Andreas Dombret: Deceptive tranquillity and the threat of reform fatigue – the need for international cooperation

Opening remarks by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a joint seminar of the Central Bank of the Republic of Turkey and the Deutsche Bundesbank, Istanbul, 4 July 2014.

* * *

1. Introduction

Ladies and gentlemen

The Italian writer Edmondo de Amicis described Istanbul as “a universal beauty where poet and archaeologist, diplomat and merchant, princess and sailor, northerner and westerner screams with the same admiration”. As far as I am concerned, he could have added central bankers to the list of those who admire the city of Istanbul.

Which is to say I am happy to be here today at the joint seminar of the Central Bank of the Republic of Turkey and the Deutsche Bundesbank. I would like to thank our Turkish colleagues for their hospitality, and to express my gratitude to all who helped make this seminar possible.

Turkey and Germany are closely connected. At the beginning of the 1960s, the first Turkish immigrants came to Germany, and today, more than 50 years later, around 3 million people of Turkish origin live within Germany’s borders. Our two countries are therefore connected not only at the political but also at a very personal level.

Last year, the central banks of Turkey and Germany added a new level of partnership. Since November, a representative of the Bundesbank has been based in Istanbul to build networks, to share information and ideas, to explain the Bundesbank’s positions and to facilitate cooperation. This joint seminar on financial stability is the tangible outcome of these efforts.

2. International cooperation in financial stability

Today’s and tomorrow’s seminar covers an issue in which international cooperation is certainly necessary: financial stability is a public good, and a global one at that. The past few years have taught us that financial crises do not stop at national borders. We live in an integrated world, and no country is able to insulate itself any more.

That said, we need a global approach to secure financial stability, and the fundamentals of such an approach are personal contacts, open exchange and mutual understanding. For me, one of the main objectives of this seminar is to strengthen these fundamentals.

Central banks in particular have a natural interest in financial stability, and in many instances they are involved in safeguarding it. Nevertheless, it is important to make a distinction between the different roles that central banks have to play. The primary goal of monetary policy is to safeguard price stability. To reach this objective, the independence of monetary policy has to be maintained in all its dimensions, at all times and everywhere. Thus, to safeguard financial stability, a different set of tools is necessary, and these tools are usually referred to as macroprudential policy.

3. Current issues in financial stability

Having established that, let us take a brief look at current risks for financial stability. Not every country faces the same risks, of course. Turkey most certainly faces different challenges than Germany. Nevertheless, there is an underlying trend at the global level that influences financial stability in most countries.

This trend has four elements: very low inflation and very low interest rates in major economies as well as abundant liquidity and low volatility in many financial markets. Together, these four ingredients make up a cocktail that may well result in a bad headache the morning after.

One potential problem is the search for yield. Investors may eventually increase the risk of their investments to make up for the shortfall in yields caused by low interest rates. And, indeed, it seems that investors have already begun their search for yield.

In its latest annual report the Bank for International Settlements (BIS) states that, "Some asset valuations showed signs of decoupling from fundamentals". One example can be found in corporate debt markets. Here, valuations indeed look somewhat stretched. The BIS estimates that gross issuance in the high-yield bond market increased to US$90 billion per quarter in 2013 – three times the pre-crisis quarterly average of US$30 billion.[1]

The strong recovery in the property markets of some euro-area countries should also set us thinking. Take the German housing market, for example. Between 2009 and 2012, prices in large cities rose by almost 25%. In 2013, they increased by another 8.9%, and Bundesbank calculations point to overvaluations in urban areas. Nevertheless, overall, prices in Germany have not yet moved away from fundamentals. Thus, at this point in time, we see some local exuberance but not a bubble.

But it is not only bond markets and housing markets we have to keep our eye on. Stock markets are an important issue as well. In 2013, there was only one way for most stock markets to go, and that was up. The EuroStoxx 50 increased by 18%, the FTSE 100 by 14%, the Dow Jones by 28%, and the Nikkei skyrocketed by as much as 57%. The BIS notes that, "As the search for yield expanded to equity markets, the link between fundamentals and prices weakened amid historically subdued volatility and low risk premia".

Market volatility indeed decreased, and reached historically low levels. However, as soon as monetary policy normalises, volatility is likely to increase. This is not reflected in today's volatility levels and might tempt market participants to neglect the necessity of hedging against changes in interest rates. Let me make it clear: low volatility does not stand for low risks, and interest rates will rise again at some point.

So, have financial markets entered a new phase of "irrational exuberance"? The Bank for International Settlement finds it "hard to avoid the sense of a puzzling disconnect between the markets' buoyancy and underlying economic developments globally". At the very least, it seems that financial markets are anticipating significant further improvements in economic fundamentals and prospects. And they are anticipating that governments around the world will continue to implement the necessary reforms. These expectations create vast scope for confidence shocks.

This, in turn, interacts in an unfavourable way with another risk arising from a prolonged period of low interest rates. A prolonged period of low interest rates could set the wrong incentives: it could encourage banks to postpone necessary balance sheet adjustments, and it could encourage governments to postpone necessary structural reforms and the consolidation of public finances.

---

1 Bank for International Settlements (2014), 84th Annual Report, Basel.

We must not let ourselves be deceived by the current tranquillity in financial markets. The biggest threats to financial stability are complacency and reform fatigue. It is in the hands of governments around the world to eliminate this threat by keeping to the course of reform.

I am now looking forward to discussing these and other issues during this seminar.

Thank you very much for your attention.