Andreas Dombret: The ECB's low-interest-rate policy - a blessing or a curse for the economy, consumers and banks?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Sparkassen-Gesprächsforum, Witten, 1 February 2017.

*   *   *

1. Introduction

Mr Heinemann

Ladies and gentlemen

Almost exactly a month ago, at the beginning of January, one of my colleagues told me about his aunt, whom he had seen at Christmas. She is 63 years old and lives in Dagersheim, a small village outside Böblingen in deepest Swabia – a region whose inhabitants are, stereotypically, the paragon of thrift. As a doctoral graduate and chemist at a major cosmetics manufacturer, she has built a nice little nest egg that she intends to live off well into retirement.

My colleague's aunt invests this wealth. For around 30 years, she has also used part of this money to trade in the markets – and she has not suffered a single loss in all that time. So when it comes to money matters, this lady is not to be underestimated. However, she has invested the bulk of her money more conservatively – in call and fixed-term deposit accounts, for example.

But what has long rankled this lady is the fact that call and fixed-term deposit accounts earn practically no interest anymore. With a nephew who works at the Bundesbank, it was, of course, inevitable that the topic would come up over a meal of Christmas goose and red wine. Various questions cropped up: where should we be putting our money in times such as these? Aren't such low interest rates dangerous? And how long will – and I quote – "this Mr Draghi" carry on like this?

The story I heard at the start of the year is still fresh in my mind. It tells me two things. First, that interest rates remain an important topic of conversation across much of society and, second, that even those who are well versed in financial matters find it hard to fully grasp the issue.

So, if you ask me, the savings bank here in Witten made an excellent choice when putting together this evening's programme. What's more, the fact that this hall is so packed further underscores the level of interest in this topic.

Interest rates – and policy rates, in particular – hold enormous sway. It is not for nothing that we have a whole system of central banks in Europe, with the European Central Bank at its core, that engages in setting policy rates. Interest rate changes have a direct impact on economies. However, that's a fact that's only dawning on many people now that interest rates have been unusually low for so long.

In Germany, the media coverage of the low interest rates tends to be negative. So, in terms of the title of my speech, the general public appears to view low interest rates more as a curse than a blessing. Let me make one thing clear from the get-go: I see this as a more nuanced matter.

But first things first. I would like to address, in turn, three key groups that are affected by the low interest rates: banks, consumers, and the economy as a whole. Furthermore, I would like to take a crack at answering the question of how long this phase of low interest rates will keep going on.

2. Effects of low interest rates on banks and savings banks

Let's begin with the effects of the low interest rates – to be more precise, their impact on banks and savings banks.

By now, word will have surely got around that representatives of financial institutions are not very happy with the current low-interest-rate environment. Yet at first glance, the conditions in which the banks are operating would appear to be perfect. After all, the European Central Bank (ECB) is – in return for the appropriate collateral – lending them unlimited amounts of money. The cost: 0%. And if the banks lend heavily to enterprises and households as well, they even receive a premium on the funds borrowed from the ECB. Just to remind you, up until a few years ago, policy rates were much higher, and far tighter restrictions were placed on money borrowed from the ECB.

The problem for banks and savings banks is now quite similar to the one facing my colleague's aunt: where to put their hard-earned money if they still want a decent return.

2.1 Interest-driven business models no longer fit for purpose

This is, to all intents and purposes, a matter of life or death. After all, credit institutions' business models – and hence their earnings, too – are heavily reliant on interest income, especially when it comes to small and medium-sized institutions. This is, to a certain extent, a natural consequence of the function they perform in the economy, but is also a strategic decision in some cases.

There are two main factors behind the income squeeze. First, higher-yielding legacy loans are maturing and being replaced by ones generating lower returns. Second, profits are falling because the spread between short-term and long-term interest rates is currently relatively narrow. Added to this is the fact that deposit-based funding is significantly less attractive than it once was. The reason? While market interest rates continue to dwindle – even dipping into negative territory for some shorter-term maturities – the fierce competitive environment makes it very difficult for banks and savings banks to pass negative interest rates on to retail customers. Corporate clients, too, are anything but thrilled by this idea. We can therefore conclude that profitability is exceedingly weak among German banks and savings banks, even by international standards. That's nothing new, but the low-interest-rate environment is exacerbating the situation.

2.2 No silver bullet in sight

But in the current situation, reversing the slow downward trend and putting income back on a more sustainable footing is no easy task. Broadly speaking, banks have five levers that they can use to increase their profit margins. Let's briefly go through these five options and examine how well they would work in the current climate.

The first lever is to utilise interest rates at the short and long end of the yield curve. Typically, the interest rate on an investment will rise as its tenor increases. So banks can boost their returns by issuing longer-term loans or making longer-term investments. We are currently seeing this effect in Germany in the case of mortgage lending. Up until around three years ago, long-term mortgages – that is to say, those with terms of more than ten years – made up around 30% of new business. By the end of last year, the share of long-term mortgages had already crept up to around 45%.

However, this move comes with two disadvantages. First, if banks use short-term funding but lend over the long term, they could run into difficulties as soon as interest rates rise again. Long-dated, mark-to-market assets would then lose value, while funding costs would mount on the liability side. In a nutshell, institutions would be exposed to heightened interest rate risk. Second, since long-term interest rates are likewise very low at the moment, the effectiveness of this lever is very limited. As you are no doubt aware, the yield on ten-year Federal bonds (Bunds) slipped into negative territory in the middle of last year – for the first time ever, incidentally. So, to generate one percentage point more of yield, banks today need to extend maturities to a considerably greater extent than previously – with corresponding consequences for interest rate risk.

The second lever: banks can consciously put money into riskier assets. Higher risk means a higher rate of interest, and thus higher returns. This is another strategy that German banks and savings banks are pursuing. We can see this in the liquidity reserve, for example, where, since 2011, the share of prime assets has been reduced in favour of those with lower ratings. The drawback of this lever is obvious: go too far and the riskiness of the assets will become so great that financial stability may be endangered. To stop that from happening, supervisors intervene early on and curb banks' risk appetite.

The first two levers can thus be summed up as ways of salvaging the interest-driven business model over time. But, as we have seen, that only works after a fashion in the medium to long term.

With that in mind, let's move swiftly on to lever number three, which tackles the problem in a rather more hands-on manner: find new sources of income. In practice, this usually means raising fee and commission income. Perhaps the savings bank sends you, its VIP clients, its annual financial report? If it does, the latest edition will tell you that the Savings Banks Finance Group raised its net fee and commission income by almost 9% between 2014 and 2015. This served to offset the simultaneous decline in net interest income.

But perhaps you don't need to leaf through the financial report to know what I'm talking about. Maybe you have already experienced increases in bank charges first-hand. If you have, I expect you weren't impressed. But you will have to get used to it – we all will. There's no getting around the fact that bank services incur costs. And after many a year in which banks could cross-subsidise these costs by means of interest income, we now have to get used to the idea that banks and savings banks will invoice them directly.

Talking about costs, that brings us straight to lever number four. After all, it is far from clear whether credit institutions can make up for the drop in interest income on a lasting basis by ramping up their commission income. That is why German banks and savings banks also need to tackle their costs. They currently have a cost/income ratio of 73% – that is to say, they have to spend 73 cents, on average, to earn one euro. That's the highest level in the entire euro area, so there is room for improvement on this score. One problem, however, is that many cost-cutting measures can't be rolled out overnight and that it will take time for them to impact positively on the bottom line. All the more reason, then, to waste no time in getting to grips with the issue of costs.

Germany's banking sector doesn't just have a relatively poor cost/income ratio by European standards – it's also one of the continent's largest. And that brings us to the fifth and final lever: consolidation among banks and savings banks. It's a topic that has many facets – institutions downsizing by streamlining branch networks, merging with other institutions or even exiting the market altogether. Eliminating slack in the banking sector can help ease competition, boost efficiency and improve profitability.

Capacities are being reduced in Germany, but progress is lagging behind the European average. Let me give you an example. Germany's banking sector scaled back the number of branches by 14% between 2008 and 2015, compared with a rate of 17% across the euro area as a whole. Some countries have made far more progress on this score. Spanish banks, for instance, rolled back their branch networks by a third. There's probably no getting around a degree of further consolidation in Germany, because the sector there still has slack dating back to the pre-financial crisis era.

At this point, some of you might interject that more consolidation and merger activity won't necessarily translate into better credit institutions, and you would be right. Indeed, predicting just how much potential there is left to harness through mergers in Germany's banking sector is anything but easy. After all, a merger between two institutions running similar business franchises – as we have often seen in the savings bank and cooperative bank sectors – does nothing to address their reliance on net interest income. Putting two weak institutions together won't create one strong one. Also, savings banks and cooperative banks have, for the most part, already pooled their computer centres at the highest tier of their respective networks. So many synergies have already been leveraged.

Ladies and gentlemen, as you can see, mergers are not a silver bullet. And as we have already seen, the same can be said about the four other levers which banks and savings banks can adjust in response to the low-interest-rate setting.

2.3 Everything's under control (for now)

So how bad, exactly, are things for the German banking sector in the environment of low interest rates? Despite all the problems, I can sound a cautious "all clear" for now, and that goes especially for the small and medium-sized institutions. It's true that the low rates have clearly eaten into their profitability – I spoke about the effects earlier on – but their effects are still bearable for the bulk of credit institutions. Let me put it clearly: capital adequacy and liquidity levels in the German banking sector are beyond dispute. But things might get tight over a medium-term horizon if interest rates persist at their current low levels. The Bundesbank intends to stay abreast of developments, so it will be running another low-interest-rate survey this year among the institutions it supervises, following on from similar exercises back in 2013 and 2015. In this survey, we will venture to look to the future and simulate a number of different interest rate scenarios so that we are ready to intervene at short notice should any genuine problems arise. The results of this survey also have a bearing on our dialogue with these institutions.

But the current situation and the risks which a persistent spell of low interest rates presents for institutions aren't the only factors we need to keep an eye on – what happens when a phase of low rates comes to an end also needs to be investigated. Because when interest rates change direction, they can potentially be a source of major risk. Especially if rates were to climb abruptly following a protracted spell at low levels, the short-term response would probably be a sharp fall in bank earnings. We can get a rough idea of this interest rate risk using a metric known as the Basel interest rate risk coefficient, which states how much equity capital, in percentage terms, would be eliminated by a two-percentage-point shift in the yield curve. This measure has been increasing continuously since back in 2011. It reveals that more than half of the savings banks, and roughly two-thirds of the credit cooperatives, are now exposed to heightened interest rate risk. I'm not saying that's necessarily a bad thing – after all, taking on that kind of risk is one of the functions they perform in the economy. But it does indicate just how important attentive risk management and capital adequacy are in the banking system.

Ladies and gentlemen, I believe one thing has become clear. There's no love lost between banks and low interest rates, and that's never going to change. Those low rates are shaking financial institutions' business models to the core and eroding their earnings. The five traditional levers which institutions could adjust to fight back against their malaise do work, but their effectiveness is limited. That's why credit institutions are so keen to see the back of the low-interest-rate setting. But the exit will need to be managed carefully if banks are to emerge unscathed.

3. Impact on consumers: is there any point in saving anymore?

You could say the situation that credit institutions find themselves in answers the question I mentioned earlier in my speech – the question my colleague's aunt raised, remember, about the risks presented by low interest rates. But let me now turn my attention to consumers. It would make sense to split consumers into two groups, though they may well overlap, of course: borrowers and savers.

Let's begin with the borrowers. The house builders among you won't be the only ones who know that credit terms are exceptionally favourable at the moment. That, too, is an outcome of the low-interest-rate setting. One need only consult the mortgage lending statistics to see that this has gone down very well among consumers. Mortgage volumes have seen substantial growth since 2009, and the rate of increase even accelerated over the last two years.

It makes perfect sense to harness today's attractive credit conditions if you are already planning to make a major investment in the medium term like building a house. But just like credit institutions, consumers, too, should always have one eye on the end of the low-interest-rate period, and consider their capacity to service their debts once interest rates start picking up again.

That brings me to the group of savers who, it's safe to say, have been attracting the most attention recently in the public debate over low interest rates. People are increasingly wondering whether there's really any point in saving with interest rates at such extremely low levels.

Let me first of all say that I can very much appreciate the concerns of savers. That said, the nominal rate of interest – the one we see on our account statements and which is very low at the moment – isn't the variable we should be focusing on. What really counts is how the purchasing power of savings moves over time. For instance, the extent to which provisions made for old age will help cover the cost of living in retirement is determined by how the purchasing power of that pension evolves over time. And at the end of the day, purchasing power developments are driven by the real rate of return – that is, the nominal rate of interest with inflation netted out. So if you are wondering how far your savings will go later in life, a 3% interest rate with inflation at 3% will produce exactly the same outcome as interest rates of zero and no inflation.

Inflation here in Germany bounced back recently to a level that is well clear of zero. Projections suggest that it will climb to 1.3% in the euro area this year. The Bundesbank expects inflation in Germany to come in at 1.4%, and the increase might even be around half a percentage point stronger if the oil price stays at its current level. But for the sake of honesty, it should also be said that the particularly safe savings deposits held at credit institutions once attracted a higher rate of interest, but then again, the rate of inflation at that time was much higher, too. Compared with the past 20 years, the real rate of return on savings deposits today isn't exceptionally low – in fact, savers had to make do with even slimmer real returns between 2011 and 2013.

It is also worth noting that Germans don't just stash away their financial assets under their pillow or in a bank account. In fact, more than half of their wealth is made up of claims on insurance corporations and securities holdings, and that figure is broadly on the rise. The real rate of return on these assets eclipses the real rate of return on particularly safe bank deposits. Plus, German household financial wealth saw steady growth in the low-interest-rate environment as well.

To sum up, then – saving still makes sense, even if there's no getting round the fact that it used to be a more lucrative endeavour. And neither savers nor credit institutions are exactly tickled pink by low interest rates – and understandably so. But if we are to make a fair and equitable assessment of the situation, we also need to consider the alternative to a policy of low interest rates. And that brings us to the impact on the economy.

4. Impact on the economy: low interest rates as a "necessary evil"

Indeed, the low interest rates have cushioned the impact of the crisis and are propping up the gradual economic recovery sprouting in Germany and Europe. Admittedly, the European Central Bank does not gear its monetary policy towards these factors – its target is inflation. But economic activity and price developments are closely linked. Because when enterprises reduce slack, prices generally go up. And as it happens, the accommodative monetary policy is proving to be particularly rewarding for export-oriented economies such as Germany’s, because it tends to push down the value of the domestic currency, thus boosting export activity.

Monetary policy, then, has created an investment-friendly environment for enterprises. Consumers are benefiting, too, as their jobs tend to become more secure, tax revenue is brisk, and general government’s interest burden declines. And of course, banks and savings banks also prefer to do business in a stable economic environment.

But that’s certainly not to say that the ECB’s ultra-loose monetary policy is free of risks. It even has serious side-effects, mainly in that it becomes less effective over time and its costs increase.

Persistently low interest rates are making it more difficult for businesses to honour their defined benefit obligations under occupational pension schemes because the amount of provisions they put to one side is based on the average interest rate over the past few years. That means, the longer interest rates remain low, the more pension provisions they will have to set aside.

The short-term impact of the low-interest-rate policy on the economy is positive. But the magnitude of the side-effects inflicted by the zero-interest-rate policy will only emerge much later down the line. Speaking at the World Economic Forum in Davos two weeks ago, the respected American economist Nouriel Roubini called the low interest rates a “necessary evil". Given the points I have raised over the last few minutes, I would say that’s a good way of putting it.

5. Exiting the low-interest-rate environment: what happens next?

The “64 million dollar question", however, is how long this “necessary evil” is supposed to last. This brings us to the last of the questions we still need to answer – how much longer will things go on like this?

First, let’s take a look at inflation. As you know, the inflation rate has been very low over the last three years, even slipping below zero in some months. There were several reasons for this, one being the sharp decline in energy prices since the middle of 2014; another, the fact that the euro-area economy is only recovering gradually, with some countries still battling the after-effects of the financial and sovereign debt crisis.

That being said, inflation has gone up again recently, largely because oil prices have bounced back. If oil prices remain static, the inflation rate might even rise to just under 2% over the next few months. So we’re now a considerable distance away from the deflationary risk that some people perceived in the last few months – and if you ask me, these warnings were always somewhat overstated in any case.

The ECB currently projects that it will take until 2019 for the inflation rate in the euro area as a whole to return to its target level of below, but close to, 2% on a lasting basis. So as far as the outlook for inflation is concerned, it makes sense to leave monetary policy in expansionary mode because the economic upturn in the euro area continues to be drip-fed by monetary policy.

But what’s also clear is that while it’s all well and good to disagree over the scope and design of the monetary policy measures, it is vital for the Eurosystem to tighten the monetary policy reins again when the time is right. Once we are within striking distance of the inflation target, we must act quickly.

Ladies and gentlemen, as you have probably already guessed, I cannot tell you exactly when interest rates will start to rise again. That’s partly because the central bank can’t just go it alone and set interest rates “willy nilly", as it were. We set the policy rates and thus indirectly control the interest rates in the economic cycle, that's true, but long-term interest rates, in particular, are driven by other factors as well.

And they do not depend solely on inflation – or inflation expectations, to be precise – but also on the real interest rate, which is driven primarily by growth expectations. After all, it is ultimately enterprises and house builders, of course, that pay interest. And they can only do that if they are in a good economic position. Only then are lenders – meaning banks, savings banks, mutual funds or private investors – in a position to charge higher interest rates.

Unfortunately, however, longer-term growth expectations are not as upbeat as they were a few years ago. This is partly because growth in some countries was driven by excessive lending before the crisis. Cast your mind back to the credit-fuelled real-estate bubbles in Spain and Ireland, for example, or the enormous levels of debt in countries such as Portugal and Greece which made it possible for public and private-sector consumption to go overboard. We will probably not return to growth rates of the kind seen in the run-up to the financial crisis for the foreseeable future.

But it wouldn't do any harm for growth to be slightly stronger than it is right now. This is where governments need to step in. They need to adopt reforms that encourage job creation in the productive sectors of the economy. The eagerness to embrace reform was strong immediately after the crisis, but it quickly waned, regrettably, once the dust began to settle.

So bearing that in mind, politicians have a major role to play in determining when interest rates start to rise again. However, we must be patient. The imbalances that helped trigger the financial and sovereign debt crisis, and which are still curbing growth even now, unfolded over many years. We cannot expect these imbalances to be resolved in the blink of an eye.

6. Summary

Ladies and gentlemen, so – should we consider low interest rates a blessing or a curse? If you ask me, the answer is a clear "neither".

There are good reasons why the European Central Bank has a very clear mandate to keep inflation at a rate below, but close to, 2% over the medium term. It pursues this objective by setting the policy rates. Its accommodative monetary policy bolsters economic activity, and that's in the interests of banks, savings banks, consumers and enterprises. But it is also true to say that the measures have considerable side-effects which will only strengthen over time. We have discussed the impact of these side-effects on all those involved.

Europe won't find a way out of the low-interest-rate environment for good if we just point our finger at the central bank. Returning to a sustainable path of stable growth and stable prices will require others to make an effort, especially the governments of the euro-area countries. They must make the necessary reforms in order to achieve sound government finances, competitive economic structures and a functioning public sector.

Ladies and gentlemen, I have reached the end of my speech, but I still haven't really answered one of the questions we asked at the start – where's the best place to put the money? I hope you will appreciate that providing investment advice is a matter for banks and savings banks, and as a central banker and bank supervisor, I am not allowed to encroach on their turf.

Thank you very much for your attention.