Jens Weidmann: Presentation of the Bundesbank's annual accounts for 2014

Opening statement by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the presentation of the Bundesbank's annual accounts for 2014, Frankfurt am Main, 9 March 2015.

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1. Welcome

Good morning, ladies and gentlemen. I am glad that you have come and would like to welcome you to our press conference on the annual accounts of the Deutsche Bundesbank for 2014.

I would like to take this opportunity to take stock in two ways. First, with regard to the size and determinants of our balance sheet and of the Bundesbank profit. Second, I would like to refer to key political and economic developments and how they have impacted on the work of the Bundesbank.

2. Continuing the course of reform is the order of the day

The debates on economic and monetary policy in the euro area were chiefly shaped last year by low interest rates and the no more than sluggish and uneven economic recovery in the countries of the euro area.

Fortunately, however, despite the continuation of the sovereign debt crisis, there were no periods of major tensions in the financial markets, such as those that occurred in 2012, for example.

On the contrary: the spreads on sovereign bonds – in other words, the risk premiums which are frequently perceived as a barometer of the sovereign debt crisis – have gone back down in all of the member states severely affected by the crisis, with the exception of Greece for obvious reasons. Moreover, interest on sovereign debt has fallen to all-time lows. The governments of Italy, Spain and Portugal are obtaining funding more favourably than at any time since the introduction of the euro.

An extremely accommodative monetary policy as well as continuing progress in adjustment in most of these countries are among the factors which have played a part in this. Despite differences in terms of how far countries have already implemented reform steps, the measures that have so far been taken nevertheless mostly point in the right direction. Price competitiveness has improved, although this is partly due to the depreciation of the euro. Large public deficits have been reduced and current account deficits have been massively cut back.

It is now all the more important not to squander the progress made so far. Lasting success will be achieved only if budgetary consolidation and the improvement of competitiveness stay consistently at the top of the political agenda.

The favourable conditions for government financing must not delude governments into thinking that further reforms are unnecessary. That naturally applies not only to the countries most affected by the crisis, but also to the large economies of France and Italy.

There, too, central governments have ultimately recognised that reforms had been pushed into the background for too long – something that was also reflected in their low rates of growth. What is of crucial importance with regard to the announced reforms, however, is that they are implemented. In the end, that is the only way to measure whether the reform efforts are having an effect. And that, in turn, is enormously important for the stability of the single currency area, which those two countries have a key part in shaping.

Latterly, however, Greece has once again been the focus of public attention. Although the newly elected Greek government takes a critical view of the assistance programme so far and of the agreed reforms, three weeks ago it applied for the existing programme to be extended.

The Eurogroup and numerous parliaments have now acceded to this wish on the basis of the existing agreements and extended the current programme by four months, but without taking on additional financial risks to begin with. For the existing programme to be extended, the Greek government had to commit to a series of economic reforms, which now have to be spelled out and then, most importantly, also implemented.

Only identifiable progress on the road to sound public finances, a competitive economic structure and a functional political system will allow Greece to regain investors' confidence and fund itself independently. Until then, the country will depend on further assistance; and I do not see that Greece can achieve an independent access to the capital market again by mid-year.

But let me say one thing clearly. As I see it, further decisions about financial resources for Greece belong unequivocally in the field of politics. While fiscal policy has not approved any further financial assistance for some months now, the Eurosystem has made considerable financial resources available – to be precise, lending to Greek banks has doubled to €100 billion.

Massive outflows of capital from Greece have been financed, and the Greek banks that are cut off from the capital market are dependent on funding by the Eurosystem, predominantly in the form of emergency liquidity assistance (ELA) from the Bank of Greece – with which, however, only temporary liquidity problems should be bridged.

Liquidity assistance, as well as Eurosystem funding quite generally, should be granted only to solvent banks. This was something that Mario Draghi stressed once again at the press conference of the last meeting of the Governing Council of the ECB.

Since banks and central government in Greece are very closely intertwined, however, the situation of the banks depends very heavily on whether the Greek government is solvent.

The Eurosystem should pay careful attention to whether the Greek banks do not worsen their liquidity position by acquiring Greek government bonds for which there is de facto still no market. Otherwise, there might arise the suspicion that the Eurosystem does not take the prohibition of monetary financing so seriously. That was something Mario Draghi clearly pointed out, too.

Given the government's and banks' lack of market access, financing of the Greek government via banks that, in turn, avail themselves of the monetary policy financing opportunities or the granting of ELA by the Bank of Greece, also raises obvious concerns with regard to the prohibition of monetary financing.

In this specific situation, governments and parliaments must decide whether they are prepared to go on extending the Greek risks and cover the funding needs of the Greek government despite the tangible uncertainty with regard to the government's will to reform. I see this less than ever as a task within the remit of the Eurosystem.

First and foremost, of course, the onus is on the Greek government. By means of credible and also quantifiable reform commitments, it must lay the foundation for a continuation of the support provided by the available assistance mechanisms. In this respect, a lot of confidence has been lost recently.

Allow me to make one thing absolutely clear. The composition of the euro area is a political decision. Every country that has joined the monetary union also bears the responsibility to contribute to the stability of the single currency with its policy and by compliance with the rules. This is also a matter of the general public's confidence in the single currency and its institutions and, at the end of the day, the promise that the monetary union is a community of stability.

3. Liability principle and commitment to fiscal rules

Ladies and gentlemen, it is not just the current situation in Greece but the sovereign debt crisis as a whole which demonstrates how quickly a situation can develop in which the Eurosystem comes under pressure to take on fiscal risks.

In order to protect monetary policy from such risks, the euro area's founders relied on sound public finances, which were to be ensured through the adoption of fiscal rules, amongst other things. Unfortunately, neither the rules themselves nor their implementation were strict enough in the past. And currently, there is not much to suggest that things will improve in the future. Quite the opposite, in fact.

The point of this is not about observing these limits for the budgetary rules' sake, placing constraints on government authorities or pushing through austerity programmes. It is about ensuring public finance sustainability and restoring confidence in sound government budgets.

This is an important requirement for a stable single currency and for ensuring that monetary policy does not risk being drawn into a fiscal policy maelstrom from which it can no longer free itself.

Budgetary rules are anchors of trust. They tend to be adopted and have their importance stressed most when trust is urgently required. When the monetary union was established, the focus was on creating trust in the new currency. The decision to commit to the common currency on a permanent basis was, in return, to be accompanied by a reliable prospect of sound public finances.

At the height of the crisis, the focus was then on obtaining approval for large-scale joint liability via the newly created European support funds. Trust also had to be built here. In return for joint liability, stricter fiscal rules were promised. The tougher fiscal rules were also intended to help restore confidence on the capital market, in an attempt to curb the increase in risk premiums.

As time went on, the risk premiums did in fact fall. But this was probably also because monetary policymakers had assumed significant fiscal risks – the Securities Market Programme (SMP), for example – or announced that they were prepared to do so if necessary – here, I refer to outright monetary transactions (OMT).

With pressure being reduced via the capital markets and given the security gained from the sizeable fiscal support funds, motivation to decrease deficits and debt evidently also declined. Calls for "flexibility" in the fiscal rules grew louder, and the European Commission eventually gave in to the political pressure.

The Commission took advantage of its stronger position with regard to the rules, which actually should have ensured stricter implementation of them, to interpret the rules with greater political leeway and to take a softer approach to their implementation.

As a result, the rules are more flexible and political today than ever before. They have become extremely complex and have hardly any logic to them. Much scope is allowed for discretion and exemptions, meaning the binding effect of the rules is now weaker than before the crisis.

The recent development in France's excessive deficit procedure poses a problem with regard to the binding effect of the fiscal policy agreements. It also weakens other coordination procedures and it certainly provides a reason not to expand euro-area joint liability elements further, as has often been called for. Liability without sufficient control undermines the stability foundation of monetary union.

4. Monetary policy stance eased further by purchase programme in early 2015

Ladies and gentlemen, I would now like to turn to the topic of monetary policy. Inflationary pressures in the euro area have been exceedingly low, especially since the second half of 2014. The ECB Governing Council responded by implementing a number of measures designed to loosen still further their already expansionary monetary policy stance. Public attention was particularly drawn to the expanded asset purchase programme adopted in January of this year.

You don't need me to tell you that I had my qualms about this decision. But the ECB Governing Council faces a tricky monetary policy situation – inflation rates right now are far off our medium-term target. Indeed, some measures of long-term inflation expectations have even diminished distinctly in recent months. But that's not just the case in the euro area; other advanced economies that have already engaged in large-scale bond purchases also find themselves in the same boat.

Finding the right monetary policy response to this predicament is anything but easy. The way policymakers interpret the drivers fuelling the current low inflation rates is naturally an important consideration. My preferred response would have been to "look through" this spell of low interest rates, rather like other central banks in advanced economies have done.

I say that because the slack price pressures in the euro area are primarily the outcome of the drop in energy prices. This decrease ought to distinctly boost growth in the euro area because its member states are net importers of oil.

Another point is that the available surveys suggest that long-term inflation expectations are still well anchored. And the drops in market-based expectations don't automatically mean that inflation expectations have contracted. Rather, they are also dictated to some extent by inflation risk and liquidity premiums.

This assessment does not mean, say, that we at the Bundesbank are not being consistent with our declared primary objective of safeguarding price stability. And it most certainly does not mean that we are making this objective play second fiddle to other considerations, for instance.

What it does mean is that in the face of a challenging monetary policy situation, we have reweighted economic factors and developments as well as risks, and continue to weight these factors differently than the majority of ECB Governing Council members.

You will no doubt know that the ECB staff project that the inflation rate will be zero this year, rising to 1.5% and 1.8% over the next two years. They also forecast that growth will climb from 1.5% this year to 1.9% in 2016 and 2.1% in 2017.

This assessment is, in part, also a reflection of expectations placed in the transmission of monetary policy decisions. But my reading of the latest data and the projection is that they are more an endorsement of a restrained monetary policy response. As I see it, the projected path of inflation clearly illustrates that the spell of low or even negative inflation rates is only a temporal phenomenon.

The effect of the lower oil price plays a particularly important role in this regard, and it also significantly eases the financial strain for enterprises and households. This in turn stimulates their consumption and investment activity, contributing to the expected economic recovery.

And it also reduces the threat of a prolonged phase of low inflation rates possibly sparking a self-reinforcing downward spiral of fallig prices, wages, production and employment.

Incidentally, I see no signs of second round effects. The collective labour agreement in the metal-working industry is largely in line with our expectation of negotiated wage rates in

Germany climbing by roughly 3% this year. And for the other euro-area countries, too, there is nothing at the moment to suggest that the European Commission's projection of a 1.3% increase in euro-area employee compensation this year is untenable.

I am not denying that the announcement of bond purchases has further reduced the likelihood of deflation. That, at least, is what the data on inflation options seem to suggest. But the likelihood of deflation was rather remote even before the measures were announced. That's why, on the whole, I don't think it would have been necessary to further ease monetary policy by rolling out the broadly based government bond purchase programme.

All the more so, given that the purchase of sovereign bonds in the euro area harbours specific risks, making it a monetary policy instrument unlike any other.

But at least it is worth noting that the decision to largely rule out risk-sharing as part of the bond purchase programme counteracts the direct threat of sovereign credit risks being mutualised. That also diminishes the legal risk involved in that kind of programme.

But the fact remains that these purchases cause fiscal policy and monetary policy to become even more strongly intertwined. For when the purchases come to an end, sovereigns will be able to finance a substantial portion of their debt very cheaply without these financing costs being differentiated in any way according to the risk of the sovereign in question.

If the member states were to become accustomed to these funding terms, they might become less inclined to embrace further consolidation or reform measures.

Together with the Commission's unambitious approach to enforcing the fiscal rules, this confluence of different factors might in fact turn out to complicate efforts to resolve the euro area's structural problems. And that might make life more difficult, further down the road, for those of us looking to achieve the target of price stability.

5. German economy has overcome weak growth

Ladies and gentlemen, after getting off to a good start in 2014, the German economy did not perform as strongly in the second half of the year as originally expected. Nevertheless, the economy appears to have emerged from its sluggish phase faster than many believed possible given, amongst other things, Germany's buoyant economic growth towards the end of last year.

The economic upturn is currently being driven by a recovery in industrial activity as well as, above all, by a decidedly positive consumer climate. The high level of employment, the favourable income prospects, the drastic fall in oil prices and the very low interest rates all promote households' propensity to spend.

In 2014, the negotiated wages of employees went up by 3% – an increase not seen in almost 20 years. In the light of the low inflation rate, real disposable incomes, too, increased considerably as a result.

Enterprises benefited not only from low oil prices and favourable funding conditions, but also from the depreciation of the euro and the gradual recovery of international sales markets. As a result, enterprises increased their output on balance.

Employment, too, continued to expand while unemployment levels fell. Given that the economic environment is likely to remain favourable, the reduction in unemployment can be expected to continue this year.

Hence, the German economy remains in good shape. Overall, many factors point to a growth rate for 2015 that is higher than what the Bundesbank published in its December projection. As things stand, the rate of 1.5% for Germany recently provided by the European Commission is fairly realistic.

Public finances, too, show a positive picture at present. In 2014, Germany's general government budget again recorded a slight surplus. While government expenditure was fuelled by a sharp rise in pension and healthcare costs, government interest payments again contracted significantly, chiefly thanks to the very favourable funding conditions.

The fiscal balance could deteriorate somewhat in the current year. Amongst other things, this is likely a result of faster expenditure growth due, not least, to the rise in social payments resulting from the pension benefits package adopted in mid-2014. However, a slight general government surplus will again be recorded this year.

Regardless of the good situation overall and the favourable economic outlook, continued risks to economic developments in Germany must not be neglected. This includes geopolitical tensions, amongst other things. What is more, the economic recovery that has got underway in the euro area remains fragile.

The bottom line is that there is no room in Germany for complacency on economic policy matters. In particular, the unfavourable demographic outlook will weigh heavily on the German economy in the medium term. By 2060, the population will have shrunk by up to 20% and the labour force by around 30%. To make matters worse, policy measures such as early retirement on a full pension at 63 are already constraining the labour supply, thereby eroding growth opportunities.

6. European banking union

Ladies and gentlemen, the Single Supervisory Mechanism (or SSM), based at the ECB, has been up and running since 4 November 2014. In parallel to the introduction of the SSM, policymakers pressed ahead with efforts to create a regime for the orderly recovery and resolution of banks in 2014 without jeopardising financial stability or using taxpayers' money, if at all possible. This project is the second pillar of the European banking union.

In this context, the EU regulation establishing a Single Resolution Mechanism (SRM) created the two elements of this pillar: on the one hand, a European resolution board and on the other, a single bank-financed resolution fund.

The SRM, which will enter into force in 2016, will apply the liability principle for banks as well. Freedom to take entrepreneurial decisions and responsibility for the consequences are to be inextricably linked here, too – and this means, if the worst comes to the worst, resolving and therefore closing a bank. Assuming they are involved at all, taxpayers will be the last to have to foot the bill, and even then only under certain conditions.

However, this new joint responsibility for the resolution of banks also means that risks from the respective national private sector might be shifted to the community. This could be in the form of legislative measures which deteriorate the risk positions of banks in favour of their national debtors. For example, changes to insolvency laws, which are being discussed in some euro-area countries, could have a significant impact. I therefore believe that the banking union requires policy coordination that goes beyond the level that has been discussed so far.

Overall, however, the SRM is undoubtedly a key step along the road to a more stable banking system.

But neither the SSM nor the SRM will solve the fundamental problem of the, in some cases, very close ties between banks and member-state governments in the euro area. This can lead to potentially threatening interactions in a crisis event.

During the crisis, distress in the banking system of some countries meant that their governments, too, faced considerable financial difficulties on account of the necessary public rescue commitments. However, this hazardous "doom loop" between banks and their sovereigns also means that sovereigns, in turn, can have a negative impact on banks. Banks holding large portfolios of bonds issued by governments at risk of insolvency can be exposed to a considerable strain or even be dragged down along with them.

That's why I have repeatedly pointed out that, over the medium term, the current regulatory preferential treatment of lending to sovereigns needs to be ended or at least substantially scaled back. The aim must be to loosen the sovereign-bank nexus over the medium term.

The conference "Debt and Financial Stability – Regulatory Challenges" being held by the Bundesbank and the Federal Ministry of Finance at the end of this month will therefore address this issue, too.

One possible future approach could be for banks to back their claims on sovereign borrowers by capital commensurate with the risk and to subject them to large exposure limits.

7. Privileged regulatory treatment of lending to sovereigns

Ladies and gentlemen, the problems caused by the interdependencies between governments and banks take on a special form in the current regulatory framework of European monetary union. This is reflected, amongst other things, by the fact that there is often very little diversification in European banks' loans to sovereign debtors.

On the contrary, in many cases, the vast majority of the government bonds held by euro-area banks are issued by just one sovereign – their domestic government. For example, in December 2014, 98% of the loans from Greek banks to euro-area sovereign debtors were granted to the Greek government.

Is it clear that in cases where the ties are so close, doubts concerning government solvency have a direct negative impact on the banking system.

It is in this particular context that we have devoted the first main article of this year's Annual Report to the topic of the sovereign-bank nexus. In particular, the article examines what would happen if sovereign loans were backed with capital, on the one hand, and if large exposures were subject to limits, on the other.

Because of the potentially significant consequences, especially of the application of the large exposure limit, any reforms would require a certain transitional period. However, the macroeconomic effects of such new rules would no doubt be positive. Financial stability would be enhanced, incentives to pursue this type of fiscal policy would be increased and lending to private borrowers would become more attractive which, in turn, might boost capital stock and economies' growth potential. It would therefore be important not to lose any time. This article should be seen as a contribution to this debate.

Against this backdrop, it is a welcome development that the Basel Committee has now added the regulatory treatment of lending to sovereigns to its agenda. Furthermore, the European Systemic Risk Board published its report on this topic just the day before yesterday. In the foreword to the report, Mario Draghi quite rightly said that a discussion on the topic was long overdue.

If it is not possible to reach a consensus at the international level on eliminating the privileged treatment of loans to sovereigns, we should push ahead with a European solution in order to make this important contribution to the long-term stability of the euro area.

As well as focusing on major issues relating to a stability-oriented regulatory framework, the Bundesbank also takes a look at the bigger picture, including, for example, the topic of payment transactions. The second main article in this year's Annual Report therefore examines digital structural change in payment services.

8. Bundesbank profit and risk provisions

Ladies and gentlemen, finally I would like to come now to our annual accounts and hence also to this year's Bundesbank profit.

The profit and loss account for the 2014 financial year closed with an annual surplus of €2.95 billion. The annual surplus for 2014 is therefore €1.6 billion below that of the previous year.

The profit is lower mainly because of the significant decline in interest income last year. Net interest income came to €3.14 billion last year, which was €2.42 billion down on 2013. This decline was due, in particular, to the lower key interest rates, which were just over two-thirds lower on an annual average.

With regard to risk provisions, it should be noted that the risks from monetary policy operations have grown considerably in recent years in the wake of the financial crisis. The Bundesbank had already reacted to this and, from 2010 to 2012, for the purpose of risk provisioning increased the provisions for general risks in three steps by a total of €12.4 billion.

The Executive Board also reviewed the requisite level of risk provisions for 2014 – as is the case each year – and, in doing so, took into account both the current risk situation of the Bundesbank and the available financial resources. As a result of this review, the risk provisions remain unchanged at €14.4 billion (as in the previous year).

There are two main reasons for not running down the risk provisions. On the one hand, the risks for the Bundesbank from the risk-weighted assets, on which attention has hitherto been focussed, have declined somewhat, since both the volume of refinancing loans from the Eurosystem and that of the securities from the Securities Markets Programme (SMP) have decreased.

On the other hand, additional credit risks will arise over the next two years. These are due to the decisions of the ECB Governing Council on the purchase programmes. These chiefly refer to the Asset-Backed Securities Purchase Programme (ABSPP) from September 2014, and the Covered Bond Purchase Programme (CBPP3). The large-scale government bond purchase programme (PSPP) that was adopted in January of this year will only have a negligible impact on the credit risks. After all, the Bundesbank primarily only purchases Federal bonds.

At the same time, the cuts in the key interest rates in June and September 2014 have led to a decline in both the anticipated annual result for 2015 and in the Bundesbank's available financial resources. In net terms, based on this overall review for 2014, no changes to the risk provisions are necessary.

We transferred the annual surplus in full to the Federal Government today. The Federal Government's Budget Act for 2015 stipulates that €2.5 billion of the Bundesbank's profit will be used for budgetary financing, and excess amounts will be used for debt repayment.