Jens Weidmann: Welcome remarks – Bundesbank conference on debt and financial stability

Welcome remarks by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Bundesbank conference on debt and financial stability, Frankfurt am Main, 27 March 2015.

*   *   *

1. Introduction

Ladies and gentlemen

I welcome you all to the Bundesbank conference on debt and financial stability. It is a pleasure to have you here.

The financial crisis and the euro-area sovereign debt crisis have certainly tainted the notion of debt. Listening to some of the discussions on the economic effects of debt, one could get the impression that debt is shorthand for "destroying economies big time".

And certainly, the notion that debt can be dangerous cannot be dismissed. Leverage does seem to be a crucial ingredient for financial crises – what matters most for financial stability may not be the size of a bubble, but how it was funded.

Seminal work by Kiyotaki and Moore[1] as well as by Bernanke, Gertler and Gilchrist[2] in the 1990s has shed light on how credit can amplify shocks to the economy. In a downturn, the deteriorating balance sheets of borrowers and lenders constrict new lending, which in turn curtails investment and hence worsens the downturn.

So, too much debt can be dangerous. But it remains equally true that debt is indispensable. It allows someone with an idea but without capital to follow through on that idea, thereby enabling wealth creation that otherwise would not have happened. Many studies show that financial development and growth go hand in hand.[3]

Doing away with debt is not an option. Rather, debt, like so many other economic issues, is not a question of "yes" or "no", but a question of "how" and "how much" – a Goldilocks issue. Or, as former BIS chief economist Stephen Cecchetti and his colleagues Madhusudan Mohanty and Fabrizio Zampolli put it: "Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare. But, when it is used imprudently and in excess, the result can be disaster."

The question then naturally arises: How much is "just right", to say it in the words of Goldilocks? Cecchetti, Mohanty and Zampolli[4] come up with concrete numbers. They find that when household debt goes beyond 85% of GDP, it becomes a drag on growth. The same threshold applies to government debt, while the figure for corporate debt is slightly higher at 90%.

According to these estimates, in the euro area we are already in the danger zone – at least with regard to public debt standing at 91% and corporate debt at 105%. Household debt currently stands at 62%. Some caveats are in order here, though. Correlation does not necessarily equal causation. Does debt slow growth, or does a slowdown in growth cause

---

[1] N Kiyotaki and J Moore (1997). "Credit Cycles." Journal of Political Economy 105 (2), 211–248.

[2] B Bernanke, M Gertler and S Gilchrist (1996). "The Financial Accelerator and the Flight to Quality", Review of Economics and Statistics 78 (1): 1–15.

[3] R Levine (2005): "Finance and Growth: Theory and Evidence", in P Aghion and S N Durlauf (eds), Handbook of Economic Growth Vol. 1 Part A, Chapter 12, pp 865–934.

[4] S G Cecchetti, M Mohanty and F Zampolli (2011). "The real Effects of Debt." BIS Working Papers No 352.

the debt-GDP ratio to rise? The policy implications would be different, depending on what really drives what.

And identifying turning points in econometric models is a notoriously tricky business. The thresholds presented by the BIS researchers should probably not be taken as precise estimates of when growth falls of a cliff, but rather as one more piece of a growing body of evidence that too much debt can be as harmful to growth as too little.

This growth slowdown can either take the form of a gradual tectonic shift, as high levels of debt weigh on new investment. Or it can take the form of an explosive eruption, as we have witnessed during the global financial crisis. And while both forms raise serious questions for policymakers, it is mainly the latter that today's conference will address, since financial stability is part of the central banks' remit.

For the reasons I have just outlined, it would probably be a futile undertaking to try to pinpoint exactly when debt starts subtracting from rather than adding to economic welfare. In the end, the amount and the form of financial intermediation has to be determined by market forces. It is therefore all the more important that this market process functions as efficiently as possible.

And this is where the regulators come in. It is our job to make sure that the regulatory treatment of debt does not give rise to incentives that endanger financial stability. And it is our job to make sure that, if things still go wrong, the financial sector can still deliver its important services to the real economy.

As the financial crisis and the euro-area sovereign debt crisis have shown, there is ample room for improvement here. In particular, we need to ensure that all actors bear the responsibility for their respective decisions.

To me, three issues are of special relevance in this regard: the question of bail-in vs. bail-out, the regulatory treatment of sovereign debt, and the tax preference of debt over equity.

2. Bail-in vs. bail-out

Let me start with a question that has been debated heatedly since the crisis broke out: the issue of bail-in vs. bail-out.

The financial sector is unique in that a malfunctioning of this sector impairs the functioning of all other sectors of the economy. And the crisis has served as a stark reminder that a malfunctioning cannot be ruled out. Some form of protection is therefore called for – otherwise, innocent bystanders in the real economy will inevitably get hurt.

Depending on the kind of malfunctioning, the central bank might be able to provide the protection. If the issue is a temporary dry-up of liquidity, it can act as a lender of last resort and supply the necessary funding – on an interim basis.

But if the issue is one of solvency, then the central bank has no role to play, as taxpayers' money might be ultimately at stake. Rather, it is then for politicians to decide whether to let a bank fail or not.

Providing insurance in the form of a bail-out comes with obvious moral hazard problems. If banks know that they are too big to fail, they are tempted to make the most of this insurance and take on excessive risks, at the expense of society at large. As the Bank of England's Chief Economist Andy Haldane put it: "Only in banking do control rights and incentive wrongs combine so uncomfortably."

Instead of the public providing cost-free insurance for banks, the onus is on banks to insure themselves against failure. Only then are risk and reward aligned in a way that serves the public good. Or, as my predecessor Axel Weber likes to say: "We need to put the market back into the financial markets."

Two aspects are crucial here: the loss-absorbing capacity of banks – that is, their capital – and their resolvability.

With regard to capital, a lot has already been done. Basel III has increased considerably the demands for both: the quantity and the quality of bank capital. But will that be enough?

Second, the capital rules that are binding as of today are risk-weighted. As a general rule, this makes sense: otherwise, banks have an incentive to invest in the riskiest assets. But risk-weighting also means that there are potentially two ways in which sufficiently high capital ratios may come about: high equity or low risk weights. If meeting the requirements is based on the latter, the capital buffer might prove to be a mirage when push comes to shove.

This is why we have to supplement the risk-weighted approach with an unweighted capital ratio: the leverage ratio. From this year on, banks are required to disclose the leverage ratio. But transparency alone is not enough. Now, we need to make sure that after a final calibration, the leverage ratio becomes a binding Pillar 1 requirement by 2018.

But capital shields against losses only up to a point. And in any case, if the business model is no longer viable, the bank must be allowed to fail – otherwise, incentives are stunted for bank managers to exercise prudence and to improve efficiency.

Regarding the development of resolution regimes, progress has been made, although in some countries more so than in others. One crucial issue still needs to be resolved: the establishment of a common standard for bail-inable capital, the so-called Total Loss Absorbing Capacity, or TLAC.

Here, it is imperative that this insurance can really be called upon when needed. And this means that a bank should be discouraged from holding the bail-in debt of another bank, as in the event of a system-wide financial crisis, the insurance has to be provided by less-leveraged market participants. Otherwise, the crisis might be spread instead of contained.

3. The treatment of sovereign debt

The importance of realigning risk and return has come to the fore with regard to yet another issue: the regulatory treatment of sovereign debt, which is the second financial stability facet of debt I would like to touch upon.

Currently, the proposal to end the preferential treatment of sovereign debt is being dealt with in the same way as physical exercise is. Everybody agrees it’s a good thing in theory. But in practice, it’s very hard to get off the couch.

Hence, as of now, sovereign debt denominated in an advanced country’s own currency is still considered risk-free. Danièle Nouy recently grasped the nettle and pointed out: “Sovereigns are not risk-free assets. That has been demonstrated, so now we have to react.”

I wholeheartedly concur and have repeatedly asked to put this issue on the regulatory agenda. Sovereign debt needs to be backed by capital, and exposure to a single sovereign must be capped, just as is the case for any private debtor.

I welcome that the regulatory treatment of sovereign debt is now being discussed by the Basel Committee. But if these discussions fail to produce an agreement, we need to move forward with a European solution. In contrast to other jurisdictions, the Eurosystem is for good reasons forbidden to act as lender of last resort for governments. The risk profile of euro-area sovereign debt is therefore different.

4. The tax deductibility of interest

As Benjamin Franklin famously said, nothing is certain except death and taxes. But actually, this timeless quip does not apply to debt. Interest expenses are tax-deductible, while equity disbursements are not.

How sensitive are banks to this difference in tax treatment? A study[5] by IMF economists suggests that they are as sensitive as any other firm. What does this imply for the leverage of banks?

The IMF economists estimate that abolishing the preferential tax treatment of debt would raise average unweighted bank equity by 2.2 to 4.2 percentage points. Even though the authors caution that the effect is likely to be lower for the biggest banks, these numbers are sizable by any measure, especially considering that the proposed Basel III leverage ratio is 3%.

Doing away with the preferential tax treatment of debt could therefore provide a major boon for financial stability.

5. Conclusion

Ladies and gentlemen, debt is like oxygen: indispensable for economic life, but when you overdose on it, you first get high, and then you faint.

Air quality regulation has made great strides over the last decades, at least in the advanced countries. I hope we can replicate this regulatory progress with regard to debt as well. And I am confident that today's conference will contribute to this process.

[5] R A de Mooij, M Keen and M Oriharai (2013). "Taxation, Bank Leverage, and Financial Crises". IMF Working Paper No. 13/48.