Jens Weidmann: A look at the euro area from a central bank perspective

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the Second Finance Forum Liechtenstein, Vaduz, 23 March 2016.

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1. Introduction

Head of Government Hasler

Your Serene Highness

Esteemed ladies and gentlemen

Thank you very much for inviting me to the Principality of Liechtenstein. I am very glad to be here with you today.

A reporter at Germany's Süddeutsche Zeitung daily once wrote, with a slight undertone of sarcasm: "Those who have the joy of spending part of their lives at banking congresses will frequently be confronted with words ending in '-ation' and '-ing'." The prime examples listed by the journalist included "regulation", "capitalisation" and "digitalisation".

Rest assured that, at today's event, you, too, will be confronted with a great many words ending in "-ation" and "-ing", especially since two of the aforementioned words were already mentioned in the invitation. There's also a good chance that you will hear terms such as refinancing and implementation, positioning and focusing, standardisation and stabilisation or even the optimisation of bookkeeping and accounting bandied about today.

Some years ago, the German language critic Bastian Sick complained, in his book Der Dativ ist dem Genitiv sein Tod – literally, The dative is to the genitive its death – of the "overweening dominance of words ending in -ation" and "-ing". Admittedly, the literary merits of this noun-heavy style of writing are not truly existent – but at a financial industry conference, that is probably not what counts. Let me therefore focus on content and not on the linguistic packaging.

In my remarks today, I would like to take a look at the situation in the euro area.

Liechtenstein borders on the euro area, and not just geographically. There are also close economic and legal ties with the EU, especially since the Principality is a member of the European Economic Area and thus part of the internal market. Liechtenstein's banks have been among the major beneficiaries. And the sharp appreciation of the Swiss franc against the euro last year weighed not only on Switzerland's industrial sector but also on Liechtenstein's exporters.

The ECB Governing Council's monetary policy decisions are therefore just as relevant to the Swiss franc zone as financial market regulation and the institutional stability of European monetary union.

Before I delve deeper into these topics, I would like to lay out three core talking points.

1. First, European monetary policy has ventured deep into uncharted territory, and there is a growing risk of it being subjugated to fiscal policy. In what is admittedly currently a difficult monetary policy environment, risks must not be underestimated, nor should the capabilities of monetary policy be oversold.
2. Second, in order to stabilise monetary union over the long run, its institutional framework needs to be reformed. The balance between actions and liability for their consequences needs to be restored.

3. Third, significant progress has been made in financial market regulation; our banking system is thus more robust today than before the financial crisis. However, the regulatory agenda has not yet been fully concluded for the banks and shadow banks alike.

2. Monetary policy in the euro area

Let me begin with monetary policy.

As you know, at its meeting nearly two weeks ago, the Governing Council of the European Central Bank (ECB) adopted an even more accommodative monetary policy stance.

The move that gained the most public attention was the renewed cut in the ECB's policy rates. The main refinancing rate is now at 0%, and the interest rate on deposits with the Eurosystem was cut further to the current level of -0.40%. But on top of that, the Governing Council also adopted a rather extensive package of measures:

beginning in June, the Eurosystem will be providing a further set of targeted longer-term refinancing operations (TLTROs) with which banks can acquire liquidity for a term of four years at extremely favourable conditions – usually at the 0% main refinancing rate throughout the entire term. Banks that grant additional loans – except for loans for house purchases – will even get something back: in the most favourable case, the difference between the main refinancing rate and the deposit rate in effect at the time of allotment.

In addition, the volume of monthly bond purchases was raised from €60 billion to €80 billion. The idea here is to also purchase, within this overall volume, non-financial corporate bonds issued in the euro area. At the same time, the Governing Council stated that it did not intend to raise its central bank rates for a relatively long period of time. Not even once the asset purchase programme has already been concluded.

This package of measures was the Governing Council's response to the very subdued price outlook in the euro area. It may be assumed that, over the forecasting horizon, the inflation rate will only very gradually approach the norm for price stability; at the end of 2018, inflation will stand at 1.6%.

In addition, the ECB staff projections show that the gradual economic recovery in the euro area will continue, but at probably a somewhat weaker pace than had been envisaged as recently as last December. The sluggish growth of the global economy is also impacting on the euro area.

Now, a gloomier price outlook need not necessarily translate into a monetary policy response – especially if price movements have been caused primarily by a sharp drop in oil prices.

For an indication of how the strong fluctuations in energy prices impact on the forecast, one need only consider that the projection of the inflation rate based on the current oil price, which is around 20% higher than the price used in the projection, would be in and of itself around 0.2 percentage point higher in 2016.

Core inflation, ie the inflation rate excluding volatile components, such as energy or food prices, also dropped unexpectedly recently. Despite a projected slight increase over the forecasting horizon, core inflation, which is used to approximate domestic price pressures, will remain below the definition of price stability in 2018 as well.

However, I believe it is still too early to say with any degree of certainty whether this decline in core inflation is temporary or of a permanent nature. That is not the only reason why uncertainty surrounding inflation projections is currently very pronounced.

Monetary policymakers can also come under particular pressure to take action if a relatively prolonged period of persistently very low inflation sharply diminishes the longer-run inflation expectations, as that could be a factor in keeping future inflation rates too low as well. At last report, market-based longer-run inflation expectations, at a value of 1.4%, were indeed well short of our definition of price stability.

This finding does not, however, represent evidence of their de-anchoring and thus of the risk of an excessively low inflation rate taking hold. Indeed, these values could also be the consequence of the liquidity effects of government bond purchase programmes and negative inflation risk premiums. This, at least, is what we can gather from a comparison with survey-based inflation expectations, which at last report fell only a very little or not at all and are running much closer to the definition of price stability. However, the risk of de-anchoring naturally increases, the longer economic agents observe an inflation rate which they perceive as being sustainably below the definition of price stability.

The new forecast picture therefore certainly did present quite a monetary policy challenge and exposed a need for action to be taken. On this topic, there was agreement within the Governing Council of the ECB. But taken as a whole, I think the decisions went too far, and the comprehensive package of measures didn't win me over.

My reservations concerning government bond purchases in the euro area are well known. Similarly, the latest downturn in the outlook for prices and growth still leaves me unconvinced of the alleged need to use this instrument, one that I regard purely as an emergency instrument. For this will ultimately lead to a dangerous commingling of monetary and fiscal policy. Even after taking note of the latest forecast revisions, I still see a very remote risk of a deflationary spiral.

It is a fact, however, that the Governing Council of the ECB is striving for an inflation rate of below, but close to, 2% in the medium term in order to fulfil its mandate of price stability.

One reason why the central banks of the major currency areas generally aim for an inflation rate of just under 2% is because slightly positive rates of price increase provide a certain safety margin to the lower bound on interest rates. As we now know, this bound is not exactly at zero, nor is it significantly below that level. If the inflation target is too low, a central bank's scope for stimulating the economy using conventional instruments can quickly be exhausted.

Naturally, the target ought not be too high, either, as we all know that inflation is costly. And not just when inflation rates hit the double digits. Which is precisely the reason why many central banks across the world now have the mandate to safeguard price stability.

Maybe a comparison with a ship will help to illustrate the situation. A ship ought to have enough water below its keel at all times in order not to run aground. At the same time, too much water would prevent the ship from casting its anchor.

It is important to emphasise that our target is a medium-run one. The medium run does not mean "sometime in the distant future", nor does it mean "as fast as possible and at all costs". The term "medium run" thus consciously contains a certain degree of vagueness over the precise time horizon. This gives monetary policy the flexibility it needs to respond appropriately to a myriad of different types of macroeconomic shock. Monetary policy would surely be unable to cope with the expectation of always being able to guarantee an inflation rate of just under 2%, for alongside the justified desire to steer inflation back towards the 2% mark, monetary policy must also keep in mind that there are risks associated with the protracted low-interest-rate policy and the non-standard monetary policy measures. One expression of this is that the ECB Governing Council is having to fend off increasingly absurd demands – such as showering the population with "helicopter money".

Ladies and gentlemen

Telling you lots and lots about the risks and side-effects of monetary policy would probably be akin to "carrying coals to Newcastle". You all know that an ultra-accommodative monetary policy brings with it long-term risks to the stability of the financial system.

First, because of the mounting risk of financial market bubbles. This is why some euro-area member states have now also taken what are known as macroprudential measures in order, for instance, to counteract excesses in real estate markets.

Of course, whenever such financial stability risks are looming, this represents a challenge, above all, to macroprudential policy. And a stability-oriented central bank should not seek a trade-off between monetary stability and financial stability; this will soon lead to monetary policy arbitrariness. However, a monetary policy which is intended to ensure longer-term price stability cannot completely ignore these risks, for at the end of the day, financial stability risks generally also threaten price stability – as was clearly shown by the financial crisis.

Second, because profitability in the banking sector can take a hit, the severity of which rises the longer the period of low interest rates persists and the flatter the yield curve is. As central bankers, our concern here is naturally not the profits generated by the banks per se; instead, it is the banks' ability to transmit monetary policy stimuli. And this capability is not independent of capital adequacy, as the latter plays a major role in shaping banks' ability to cushion shocks.

It is all the more important, then, for banks to gear their operations towards sustainable profitability. To achieve this, they need to review their business models, get their balance sheets in order and harness any available scope for consolidation in order to cut costs. Failing this, they may find it difficult during a protracted phase of low interest rates to retain profits with a view to further strengthening their capital base.

3. Institutional framework of monetary union

Another risk of the ultra-accommodative monetary policy is that the low interest rates and the extensive asset purchases will ease the pressure on member states to consolidate and reform.

But that's not all. These bond purchases are increasingly fusing monetary policy and fiscal policy. For a significant share of sovereign debt, government financing costs have become decoupled from capital market conditions: since the purchases ultimately increase banks' surplus liquidity, when all is said and done, governments are obtaining this share of their funding at the – currently negative – deposit rate.

With regard to the assets purchased by central banks, interest rates are quite simply no longer being geared to the soundness of a country's public finances, which is a far cry from the principle of capital market funding. However, bonds held outside central bank balance sheets are also affected indirectly. On the whole, this undercuts market discipline, the intent of which is to secure not only compliance with fiscal rules but also sustainable budgets.

The recent waning of the euro-area countries' enthusiasm for consolidation is no surprise. If the cyclical improvements are factored out of the euro-area countries' budget deficits, adjusted for interest expenditure, for the past two or three years the relevant primary surpluses have either been treading water or have even been receding.

The opportunity opened up by the low interest rates to bring down budget deficits particularly quickly was thus squandered. And this could mean repeating a mistake that was already made by many member states in the early days of monetary union.

A recent comment in the Italian daily newspaper Corriere della Sera said it all:

"At the beginning of the new millennium, Italy wasted a golden opportunity created by the narrowing of yield differentials, the notorious spread. The advantage afforded by accession to the single currency led instead to an expansion of government spending, the productivity of which was extremely low with respect to investment and jobs. It would not be desirable for this opportunity to be squandered, either, for that is something we would deeply regret."

This quote, through referring to Italy, is certainly applicable to other countries.

In fact, stricter fiscal rules for the euro-area member states had been agreed in response to the financial and debt crisis; however, their binding effect has proven to not be as strong as was promised.

This is due not least to the fact that the European Commission, in its dual role as the guardian of the Treaties and a political institution, has made compromises time and again at the expense of fiscal discipline. But in fact the whole point of stricter fiscal rules was to ensure sounder public finances over the long term. That was the basis for creating the permanent ESM firewall in return.

As part of the measures to contain the crisis in the euro area, however, risks were then communitised not only through the euro rescue shield but also through the Eurosystem's balance sheet.

These measures undoubtedly stabilised monetary union during the crisis. Yet they have also upset the balance between actions and liability for their consequences. The increase in joint liability, however, has not gone hand in hand with an increase in joint action. This is a bit like opening a joint account with your neighbour but not being able to influence your neighbour's spending. It can work, but that is by no means certain.

This equilibrium needs to be restored in order to stabilise monetary union once and for all. In the euro area, the principle of independent national responsibility is currently in force. The Maastricht Treaty, with its "no bail-out" clause, even explicitly ruled out mutual liability among member states.

However, that does not mean that each country can run up debt at will. On the contrary: sound public finances are a key prerequisite for a monetary policy based on price stability and for keeping the euro area stable over the long term. Therefore, additional rules were put in place to protect the single currency: the debt rules, which were fleshed out in the Stability and Growth Pact, and the ban on the monetary financing of the public sector, ie the ban on financing government deficits by printing money.

At the same time, many proposals for institutional reform are aimed at increasing risk-sharing still further, yet they remain vague when it comes to surrendering sovereign rights to the European level. That comes as little of a surprise. After all, willingness among member states to relinquish sovereignty is not particularly pronounced.

As long as member states cling to national decision-making, increased risk-sharing in the policy fields affected will undermine the stability foundations of the euro area.

Let me give you a specific example. As long as member states can have a major say on the quality of bank balance sheets, such as through national insolvency legislation, then a European deposit protection scheme would not only be premature but would also create incentives to shift risks to the banking system; these would then have to be borne by all.

A European deposit protection scheme, moreover, would be justifiable only if banks were less dependent on the solvency of their home countries. However, since the banks are currently holding large quantities of their own countries' sovereign bonds, a European deposit protection scheme would be tantamount to communitising sovereign debt.

Without the willingness to extensively relinquish sovereign rights, there is only one way to weatherproof the structure of the euro area: we need to reinforce individual national responsibility by making the "no bail-out" clause enshrined in the Maastricht Treaty more credible. After all, the only way this "no bail-out" clause can exert its disciplining effect is if financial market players also believe it to be in force.

In order to lend credibility to the "no bail-out" rule, sovereign debt restructuring would need to be possible without jeopardising financial stability. As things now stand, were one euro-area member state to become insolvent, this would threaten the entire euro-area financial system owing to the close nexus between sovereigns and banks. Member states, fearing contagion effects, were therefore willing to provide fiscal assistance to Greece and other euro-area countries in crisis.

But it's not just the recipient countries that benefit from the ESM firewall, the private creditors are, too, as, thanks to the ESM loans, they get back all the funds they lent to the crisis countries, for which they will, in most cases, have collected a sizeable risk premium. Only in Greece have private creditors taken a voluntary haircut, but that wasn't until 2012, two years after the first fiscal assistance was granted.

This practice is not compatible with the liability principle propounded by Walter Eucken ("Those who enjoy the benefits must also bear the costs").

Against this background, the Bundesbank presented a relatively simple proposal a number of years ago that is designed to prevent private investors being let off the hook at taxpayers' expense. This idea would require the bond terms and conditions to be changed such that the paper automatically rolls over by, for instance, three years if a country applies for ESM assistance.

During this period, it would need to be determined whether the country was only temporarily illiquid or actually insolvent. Should the latter be the case, private creditors could then be bailed into the necessary restructuring. This would minimise the risks to taxpayers since the required volume of assistance loans would be lower from the outset.

Creditor liability, of course, presupposes the creditors' ability to bear the resultant losses. Ensuring this is, not least, a task for financial market regulation, which brings me to my third and final topic.

4. Financial market regulation

I have already mentioned two flaws in the existing institutional framework: the weakened binding effect of the fiscal rules and the lack of credibility afflicting the "no bail-out" rule. A third flaw – in effect, an Achilles' heel of monetary union – turned out to be the banking system during the crisis.

Many banks are still suffering from legacy risks in their balance sheets to this very day. Large volumes of distressed loans have been taking their toll on poorly capitalised and insufficiently profitable euro-area institutions, in particular. Although the cleansing of balance sheets is making progress, it will not be completed for the foreseeable future.

Bearing this in mind, it is, moreover, little wonder that euro-area bank lending is still mired in a slump despite the extremely accommodative monetary policy.

This state of affairs likewise shows that the expansionary monetary policy is reliant on actions by other agents as well as by policymakers in order for its full effects to materialise. This explains, for instance, why Japan suffered at least a "lost decade" while the United States overcame the financial crisis very quickly.

However, significant strides have been made towards a less fragile banking system in the seven and a half years that have passed since Lehman Brothers collapsed. Misguided incentives were reduced and institutions' resilience has been strengthened. Important regulatory measures have been implemented or are currently being finalised. A case in point is Basel III, which has already increased the quantity and quality of capital being carried on banks' balance sheets.

In Germany, the average tier 1 capital ratio was languishing at just 9.1% at the beginning of 2008. By mid-2015, though, it stood at 15.6%, while the quality of own funds had improved perceptibly at the same time.

The revamping of the Basel framework is scheduled for completion before the end of this year. A further significant tightening of the capital adequacy requirements, in the sense of a "Basel

IV", is not on the agenda, however. I think this is an important message, as the banking system should not be additionally burdened by unnecessary regulatory uncertainty.

Global systemically important banks (G-SIBs), which are generally regarded as being "too big to fail", will have to demonstrate their total loss-absorbing capacity (TLAC) going forward. But the other EU banks, too, will be asked to hold capital instruments which, in a resolution event, can be converted into liable capital.

Bail-in will take precedence over bail-out in future. It needs to be possible to resolve distressed banks in an orderly fashion, with the taxpayer only footing the bill as a last resort.

Naturally, this implies higher risks to investors, who also witnessed this first-hand in the past few months. However, those now calling into question, yet again, the liability of owners and creditors should also step forward and say who should pay for the losses of a failed bank instead. This must not be the taxpayer, at any rate, for that would jeopardise the standing of our free market economic system in society at large.

Ladies and gentlemen

The creation of the Single Supervisory Mechanism (SSM) for banks in Europe has been a significant step – the most important step, even, since monetary union was launched. The SSM has remedied an inherent flaw in economic and monetary union, consigning the occasionally rose-tinted glasses of national supervisors to the history books.

Much has been done, then, to make the banking system more robust. Yet a banking system can only ever be truly stable if banks' reliance on the solvency of their national sovereigns is effectively reduced as well.

Too little has been done in this regard thus far. On the contrary: banks in some euro-area countries have invested heavily in their domestic government bonds in the past few years, making them even more reliant on the health and wellbeing of their governments' public finances. Italian banks have pumped nearly all their capital into domestic government bonds, and the situation is similar in Spain.

The preferential regulatory treatment of sovereign borrowers is one of the primary reasons for this. Unlike private sector borrowers, governments are not subject to the cap on large exposures. In addition, virtually no capital is required to be held by banks against government bonds since such bonds are permitted to be given a zero risk weight. The European Commission's own think tank has therefore written quite rightly in a recent paper that "zero-risk weighting of sovereign debt in the EU, as well as the exemption from existing large exposure requirements, are a source of vulnerability."

I have therefore been advocating, for quite some time, the abolition of the preferential treatment of sovereign borrowers and welcome the fact that this issue is now also on the agendas of the relevant regulatory forums.

There has been opposition to this proposal and that's hardly surprising. It ought to be clear that such rules could only be phased in gradually, as countries would need time to adjust to the new regime. But it is equally clear that only if banks can deal with a sovereign default will the restructuring of a highly indebted sovereign's debt emerge as a realistic option.

Financial markets are, by their very nature, crisis-prone as they tend towards exaggerations. Smart regulation is therefore indispensable.

Appropriate capital adequacy requirements are the best and most important contribution that financial market regulation can make towards the stability of the banking sector. The better a bank's capital base, the more readily that bank will be able to withstand losses and a period of low profitability brought about by the low-interest-rate setting, say. And this is a point where some people see regulation as an impediment because, in their view, it imposes limits on banks or creates costs. In this sense, regulation always walks a fine line between too strict and too lenient.

In addition, care has to be taken to ensure that bank regulation does not lead to undesirable evasive action on the part of banks. I am thinking here, in particular, of business being shifted into what is known as the shadow banking sector, the importance of which has grown in the past few years.

In Europe, especially, this trend is not problematical in and of itself. Given the major importance of bank lending for corporate finance, enhancing the role of alternative, market-based sources of funding could well be quite conducive to financial stability – provided, that is, the potential risks are adequately and consistently regulated.

This is an area where significant progress has been made globally and at the European level over the past few years. Examples include the regulation of managers of alternative investment funds or the rules governing securitisation. However, a number of items on the regulatory agenda still need to be wrapped up.

At the global level, for instance, liquidity rules for investment funds need to be developed in order to prevent excessive maturity transformation. And, at the European level, it would make sense, during the process of creating a capital markets union, to regulate credit funds in an adequate and consistent manner in order to avert risks to financial stability.

Ladies and gentlemen

You might have heard the tale about the client that goes up to a bank teller and says, "Tell me how much money's in my account – and hurry up, you fool," whereupon the teller goes to the manager to complain about the cheeky client. The manager then asks him, "How much does the guy have in his account?" "Three million," the teller replies. The manager then says, "Tell him how much is in his account – and hurry up, you fool."

Quite apart from the fact that, in times of negative central bank deposit rates, large sums of customer funds are possibly no longer all that welcome, this anecdote also seems a bit dated in the light of digitalisation. I mean, who still goes to a bank these days to check the balance on their account?

The current wave of digitalisation sweeping through the financial sector, in fact, goes far beyond internet banking, which is now standard operating procedure. It is in the process of revolutionising the banking industry.

Highly specialised, innovative financial technology enterprises, also known as fintechs, represent a new group of competitors to traditional bricks-and-mortar banks. Blockchain technology, originally developed for the virtual currency known as the bitcoin, has a wide variety of uses for financial services, such as in securities trading.

At the same time, increasing digitalisation is making the financial system ever more reliant on technical infrastructures. Cyber risks have grown considerably in the past few years.

There's no need to elaborate on this issue here, all the more so as these topics will be discussed on several occasions in the course of today. It is clear that digitalisation and cybersecurity are a major challenge not only for banks but also for supervisors.

We should not stifle the innovative power of fintechs, yet we need to keep an eye on potential risks to financial stability. To quote Felix Hufeld, the head of the German financial supervisor, "It is not a firm's 'coolness factor' which is decisive, but the type of business it conducts and the risks it takes in doing so."

Ladies and gentlemen

There is no question that banks are currently facing major challenges. However, I have no doubt whatsoever that banks will also continue to play a crucial role in the European financial system going forward. Since the economic structure features a large number of small and medium-sized enterprises, the financial system will remain primarily bank-based.

5. Conclusion

I would like to conclude with a few remarks.

At the beginning, I quoted a journalist who, at banking conferences, always heard all those words ending in "-ing" and "-ation." As you will have noted, my speech, too, was teeming with nouns ending in "-ing" and "-ation"

I started with monetary financing of the public sector, continued with fiscal consolidation and interest rate differentiation, the disciplining effect of the markets and the restructuring of sovereign debt, the finalisation of regulation, the "deprivileging" of government bonds, and I ended with digitalisation.

The Canadian-born economist John Kenneth Galbraith, who passed away nearly ten years ago, is credited with the caustic remark that "meetings are indispensable when you don't want to do anything."

With regard to the Finance Forum Liechtenstein, that's most certainly not a view that I would espouse. Quite the opposite, in fact – exchanging views and refreshing contacts is certainly doing something, and will ultimately also benefit your firms.

I would therefore like to wish you a rewarding conference and thank you for being such an attentive audience.