Jens Weidmann: The macroeconomic importance of capital markets

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the annual reception of Deutsches Aktieninstitut e.V.,Frankfurt am Main, 22 May 2014.

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1. Welcome

Mr Baumann,
Dr Bortenlänger,
ladies and gentlemen

I would like to thank you very much for giving me the opportunity to speak to you at today's annual reception of Deutsches Aktieninstitut. I would like to use this occasion to talk about the importance of capital markets. Given that I am speaking before an audience of capital market experts, I shall try to avoid the danger of telling you what you already know and focus instead on the macroeconomic view of capital markets as seen by a central banker.

First, however, I would like to congratulate the winners of the University Prize, who are being honoured here today. They approached the subject of capital markets from different angles, analysed it from a scientific perspective and obtained valuable insights.

2. Doubts about the efficiency of financial markets

In macroeconomic theory, economists traditionally assume the ideal state of a "perfect capital market". Such a market is characterised by a high level of efficiency. This is, of course, based on assumptions that are not necessarily realistic. Economists, too, are aware of this – or at least most of them are.

You may be familiar with the dialogue between the two economists crossing the road. One of them says: "Look. There's a one hundred euro note lying there." The other one replies: "If a one hundred euro note were lying there, someone would have picked it up by now", and walks on.

Economists' faith in the efficiency of the markets is sometimes measured against reality and found wanting. The financial crisis, too, has sorely tested this faith in the markets' efficiency. This applies especially to the financial markets. In other words, the same markets that were previously regarded as being particularly efficient, as information spreads quickly in these markets and can therefore be promptly priced in by market participants.

However, it has become evident that market participants do not always act rationally. In addition, markets are not completely transparent and do not function smoothly at all times.

Eugene Fama's Efficient Market Hypothesis was, of course, criticised long before the financial crisis. Way back in the 1980s, Robert Shiller, who last year was awarded the Nobel Prize for economics jointly with Eugene Fama, characterised the Efficient Market Hypothesis as "one of the most remarkable errors in the history of economic thought". However, it was the financial crisis that gave wider credibility to the critics of financial market efficiency.

The crisis clearly demonstrated how fragile and how susceptible to crises the financial system as a whole really is. So what conclusion should we draw from this insight?

In my view, it would be quite wrong to jump to the conclusion that the macroeconomic utility of stable financial markets is now questionable. We must take care not to throw the baby out with the bath water. Nor should the public discussion about financial stability let us lose sight of the benefits of a modern financial system.

The aforementioned Robert Shiller takes a similar view. In his book Finance and the Good Society, he writes: "Finance, despite its flaws and excesses, is a force with the potential to help create a more prosperous and more equitable society".

There is much to suggest that a developed financial sector is good for a country's welfare and economic progress. Whether this tends to encourage the convergence or divergence of incomes is a hotly disputed point and a subject of the current debate on the role of capital markets.

However, the examples of Iceland, Cyprus and Ireland have clearly illustrated how vulnerable a country with an oversized financial system can become.

But there is also evidence outside the experience of financial market crises suggesting that further growth in the financial sector above a certain threshold can harm aggregate productivity. One factor in this context that should not be underestimated – and which was pointed out by James Tobin some 30 years ago – is the fact that the well-paying financial sector snaps up many of the best talents from the real economy. Hence the larger the financial sector, the greater the lack of talent in the real economy.

While several studies have concluded that the banking sector has innate thresholds which, if exceeded, can damage the course of economic development, recent studies indicate that the jury is still out on the question of whether similar thresholds exist for capital markets. For example, a recent BIS paper found that a further increase in financial market activity – measured by share turnover – beyond a certain point no longer contributes to economic growth or may even inhibit growth.

But there is no need to be as pessimistic as the former Chairman of the Federal Reserve, Paul Volcker, who, at the height of the financial crisis, was quoted as saying that the only useful financial innovation in the past few decades was the invention of the ATM.

After all, there are also studies that find no evidence of such a threshold in the capital markets.

3. Core hypotheses regarding the role of capital markets

Any attempt to assess the macroeconomic importance of capital markets solely on the basis of empirical studies of their growth-promoting impact would surely overstate the meaningfulness of such studies. Instead, a more comprehensive approach is necessary to address this issue.

But first, let me present four core hypotheses regarding the importance of the capital market from a central bank's perspective, on which I will then expand in the course of my speech.

1. Developed capital markets are instrumental in providing investors with a broad range of investment products, enabling them to select the best risk-return mix in their particular case. Key determinants of developed capital markets are liquidity, transparency and integrity. From the point of view of corporations, developed capital markets ensure a broad range of financing sources. This makes capital market funding an important and welcome supplement to bank borrowing for firms. A stronger role for equity capital would be desirable, not least in Germany.

2. Investor protection is essential. It contributes to making the capital market attractive to broader groups of investors. The best form of investor protection is a broadly based system of general financial education. However, it is also crucial to ensure that products are sufficiently transparent.

3. It is not the responsibility of central banks to provide investment advice or to protect investors against losses. A monetary policy approach that was forever willing to clean up the mess after financial market bubbles have burst would create the wrong incentives. The primary objective of monetary policy is to safeguard price stability;

financial stability ought to be ensured mainly through macroprudential instruments along in tandem with effective regulation and supervision.

4. Capital markets have an important disciplining function, especially with regard to fiscal policy. In the run-up to the crisis in the euro area, the capital markets did not always live up to this role. The institutional framework of monetary union should be structured in such a way that capital markets can perform their disciplining role effectively.

4. Capital markets from the investors' and issuers' perspective

4.1 Capital markets from the investors' perspective

When talking about the economic significance of capital markets, it is useful to distinguish between the investor's and the issuer's perspective. For this reason, I will first focus on capital markets as an investment opportunity, and specifically in terms of their attractiveness to retail investors. Unlike bank deposits, capital market products offer retail investors a useful vehicle for widening their spectrum of investment. Equities and bonds enable broad sections of the population to benefit from an enterprise's commercial success. At the same time, however, these chances go hand in hand with risks of incurring losses.

Moreover, given Germany's ageing population, it is important that retail investors turn more towards the capital market since market-based supplementary private pension plans will become increasingly necessary. The financial crisis has not changed this situation one iota. A key requirement, of course, is that individuals should invest their savings wisely by diversifying them across a broad range of capital market products.

According to the German Investment Funds Association BVI, savers who regularly invested in European mixed funds over the last 25 years doubled the value of their stake, which works out at an average nominal return of 5.2%. Investments in German equity funds yielded as much as 6.6% per year, albeit at a greater risk. Less risky bank and insurance products could not have generated such gains.

Needless to say, such calculations always depend on the particular type of investment and timeframe being considered. Short-term investments in the share market can, for example, result in big losses. However, losses become less and less frequent, the longer the time horizon of the investment. Survey data compiled by Deutsches Aktieninstitut indicate that the number of shareholders and equity fund investors in Germany relative to the general population has fallen by around one-third since its peak. In 2011, 20% of respondents held shares or equity fund units. By 2013, the percentage had dropped to less than 14%.

This low shareholder participation rate is, however, in no way confined to Germany, as is attested by the Eurosystem's "Household Finance and Consumption Survey", which presents comparable data for the whole euro area. In the economic literature, this phenomenon is referred to as the "stock market participation puzzle".

One striking finding of the Household Survey is that willingness to participate in the capital market is greatly dependent on income and wealth. Among the top ten per cent of income earners in Germany, 46% of households hold mutual fund units and 32% own shares, the middle twenty per cent of earners report holdings of just 22% and 8% respectively, while the bottom twenty per cent have equity holdings of just 11% and 2% respectively. Households' wealth shows a similar picture.

Naturally, wealthy households are clearly in a much better position to follow the maxim of only investing money in the stock market that you do not need in the short term. Yet that does not mean that direct shareholdings and mutual fund investments are the preserve of the rich. In particular, medium-income families and individuals, who are typically savers, are missing an opportunity to diversify their investment income.

So this raises the question: why do 86% of Germans turn their back on the equity market?

On the one hand, I think this is one of the lingering after-effects of the bursting of the New Economy bubble. The euphoria surrounding the New Economy prior to its demise – and here I am thinking especially of the Deutsche Telekom IPO, which was marketed as an investment for the man and woman in the street, attracted many Germans to the stock market for the very first time, only to see the value of their shares plummet subsequently. And, of course, the recent financial crisis has also scared people off investing in the capital markets.

On the other hand, we have a comparatively sound pay-as-you-go statutory pension scheme in place in Germany. The currently planned improvements for certain groups of pensioners may well make the statutory pension scheme appear even more attractive. But this popular perception runs counter to the reality, namely that the statutory pension scheme will progressively be less and less able to maintain people's living standards in old age.

However, another problem might be a general lack of financial awareness among the population. People who cannot tell the difference between a share and a bond and who have difficulty in calculating percentages are likely to steer well clear of capital market products in the belief that they had best not burn their fingers.

Alternatively, they might well be lured by products promising maximum safety plus sky-high returns which, however, ultimately fail to deliver on both counts.

Henry Ford is said to have commented that "It is well that the people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning". Germany's President Joachim Gauck takes the opposite view. Speaking at the German Banking Congress, he noted that "If you want to understand where prosperity comes from and to maximise the reward while minimising the risk, you need to do your homework and brush up your financial skills. And you need to forget the old idea that money is not a subject for polite conversation." That is why it is important to enhance the general public's understanding of financial and economic matters. Achieving progress in this area is a joint objective of the Bundesbank and Deutsches Aktieninstitut, albeit with a differing focus. The Bundesbank strives to educate the population in issues related to money, currency and central banking, to which end it has considerably extended the amount of information provided on its website, whereas Deutsches Aktieninstitut is geared more to conveying basic capital market knowledge.

I share Christine Bortenlänger's belief that retail investors would invest more in equities if they had a better economic education.

The planned introduction of a financial transactions tax is counterproductive to the development of an "equity culture" in Germany. It will tend to make investment in the capital markets less attractive.

The introduction of a financial transactions tax is intended to achieve several aims, both fiscal and non-fiscal. One objective, for example, is to make the financial sector pay a share of the costs of dealing with the current financial crisis, and another is to discourage transactions that are regarded as having a destabilising effect. An additional, very important aim is, of course, to generate extra revenues for the public budgets.

The problem with trying to bail in the financial sector to bear a share of the costs is that the tax will not necessarily hit those who are supposed to be paying it. This was summed up somewhat sarcastically in a commentary in the German daily newspaper Frankfurter Allgemeine Zeitung, which read "Anyone who believes that banks will bear the cost of the financial tax probably also thinks that cauliflowers grow in supermarkets". The reality is that the financial sector may well simply pass on the tax burden to its customers, and thus to the real economy and to retail investors.

The intended steering effect with regard to risky transactions can be achieved more effectively and more directly by other instruments. One example that comes to mind is the

regulation of high-frequency trading. It already applies with legal force in Germany and will be introduced throughout Europe as part of the Markets in Financial Instruments Directive (MiFID).

The financial transactions tax is most likely to achieve the intended fiscal goal of boosting public revenues. But doubts are warranted in this case, too. If only a small number of countries end up collecting the tax in the end and major financial centres, in particular London, opt out, the windfall gains are likely to be small as this would encourage tax evasion.

The Bundesbank has therefore consistently advocated that the costs and benefits of such a tax should be weighed up carefully. If the tax has to be introduced at all, then the objective should be to achieve the broadest possible introduction at international level.

Ladies and gentlemen, the current situation on the European capital markets is undoubtedly also being influenced by the macroeconomic fall-out of the crisis in the euro area and the corresponding response of policymakers and the Eurosystem. The economic recovery in the euro area is moderate, but still fragile. And inflation is currently very low, significantly below 2%.

European monetary policymakers have combatted the crisis using a wide-ranging combination of conventional and unconventional measures. Keeping the key interest rates low is appropriate, given the subdued inflation outlook and the sluggish economic recovery. Yet although the risk of deflation is very small, an extended phase of very low inflation can likewise have negative implications for the European economy. The ECB Governing Council has therefore clearly signalled that the key interest rates are likely to remain at present or lower levels for an extended period of time.

I can understand that the historically low interest rates are annoying for many savers, particularly as the real interest rate, ie the rate of return after deducting inflation, is negative for many safe forms of investment. However, it is not the responsibility of central banks to guarantee savers a minimum return. Our job is to safeguard price stability.

While the low-interest-rate environment is putting a strain on savers, it is simultaneously benefiting business people or home-builders, as they can obtain cheap loans, or employees, whose jobs would be endangered if the crisis were to escalate, or shareholders, who are investing in the economy.

Of course, we do not make monetary policy "for the stock exchange". Nor is it the task of monetary policy to protect capital market investors from losses. As I mentioned earlier, a monetary policy approach that is always guaranteed to step in and pick up the pieces whenever a financial market bubble bursts actually creates moral hazard in the capital markets. The principle formulated many years ago by the celebrated German economist Walter Eucken, namely that those who reap the benefits must also bear the costs, applies in this case, too.

Does this mean that monetary policymakers should sit back and do nothing when financial imbalances begin to build up?

No. Monetary policy instruments should be deployed if the financial imbalances begin to pose a risk to price stability. However, interest rate hikes are always rather a blunt instrument when it comes to counteracting imbalances in individual market segments. Macroprudential instruments promise greater accuracy and should therefore build the first line of defence against such risks to financial stability.

The bull market of recent months has not altered the fact that the portfolio decisions of German retail investors since the financial crisis have been shaped by risk aversion and liquidity preference. They are therefore still favouring the accumulation of financial assets in low-risk investment vehicles, such as bank deposits or insurance products.

However, in a low-interest-rate environment, in particular, there will always be badly informed investors who are enticed by the high coupons in very risky and illiquid investments. Elke

König, the head of Germany's Federal Financial Supervisory Authority (BaFin), therefore offers the advice "You should invest at least as much time in making investment decisions as you do in purchasing a smartphone."

Investors must not only look at the possible returns but must also take due account of the risks involved. It is now the task of investor protection to ensure that issuers provide adequate information about the chances and risks of their products.

Investor protection is important. It not only serves to protect the consumer but also to boost the attractiveness of the capital markets. However, it would be in nobody's interest if investor protection were mainly to get bogged down in greater bureaucracy.

But capital markets do not just offer attractive alternatives to bank deposits. They also offer firms interesting forms of external financing, as an alternative or a supplement to bank loans – which brings me to the topic of capital markets as a financing instrument.

4.2 Capital markets from the issuers' perspective

Capital markets offer enterprises access to funding, which they can use to develop and create jobs, for example. They enable firms to grow and innovate, thereby creating welfare gains. That being said, the advantages of bank loans should not be overlooked either.

As I mentioned earlier, the information we have is not complete. Instead, capital users are normally better able to judge the risks and opportunities of their investments than capital providers. Relationship banking, in particular, helps to overcome the problem of information asymmetry.

After all, relationship banks are especially interested in obtaining information about these important customers' financial situation. This applies, in particular, to an economy like Germany's, with its large number of small and medium-sized enterprises, or SMEs, that often produce niche products – otherwise known as "hidden champions".

Capital market financing allows firms to broaden their funding base.

Euro-area enterprises are increasingly turning to the capital markets for funding. Over the last few years, this has mainly taken the form of bond issuance, while equity issuance is rather weak. So enterprises are breaking away from the banks to a certain extent.

They are not always doing so voluntarily – some banks are having to reduce their balance sheets. But surveys such as the ifo credit constraint indicator show that, on the whole, German firms are not finding it difficult to obtain bank loans.

Nevertheless, many enterprises are taking advantage of the unusually low interest rates to diversify their funding structure, especially since risk spreads on long-term corporate bonds with a BBB rating over German Bunds are extremely low.

However, banks continue to play a very important role in both the German and the European financial system despite the growing capital market orientation, which is particularly striking in comparison to the United States. The proportion of total bank lending to non-financial corporations relative to their total debt (debt securities and all loans) is around 51% in Germany, 46% in Spain and 42% in the euro area as a whole. In the United States, this ratio stands at 11%.

The share of bank borrowing as a source of corporate financing in all the countries mentioned has been on the decline for several years, even since before the crisis. However, because banks remain important financial intermediaries, the mostly contractionary trend in lending, which in some euro-area countries is also associated with banks' need to deleverage, may hinder the upturn. This is because many enterprises rely on bank loans.

Against this background, it is important to ensure that euro-area banks are resilient. The aim of carrying out an asset quality review for banks prior to the launch of the Single Supervisory

Mechanism is to identify particular risks. An adequately capitalised banking system is essential if lending is to pick up again in Europe.

In light of this weaker lending trend, however, measures to revitalise the securitisation market are also being discussed. This could stimulate lending to small and medium-sized enterprises in some euro-area countries, for example. However, I do not consider reviving this market as one of the primary tasks of a central bank.

To quote a recent article in the Süddeutsche Zeitung, "the word 'securitisation' still evokes feelings of panic five years after the outbreak of the financial crisis". After all, securitised sub-prime mortgage loans are considered to have fanned the flames of the global financial crisis. It became evident that the capability to trade risk created incentives for excessive risk-taking, which in turn threatened the stability of the financial system.

Even so, the securitisation of loans and other financial contracts can in fact be worthwhile and useful from a macroeconomic perspective if there is sufficient transparency and the risks are broadly diversified. It is first and foremost a regulatory task to lay down guidelines that allow the securitisation markets to develop without posing a risk to financial stability in the future.

However, hopes of a revival of the securitisation market should not be too high: the very heterogeneous structure of the SME sector and the large information asymmetries between lenders and enterprises entail high firm-specific monitoring costs for lenders.

Ladies and gentlemen, when talking about the capital markets as a financing instrument, we must not forget a very important player: sovereigns.

Euro-area governments have issued bonds worth over seven trillion euros, just under a quarter of which were German bonds.

The financial crisis illustrated how seriously a withdrawal by investors can affect governments' funding. This disciplining effect of the capital markets is instrumental in helping monetary union to function properly. The capital markets have not always performed this function in the past, an insight which also became clear during the crisis.

The significant fall in long-term interest rates in some euro-area countries over the last few months has also reduced these countries' borrowing costs. However, there is a risk that market valuations may be running ahead of the adjustment processes. The current long-term yields on some European government bonds already appear to have factored in the required adjustment gains to a certain extent. This creates great setback potential. It is therefore all the more important that policymakers ensure that the necessary progress is actually achieved. One may justifiably question their determination to see this through to the end.

To ensure that monetary union remains a stability union, it is important to reinforce the principle of national fiscal responsibility built into the founding architecture of monetary union. Those who wish to keep control of their fiscal policy decisions must also bear the consequences. This is also an essential precondition for the capital markets to have a disciplining effect.

5. Conclusion

Ladies and gentlemen, this brings me to the end of my speech.

There is no doubt that capital markets perform important macroeconomic functions. The increasingly important role of the capital markets as a source of corporate financing is a positive development, particularly as they diversify firms' funding structure and make them less vulnerable to crises.

By not participating in the capital market, retail investors are missing opportunities to share in business success. Where this is due to a lack of knowledge and understanding, financial

education as provided by organisations such as Deutsches Aktieninstitut can help to gradually increase the participation rate.

Balanced rules to protect investors and measures to secure financial stability are necessary and in the interests of all capital market participants.

Finally, I would like to thank you for listening to my arguments and remarks. One last thing: if somebody tells you there is a one hundred euro note lying on the pavement on your way home, do stop and take a look.