the ECB's purchasing programme. These actions will only take place if Athens cooperates. In order to ensure this cooperation, a successful second review should be made an explicit condition for these relief measures.

But even if there is a bumpy road ahead in Greece, any possible contagion effects on the rest of the Euro area will remain limited, as they did in 2015.

The same cannot be said for Italy, which is undoubtedly systemically relevant for the Euro area. Here the objective must be to get the economy moving again, so that the reforms undertaken in recent years pay off. Such a success would likely reduce the share of protest voters and lower the danger of the Eurosceptic Five Star Movement getting into power in the upcoming elections.

However, more dynamic growth can only occur if the Italian banking system is finally cleaned up. Banks and companies are overburdened with old debts from all those years of economic crisis. They are in danger of becoming zombies which are not able to finance new investments.

The financial authorities in the country have therefore rightly increased the pressure to finally resolve the long-festering problem of defaulting loans in the banking system. There is a time window after the referendum, and well before the next election, which must be used to take decisive action. However, the new rules of the banking union, in particular the bail-in rules, must not be undermined in this process.

A precautionary recapitalisation of banks from the state budget is fundamentally possible under the rules of the Euro area, but it is subject to clear conditions – the impacted banks must in principle be solvent and supporting them must prevent a systemic macroeconomic shock. The banking union is therefore encountering its first credibility test in Italy – and it must succeed.

4. Proceed to terminate ultra-expansive monetary policy

The third area of activity for 2017 is the job of the European Central Bank, and consists of initiating a turnaround in monetary policy. The Euro area has been growing moderately but constantly for some time. Important economic indicators continue to point upwards. Money supply growth and lending have clearly recovered. Inflation is growing slowly due to increasing energy costs compared to last year and inflation expectations have clearly climbed in financial markets. This means the argument about the danger of deflation is no longer valid; and it was on this basis that a change from a very expansive to an ultra-expansive monetary policy was justified.

In this environment, the dangers that the ultra-expansive monetary policy poses to financial stability take on greater prominence. On the one hand, there is an increasing risk of credit-driven asset price bubbles. Here, the monetary policy for financial stability should not be left solely to financial regulators. On the other hand, one must take greater account of the burden placed on banks and insurance companies by extremely low interest rates, in order not to further weaken these pillars of the financial system.

For these reasons, the ECB should begin to withdraw anti-deflation measures in the first quarter of 2017 if the economy continues to recover. Above all,

- it should initially increase the negative deposit rate for banks by 0.2% and, soon after, set it to at least zero;
- the key interest rate (main refinancing rate) should be increased from zero to 0.1%, and soon after, to 0.25%;
- the ECB's (hastily extended) bond purchasing programme should really be phased out by the end of 2017 as planned and this should be announced in the spring, in addition, the monthly volume could be reduced more quickly;
- in the event of a quick increase in inflation, stronger countermeasures should be taken where necessary.

Withdrawing anti-deflation policies does not yet represent a fundamental change in interest rates – understood as the start of a period of interest rate increases. But the time for this step will be approaching during 2017. If the economy continues to improve in the Euro area until the end of 2017, the beginning of 2018 – once some time has passed since the end of the bond purchasing programme – would be an appropriate time for this. Those concerned about

a change in interest rates must understand that monetary policy would continue to remain expansive; only the extent of the extreme expansion would be gradually reduced.

The ground for a change in interest rates would have to be prepared early and with proper communication, if only due to the high private and public debts in some Euro area countries. This must be done in order to avoid a surprise to the financial markets and possible turbulence. In addition, one must prevent the overheating of the economy and, eventually, the need for very rapid and clear interest rate increases due to the long delays in the effects of monetary policy. This could endanger the ability of the private and government sectors to support debt, given their debt overhangs.

Furthermore, it is fundamental to change market expectations – especially at the long end of the yield curve. This must be done to prevent financial market actors from being too strongly attached to the current extremely low interest rates on their long-term loans, thus making them susceptible to a change in rates.

Once the danger of deflation has disappeared, the European Central Bank will regain room for manoeuvre, especially when it comes to monetary policy. It cannot solve the economic structural problems, or even soften them. In this respect, the end of the low interest phase will also herald a normalisation in the distribution of economic policy roles (assignment problem).

5. Protectionism is especially dangerous for us

Particularly in the very open and export-based German business model, it would threaten our prosperity if walls to global trade become more the rule than the exception. The motto “America First” demonstrates a new spirit of nationalism and unilateralism which is also making its way across Europe. You only need to look at the industrial policy of cushioning national champions and preventing the relocation of production facilities to other nations. Economists know that prosperity cannot be secured over the long term through protectionism. Short-term success is possible, and can convey the impression to those sceptical of globalisation that the Trumps of this world are setting the right course - with the right language.

Despite nearly seven decades of trade liberalisation since the beginning of the GATT in 1948, the danger is great that the wheel could now be turned in the other direction. Fertile ground has been laid for protectionism and beggar-thy-neighbour policies:

- Global growth has been anaemic for a long time. There are excess capacities in many sectors - not only in steel. The strong competitive pressure from China is perceived as a burden in the US and elsewhere.
- The distributional impact of open markets and the global division of labour is a problem which has been underestimated for a long time in many economies that have insufficient practical training opportunities and inadequate further education. Not only do people in industrial countries with low professional qualifications feel that they are victims of globalisation, but they also feel as if they have no prospects.

Especially in countries such as the US, UK or in France, in which enormous regional differences have developed, economic policy is faced with the challenge of correcting decades of failure or mismanagement. This easily leads to false economic ideas – such as protectionism and building fences – which make an impression on the public.

That’s the strategy Donald Trump wants to use to fight the USA’s trade deficit and bring new strength to the country’s industry. But his rhetoric overlooks the other side of the coin – the trade deficit goes hand in hand with billions in net capital inflows each year. The liabilities of the USA to the rest of the world exceed claims by more than USD 7 trillion.

Direct investment plays an important role here – and nearly 60% of direct investments come from Member States of the EU. The EU therefore plays a role in financing the investment

activities and economic growth of the United States, and the US economy owes a not insignificant proportion of its prosperity to international investors. Isolation would further damage the competitiveness of US industry, which, according to a 2013 MIT study (“Making in America”), is already limited. Consumers would be hurt by higher prices and poorer quality as well as further increasing the trade deficit.

If the US were really to take severe protectionist measures, Germany would be seriously affected: for Germany, the USA is the most important market in the world in terms of exports. About 9.5% of German goods exports are to the US; in the pharmaceutical industry this figure rises to 19%, and in the automobile industry it stands at 15%. Since exports of vehicles and vehicle parts account for nearly one fifth of Germany's goods exports, this is an Achilles heel that would prove to be particularly painful if the announced protectionist course were to be pursued in the future. Nothing can be excluded at this moment. This applies all the more if there is still a security vacuum too, because it is not clear how committed the US will be to NATO in the future.

The World Trade Organisation (WTO) serves as a bulwark against an increase in trade barriers on a broad level. But as the malaise of Doha Round demonstrates, the WTO is suffering too. Multilateralism is not a stable balancing force, because some large countries can use protectionism to create short-term benefits for themselves at the expense of others. If the leading economic nation were to abandon the WTO, there is a chance of the global trading system becoming unbalanced.

The “America first” strategy touted by Donald Trump could result in exactly this. He would rather rely on bilateral than multi- or plurilateral trade agreements. This would allow the USA to exercise full power against its smaller partners and the country would not be constrained by inconvenient rules of conduct which discipline strong powers and protect the weak - as are provided for by the WTO or contracts and agreements such as the TTIP.

In addition, the new US President has clearly expressed that he wants to conclude no more agreements with developing and emerging countries in order to curb low-wage competition in the USA. This is the primary reason why he has distanced himself from the Trans-Pacific Partnership Treaty (TPP). He is thus able to limit better access to the US market by countries like Vietnam or Malaysia. However, he is neglecting the Asia-Pacific region, an important sphere of influence, thereby weakening the USA from a geopolitical perspective. China, which was outside the TPP, is now just waiting to plug this gap with its “Regional Comprehensive Economic Partnership” (RCEP) – and then exclude the USA.

The difficulties of promoting globalisation and increasing its acceptance undoubtedly have their roots in the 2009 financial and economic crisis. It was clear back then that the normative anchors of globalisation had been loosened in large parts of the economic elite, despite the meetings to address this in Davos and elsewhere. If there is no entrepreneurial freedom and responsibility, flexibility and the rule of law, if there is no suitable relationship between sustainability and a willingness to take risks, then one cannot be surprised about criticisms of globalisation from vast swathes of the population – not just from those who actively attack it. Whoever takes China as a model due to shorter procedures and less interference by other pluralistic interests should know that doing so damages the image of market economies.

Entrepreneurs and corporate managers must now demonstrate the right attitude and, in a credible way, take into consideration the normative anchoring of globalisation – freedom and justice, human and civil rights, popular sovereignty and democracy, and procedural security instead of arbitrary actions. In this sense, entrepreneurs and corporate managers must also comply with economic conditions and resist arbitrary political pressures, such as those expressed by Trump.

6. Europe as an opportunity instead of a burden

Where would all dissatisfied Europeans direct their anger, annoyance and rejection if the European Union did not exist? The problems would perhaps exist in a different form, but in principle their causalities would be the same:

- The weak growth and high unemployment rates in the crisis countries of the Euro area result from supply policy failures and demand policy overstretching; the common currency only serves to highlight this, and demands more honest answers. The devaluations that took place in previous decades clearly show that this instrument has never led to an improvement of the situation in crisis countries in the long term.
- The pressure of migration towards Europe is not caused in Europe, but Europe could nonetheless respond to it by taking powerful action based on moral conviction and economic strength. If the European Union and the concept of jointly securing its external outside borders did not exist, extensive national border regimes would have to be developed, which would destroy the internal market. The Member States would discover that they cannot react alone in a suitable manner.
- Much of the political irritation coming out of Brussels is also caused by the fact that European politics is being used in dishonourable fashion in a bid to promote domestic policy interests in the Member States. In addition, it is noticeable that European politicians are criticised more severely and shamelessly than national politicians - which is welcomed by national governments.

Nevertheless, regardless of how this fateful year turns out, the European Union will have to undergo change in 2017 – and this is irrespective of whether there is a threat of dissolution or not.

The goal of “towards an ever-closer union” must be abandoned insofar as it targets the contrast between the nation state and European integration. The obvious search of people for an identity cannot be resolved by creating distance. Nations and nation states serve as anchors and home countries to mobilise European identity; the concept of Europe supports this. The mantra-like demand for an ever-closer union is a burden, rather than a promise, for the people. In addition, it suggests that European unity is the solution to all problems, regardless of concrete factual interdependencies. This burden has proven to be counterproductive.

Europe-wide public benefit must be placed at the centre of integration efforts. Europe can only play a part in the G2, and thus remain part of the Big Three, if it can demonstrate a convincing degree of unity.

- This requires the four basic freedoms without restriction. Only if Europe remains adamant on this matter will it be possible to speak out strongly in favour of free trade and freedom of movement in the world. CETA will then be imbued with life; and this is the only way the TTIP would have another chance.
- Freedom of movement for employees does not in any way mean direct and unconditional immigration into national social systems. Both the compromise that was made with the UK in the spring of 2016 and the rules changes in Germany clearly illustrate this.
- The justified security requirements of the people in these times of global terror cannot be satisfied at a national level. Internal and external security forces are increasingly interlinked, as cybersecurity and cyber war go to show. A European security and defence union is therefore needed, with a view to securing the external borders. Should the USA withdraw from NATO or significantly decrease its commitments, there is no alternative to the pooling of forces.
- This is inextricably linked with the organisation of a digital single market 2.0, because the standards and procedures for digital transformation in global competition can only be established on a European level, and because they also significantly concern issues related to data sovereignty and data security.
- Best-practice solutions that adhere strongly to the principle of flexicurity must be anchored at European level to create social cushioning. To this end, better use needs

to be made of the European Semester. The burden of youth unemployment can only be effectively countered by dual vocational training if entrepreneurs in other European countries realise that they must support the second part of the system.

The Bratislava roadmap provides a realistic core that must be consistently placed at the forefront of integration policy. The message is: Europe must not only become a region with sustainable prosperity, but must also be a region in which the security wishes of its citizens can be fulfilled in a credible manner. If we put this perspective up against the nihilism of the populists, if we compare the prospect of a peaceful and cooperative Europe with that of isolation, the choice should be clear. Let's deal with Europe in a critical and fair manner. Any other approach would cost us dearly for years to come.