Andreas Dombret: The euro area, the German economy and the Pfandbrief

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Pfandbrief seminar, Tokyo, 18 February 2014.

*   *   *

1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak at the Pfandbrief seminar here in Tokyo. It is a pleasure to be here today.

When abroad you suddenly become aware of the cultural stereotypes that surround us. And then you realise that all of them are wrong – except for the flattering ones, of course. Regarding Germans, some of the more flattering stereotypes include reliability, punctuality and exactitude. Incidentally, these are also some of the characteristics which make for an extremely good debtor: reliability to repay your debt, punctuality to repay it on time and – maybe most important of all – exactitude to honour the debt and not accidentally forget all about it.

In this respect, the Pfandbrief is indeed a typical German financial instrument. It combines all of the virtues I mentioned and its global success shows that it is well-regarded throughout the world.

I will offer some thoughts on the Pfandbrief later on. But first, let us take a look at the big picture, as central bankers like to do. To gain an understanding of the Pfandbrief's habitat, I will discuss the current state of the economy in the euro area and in Germany. After all, Pfandbrief cover pools mainly consist of public bonds and mortgages. Thus, the state of the sovereign debt crisis in Europe and the condition of the German real estate market play an important role for the Pfandbrief.

2. The big picture – Germany and the euro area

For nearly four years now the debt crisis has been the most relevant issue when debating financial stability in the euro area. And it remains a topic discussed with some concern. Thus, I am delighted that in early 2014 I can offer some good news.

The euro area as a whole has finally left recession. By now, we have seen two consecutive quarters of economic growth, 0.1 % in the third quarter of last year and 0.3 % in the fourth quarter. Looking ahead, the outlook for 2014 is quite encouraging. Forecasts are projecting that euro-area GDP will grow by more than 1 %. And this recovery is not only driven by the so called "core countries" such as Germany. Some of the crisis-hit countries have also finally embarked on the path to recovery. And those which have not can at least see the light at the end of the tunnel.

Take Greece for example, which has been at the centre of the crisis since May 2010. Here, significant progress has been made with regard to structural reforms: unit labour costs have decreased markedly and price competitiveness has improved. Nevertheless, Greece must stay on the path of agreed reforms. In particular, the lag in privatisations should be addressed and the efficiency of public administration needs to be improved.

Elsewhere, it also seems that the efforts to implement structural reforms are gradually bearing fruit. True, the high levels of unemployment in many countries paint a gloomy picture and emphasise what a social catastrophe the crisis has been. Nevertheless, the unemployment figures at least appear to be levelling off, and they are already coming down in some countries such as Ireland, Portugal and Spain.

In addition, competitiveness has improved in most peripheral countries over the past few years. Almost all of the countries have seen their national unit labour costs fall substantially. Improving competitiveness in turn drives exports higher. All peripheral countries – except Cyprus – are projected to see some export growth this year. These achievements are reflected in current accounts reverting more and more to positive balances.

And Germany is part of the rebalancing equation. Since 2007, the intra-euro-area German current account surplus has continuously shrunk from 4½% of GDP to 2¼% of GDP. This adjustment has been driven by shrinking exports. Furthermore, business investment in Germany is projected to rebound in 2014 and 2015. Thus, the rebalancing should proceed.

The progress that these abstract figures reflect is also visible in more concrete events. For example, Ireland and Spain have exited their financial support programmes without any frictions. And Portugal is planning to leave its adjustment programme in the first half of 2014. All three countries have recently accessed the sovereign bond markets at low yields.

It seems that international investors increasingly acknowledge the countries' efforts and achievements, which have boosted confidence overall. In the case of Ireland and Portugal, international investors have bought more than 80 % of the newly issued bonds. I would argue that these developments underscore the impressive progress that the peripheral euro-area countries have made in adjusting their economies.

All in all, it is safe to say that the adjustment process is underway, with some countries making more progress than others. A leading group of countries is already within sight of the finishing line, while others still have some way to go. Nonetheless, the peripheral countries still face some challenges. Against this backdrop, it is essential to maintain the momentum and ensure that the necessary reforms are implemented.

A country that can justifiably claim to have some experience with reforms is Germany. Not too many years ago, Germany was dubbed "the sick man of Europe". But structural reforms have brought the country back on track. The medicine which was decried back then as "taking a wrecking ball to the welfare state" showed remarkable effect.

Of course, reforms in Germany cannot serve as a blueprint for other countries. The structural features of the European economies differ markedly and every country needs a different set of reforms. Nevertheless, the German experience may serve as evidence that reforms do pay off in the end.

The reforms also helped Germany to recover rather quickly from the crisis. Indeed, the German economy regained momentum last year and according to all forecasts this upturn will continue. The Bundesbank's economists expect the German economy to expand by 1.7 % this year and by 2.0 % in 2015.

Admittedly, one of the reasons for the good news I just presented are the extraordinary monetary policy measures the ECB has taken. And there are commentators who propose an even more expansionary monetary policy.

They often cite the risk of a Japanese scenario, warning that the euro area faces a fate similar to that of the Japanese economy, which has suffered from the effects of a deflationary trend during the last two decades. But the situations differ greatly.

First, the Japanese yen appreciated sharply at the beginning of the 1990s. The result was that import prices receded, acting as a brake on the general price trend. The euro experienced no such strong appreciation during the crisis.

Second, deflation requires that nominal wages fall – or at least expand at a slower pace than productivity – over a protracted period of time. In Japan, labour income per employee dropped considerably over many years. In the euro area, no such broad-based development is to be seen. Only in Ireland and Greece has compensation per employee fallen markedly.

Fears of a Japanese scenario are therefore misplaced. Moreover, the notion of Japan's "lost decades" needs to be seen in perspective. The weakness of growth in Japan is partly a natural consequence of the country's demographic change, as the working-age population has been shrinking since the mid-1990s. And that, by the way, is an economic policy challenge that awaits Germany in the years to come.

In any case, there are two things we should bear in mind: first, monetary policy can buy time but it cannot buy a solution for the underlying structural problems. Second, a prolonged period of low interest rates and high liquidity provision might sow the seed for new exaggerations and mispricing in some markets.

For example, signs of a search for yield are becoming increasingly visible. In corporate debt markets, for instance, valuations already look rather stretched. And in the global low-interest rate environment, ambitious valuations may well spread to other market segments. In this regard, the strong recovery in some countries' property markets should set us thinking.

The German housing market is no exception. Between 2009 and 2013, prices in large cities rose by almost 36 %. And in 2013 they increased by another 8.9 %. Some indicators already point to overvaluations in urban areas. Nevertheless, when looking at the German market as a whole, the situation seems less dramatic. According to data from the "Association of German Pfandbrief Banks" – the host of today's seminar – prices rose by around 3.5 % during the first three quarters of 2013 – a figure that does not appear too exciting. Overall, prices in Germany have not yet moved away from fundamentals.

For me, warning bells would start ringing as soon as a rapid increase in housing prices would be accompanied by a significant rise in credit. And even more warning bells would be ringing if this rise in credit was accompanied by deteriorating loan standards. Having said this, I can assure you that at this point in time I am surrounded by silence. We think that macrofinancial risks in this area are rather low for now.

3. The German Pfandbrief and the search for safe assets

All in all, the big picture does not look too bleak. And this is certainly good news for Pfandbrief investors. As the underlying cover pools are mainly composed of government bonds and mortgages, developments in these markets are of fundamental importance to the Pfandbrief. Sound public finances, a healthy housing market and a stable economic environment are the pillars that underpin the reliability of the Pfandbrief. If the Pfandbrief today can boast of a reputation of reliability, it is to a great part because it rests on a solid German state and a sound economy.

And it has been resting there for quite some time now. Originally, the German Pfandbrief was introduced over 200 years ago by the Prussian king Frederick II. Frederick's intention was to ease a credit crunch after the Seven Years' War, and with the Pfandbrief he created a financial product of extremely long standing.

After more than 200 years of trading experience on the German bond market, the Pfandbrief has gained the trust of investors and a reputation as a secure and crisis-proof investment. In 2012, the size of the Pfandbrief market was some Euro525 billion, which amounts to almost 19 % of outstanding global covered bonds.

The trust in the Pfandbrief also stems from the fact that since 1901, no German Pfandbrief bank has had to declare bankruptcy. But as Frederick II remarked: "what is the good of experience if you do not reflect on it?" More than 100 years without a single default is certainly an impressive feat. However, we have to reflect on the question of how to continue this accomplishment in the future.

We have to acknowledge that during the crisis some Pfandbrief banks encountered difficulties. Hypo Real Estate, for instance, had to be saved with public money. And in the first half of 2009, the Pfandbrief market as a whole was affected to a certain degree when the broader covered bond market experienced significant stress. The intervention of the Eurosystem in the covered bond market certainly helped to ease that stress.

In the wake of the financial crisis, though, many sovereigns and banks lost their top ratings. The consequence was widespread downgrades, also in the covered bond market. Many Pfandbriefe were affected and lost their AAA-rating. Nonetheless, their spreads versus risk-free securities did not significantly change, displaying unbroken investor interest and trust.

Meanwhile banks have adjusted to the changing conditions. Regarding Mortgage Pfandbriefe cover pools, for instance, overcollateralisation more than doubled. In 2007, assets in these cover pools on average had a value of 116 % of issued Pfandbriefe. In the third quarter of 2013, the value of cover pools rose to 133 %.

Indeed, overcollateralisation has become all the more important. An obvious reason is that the share of riskier commercial mortgage loans in cover pools has increased steadily to surpass the share of residential mortgage loans. Only recently did this trend appear to reverse again. This reversal is probably linked to individual banks having reconsidered their commercial real estate lending activities outside Germany.

All in all, it seems fair to say that the crisis lead to a renaissance of the Pfandbrief. In 2010, a German newspaper described it as the “comeback of a bore” while Forbes Magazine asserted “covered bonds can rebuild America”. It seems that the Pfandbrief is a winner of the crisis.

Looking to the future, the Pfandbrief might benefit further from crisis-driven regulation. Basel III sees the introduction of global liquidity standards for banks for the first time ever. These new standards will increase the need for secure collateral in the financial system. And Pfandbriefe are eligible assets for the envisaged Liquidity Coverage Ratio and will in all likelihood count as “stable funding” for the Net Stable Funding Ratio.

Likewise, stricter standards for margin requirements on OTC derivative transactions will probably increase collateral usage. Furthermore, the prevalent use of central bank lending against secure collateral underpins demand for collateral in the euro area – at least for the time being. As a consequence, Pfandbriefe, along with other secure collateral, might be increasingly sought after.

For participants in the Pfandbrief market, these are certainly positive developments. As a central banker in charge of financial stability, however, I have to take them with a pinch of salt. This is mainly because an increasing amount of assets in banks’ balance sheets may get tied up as collateral – a development that has been coined “asset encumbrance”.

Increasing asset encumbrance tends to increase expected losses for unsecured investors should a bank fail. Consequently, unsecured investors are inclined to demand compensation for their more junior position in the debt hierarchy – in effect driving a bigger wedge between secured and unsecured funding costs. As a result, some banks may find it more challenging to meet their overall refinancing needs.

Potential problems could also arise in conjunction with policies aimed at bail-ins. If the ratio of encumbered assets rises, bail-in policies could be less effective, as losses would have to be distributed between fewer and fewer unsecured investors.

Some argue that to combat the potential effects of higher asset encumbrance we need to introduce widespread limits on covered bond issuance. The objective is to restrict the share of encumbered assets on banks’ balance sheets.

Indeed, central banks and supervisory authorities need to monitor the matter closely. Nevertheless, I would argue that we should not rush to implement heavy-handed measures, lest we throw the baby out with the bathwater. My argument rests on three pillars.

First, most observers agree that there is still an adequate general supply of collateral in the global financial system. Any potential scarcity of collateral may vary by jurisdiction. And different levels of asset encumbrance may well be justified taking into account specific business models of banks. In Germany, for example, there are currently no signs of an increase in asset encumbrance that would worry us. Against this background, it does not seem advisable to introduce international regulation directly aimed at limiting asset encumbrance at the current juncture.

Second, incoming regulation already addresses the potential problem of asset encumbrance, albeit somewhat implicitly. Liquidity regulation within Basel III, although accepting covered bonds to a certain extent, at the same time implements a "buffer" of unencumbered assets. And minimum requirements for "bail-inable" debt, as foreseen in the European Bank Recovery and Resolution Directive, will likely tackle the issue of asset encumbrance from another angle.

Third, collateral shortages could well be a temporary phenomenon. As regards Europe, once the banking system has recovered and bank funding markets have normalised, collateralised funding through the Eurosystem should decrease perceptibly. As a result, demand for collateral would shrink.

This last point also illustrates a more general thought: we should focus on the underlying root causes of any excessive encumbrance of assets. Soothing the symptoms alone will not take us forward. In this vein, the ECB's comprehensive assessment of banks' balance sheets is an important step as is continued support for an orderly deleveraging process of European banks. Both steps should take us a long way towards addressing any adverse effects from asset encumbrance in the financial system.

4. Conclusion

Ladies and gentlemen, allow me to sum up: economic conditions in the euro area are beginning to improve. We finally see the silver lining we have been looking for. Germany, too, is in a good economic condition and will continue to provide a solid economic base for investors.

This environment is certainly beneficial for the German Pfandbrief. And looking to the future, the Pfandbrief may further benefit from crisis-driven regulation, especially if safe assets and collateral become even more sought-after. Participants in the Pfandbrief-market understandably welcome this. Central banks and supervisors, however, will closely monitor possible side-effects, such as asset encumbrance in banks' balance sheets. In any case, we should not rush to introduce new legislation, but rather try to tackle the root of the problem.

With some satisfaction I would now like to point out that I have finished my opening remarks in time. So, with regard to the virtues of reliability and punctuality, a German central banker and the Pfandbrief indeed seem to have a lot in common.

Thank you very much.