Jens Weidmann: Of credit and capital – what is needed for an efficient and resilient financial system?

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the IIF (Institute of International Finance) Europe Summit, Frankfurt am Main, 25 June 2015.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak here before you today.

The former Italian President Sandro Pertini is quoted as joking that speeches were always harmful. “Before lunch they spoil people’s appetite, and after lunch they spoil people’s digestion.” With this in mind, I’ll try to be brief so that the immediate effect of my speech should – hopefully – be limited.

But lunch is actually an excellent cue, for it calls to mind one of the fundamental principles of economics: “There ain’t no such thing as a free lunch.” Interestingly, though, the phrase was coined not by an economist, but by the American science fiction writer Robert A Heinlein.

Although it may have come from the pen of a science fiction author, this adage has proven to be far more durable than many theories put forward by economists. And the fact that you now have to sit through my speech would strongly suggest that Robert Heinlein might have been onto something here.

That something is a pretty fundamental insight: that each and every economic decision involves a trade-off that needs to be factored into that decision. As such, economic decision-making is about weighing benefits and costs, about striking a delicate balance.

Take central banks, for instance. The task of monetary policy is to find the interest rate that neither chokes off the economy nor causes it to overheat. Only in balance will inflation be low and stable – and this is usually a central bank’s mandate. Economist Knut Wicksell termed this rate the “natural rate of interest”.

And striking the right balance is the core challenge with regard to another central bank function as well – its role as lender of last resort. Overly restrictive provision of liquidity in times of financial turmoil might fail to quell the upheaval – possibly causing a conflagration.

But providing too much liquidity for too long might end up causing problems as well. If non-viable banks are kept on life support with central bank money, they will go on to make evergreen loans to non-viable companies – a situation which heightens the risk of future problems in the banking system. And if the liquidity is channelled towards sovereigns that find it otherwise hard to access the markets, we run the risk of blurring the lines between monetary and fiscal policy.

Greece is a case in point here. The emergency liquidity assistance (ELA) – which was originally conceived as a temporary source of liquidity for financially sound banks in return for good collateral – has been provided for a protracted period of time and has become the banks’ only source of funding. This casts doubt on their financial solidity. The latter is especially undermined by Greek policy decisions that have sparked capital flight and large-scale cash withdrawals.

Banks receiving ELA should be urged to do their utmost to improve their liquidity situation and be prevented from worsening it further by rolling over illiquid T-bills of their sovereign. Against this background, it should be clear to all the parties to the current negotiations that the Eurosystem must not provide bridge financing to Greece even in anticipation of later disbursements. When banks without access to the markets buy debt of a sovereign which is likewise locked out of the market, taking recourse to ELA raises serious monetary financing concerns.

Respecting the core principles upon which our monetary union is built is not a matter of dogmatic German stubbornness, but a key policy condition for long-term economic prosperity in the euro area and for maintaining popular support for the historic project which European integration no doubt is.

Besides the balance that monetary policymakers themselves have to strike, there is another state of balance they count on to maintain price stability – a well-balanced financial system.

2. Credit and capital: Competition or complementarity?

Let us have a closer look into the relationship between bank-based financing and market-based financing. Does one detract from the other, or can one deliver benefits where the other one comes up short? To put it succinctly: Are credit and capital competitive or complementary?

The debate on the superiority of bank-based or market-based financial systems is decades, if not centuries old.[1]

One notable development that sparked this debate was the differences in growth between Germany and the UK in the late nineteenth and early twentieth centuries. Some argued that it was the pre-eminence of banks and their close relationship with their clients that facilitated the rapid growth of Germany's manufacturing industry. Others pointed out that while manufacturing growth in Germany was faster, overall growth rates were broadly the same.

Similar arguments are being made today. In general, proponents of the bank-based system argue that banks are better suited to dealing with information asymmetries, as their long-standing ties with their clients allow them to glean information about firms and managers. This information leads to more efficient capital allocation and better corporate governance.

The long-standing ties of banks to their clients deliver a quality of information exclusively to the bank. Naturally, it is inclined to keep this information to itself. In contrast, financing via capital markets quickly disseminates information on firms, as Joseph Stiglitz[2] pointed out. This may, however, stunt incentives for the individual investor to acquire private information on the soundness of creditors.

Proponents of market-based systems make the opposite claim: large and liquid financial markets strengthen rather than weaken incentives to gather information about a firm, as the information can be used on a grander scale.[3]

And rather than banks' using their private information on firms to channel resources to those which are most productive, they might use the information to shield their existing clients from competition.[4]

At first sight, the two views seem irreconcilable. On closer inspection, though, the contradictions begin to disappear – regardless if one takes the perspective of the individual firm or a broader macroeconomic view.

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1 Levine, R. (2002): "Bank-Based or Market-Based Financial Systems: Which is Better?", Journal of Financial Intermediation 11 (4), pp. 398–428.

2 Stiglitz, J. E. (1985). Credit markets and the control of capital. Journal of Money, Credit and Banking, 17, pp. 133–52.

3 Homstrom, B. and Tirole, J. (1993). Market liquidity and performance monitoring, Journal of Political Economy,101, pp. 678–709.

4 Rajan, Raghuram G. (1992). Insiders and outsiders: The choice between informed and arms length debt, Journal of Finance 47, pp. 1367–1400.

Whether a bank credit, a bond or an equity issue is preferable from the perspective of the individual firm depends to a large extent on what stage the firm is at in its economic life cycle. Or put simply: If it is an innovative start-up, it might benefit from the expertise of a venture capital fund. If it is a small firm with long-standing ties to its bank, chances are that a bank credit is best. But if it is a large, developed firm, a bond issue might be the route to take.

So from the perspective of the individual firm, the answer to the question “credit or capital” is “it all depends”. But maybe the answer is more clear-cut when taking a systemic perspective?

Well, there are some indications that market-based systems might be more procyclical than bank-based systems.[5] The more pronounced asset price booms and busts in market-based systems might be the explanation for that. But we know from the extensive literature on the financial accelerator effect that procyclicality besets bank-based systems as well.

And while research conducted by the Bank for International Settlements has shown that bank-based systems are more effective in smoothing the impact of “normal” business cycle fluctuations, market-based systems allow for a speedier recovery after financial crises.[6] That the US economy made up lost ground more quickly than Europe after the Great Recession, even though the crisis originated in the US, is a case in point.

Therefore, the answer to the question is not an “either/or”. From a macroeconomic perspective, credit and capital are complementary. Little would be gained by simply substituting one leg for another. We need to supplement Europe’s financial system, not supplant it.

This does not mean that the European financial system of the future will look exactly like the American one, for instance. The structure of the financial system reflects the corporate structure of an economy – and in an economy with a comparatively high share of small firms, like the European one, one would expect a prevalence of bank-based financing.

Another question is whether the large proportion of very small firms in Europe is optimal. Research strongly suggests that the answer is no: Larger firms are, on average, more productive and are better placed to compete in export markets.[7]

Unfortunately, the growth of small, innovative enterprises is hindered in some European countries by a plethora of red tape that kicks in when firms reach a certain size.

In France, for instance, many regulations become binding when a firm reaches a size of 50 employees.

Other size-contingent regulations exist in other countries such as Portugal or Italy, where the threshold is 15 employees. What these regulations all have in common is that they deter firms from expanding. Therefore, they are a drag on growth.

Structural reforms that remove these barriers are urgently needed. But they will only have their full effect if firms can find a suitable form of financing as well. And this is why we need to remove the impediments to a fully integrated European capital market.

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[5] Leroy, A (2014), “Credit Procyclicality and Financial Structure in the EU”. Available at SSRN: http://ssrn.com/abstract=2568112 or http://dx.doi.org/10.2139/ssrn.2568112.

[6] Gambacorta, L., Yang, J., Tsatsaronis, K. (2014): “Financial Structure and Growth”, BIS Quarterly Review, March 2014, pp. 21–35.

[7] Garicano, L. ,Lelarge, C. and Van Reenen, J. (2013), “Firm Size Distortions and the Productivity Distribution: Evidence from France”, CEPR Discussion Paper 9495.

3. Capital markets union

These impediments still abound, and some of them are addressed by the European Commission's proposals for the design of a European capital markets union: the market for high-quality securitisation is one example. Other areas for early action include private placements, crowd-funding or the harmonisation of prospectuses.

Eliminating these impediments would be a step forward towards a more prosperous Europe, which is why the Commission's initiative deserves our support.

With a view to the longer run, however, we will probably need to go further. Harmonising insolvency laws across Europe, for instance, would improve the integration of capital markets as well – and of venture capital markets in particular.

3.1 Tax deductibility of interest

In addition to the existing impediments, the development of equity markets in general suffers from what the Economist has recently called "the great distortion at the heart of the world's economy": the preferential tax treatment of debt vis-à-vis equity. While interest is tax-deductible, equity is not. Removing this bias in taxation would encourage companies to strengthen their equity base.

And this is not only important for the development of equity markets, but spills over to the other side of the financial system, i.e. banks. A study[8] by IMF economists suggests that abolishing the preferential tax treatment of debt would raise average unweighted bank equity by 2.2 to 4.2 percentage points – implying no less than a doubling of the leverage ratio.

Even though the authors caution that the effect is likely to be lower for the biggest banks, these numbers are sizeable 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 boost to financial stability.

3.2 Improved risk-sharing

But in Europe, in particular, the benefits of stronger equity markets extend even further. It might be the single most important step we can take towards bringing Europe closer to an optimal currency area.

Economists like Robert Mundell and Peter Kenen have highlighted the importance of effective risk-sharing arrangements for the functioning of a monetary union. In public debates the most frequent (and most contested) proposal is to strengthen fiscal risk-sharing arrangements. But this debate runs the risk of missing the bigger picture.

In the United States, for example, studies[9] show that fiscal policy cushions only 10% to 20% of economic shocks, so that a local income shock does not translate into a drop in consumption to the same extent.

Integrated capital markets play a far larger role – especially integrated equity markets, which smooth out around 40% of the cyclical fluctuations among the US federal states. Another share of around 25% is cushioned via the credit markets. Altogether, around 80% of a given

[8] de Mooij, Ruud A. and Keen, M. and Orihara, M., Taxation, Bank Leverage, and Financial Crises (February 2013). IMF Working Paper No. 13/48.

[9] Asdrubali P; Sørensen, B. E.; Yosha, O. (1996), "Channels of Interstate Risk Sharing: US 1963–1990", Quarterly Journal of Economics, 111(4), pp. 1081–1110.

economic shock in the US is absorbed before it can affect consumption. Studies for Canada yield similar results.[10]

In Europe, the picture looks different. Here, it is mainly credit markets that cushion economic shocks – and they are not very effective in doing so. Altogether, only around 40% of a given shock is absorbed before it can affect consumption.[11]

Increasing the share of capital markets and integrating them across borders would therefore help improve risk sharing in Europe and also protect monetary policy by containing economic divergence.

The recently published "Five Presidents" report on the future of the euro area underlines the importance of capital markets with regard to strengthening risk-sharing arrangements, too.

The report also proposes establishing a fiscal risk-sharing mechanism in the longer run. But extending common liability would have to be balanced by a commensurate shift towards European control; otherwise, the incentives for fiscal prudence will get out of kilter. Here, the sequence is of the essence: Shifting fiscal control and intervention rights to the European level must come first; after that, the mutualisation of liability may follow.

But let's be frank here – the Greek drama has eroded public and political support for further transfers of national sovereignty to the European level as it has raised doubts over some parties' determination to assume their responsibility for preserving European monetary union as a stability union that is firmly grounded on a set of commonly agreed rules. So it's crucial for further solidarity to be linked to a strong conditionality and for agreements to be adhered to. This holds true not only because the root causes of the Greek problems will otherwise never be fixed, but also for the stability of monetary union itself.

By the same token, a European deposit insurance system seems feasible only if the policy areas that influence the health of banks are European responsibilities. Otherwise, it will open the door to a situation in which the burden of bad national policy choices can be shifted to all Europeans creating severe moral hazard problems.

4. The sovereign-banking nexus

Ladies and gentlemen, strengthening capital markets will bring about tangible benefits only if we reduce barriers to their functioning, not if we introduce new distortions to shift activity from banks to markets.

By the same token, the regulation of banks will produce lasting success with regard to fostering financial stability only if we harness the disciplining forces of the market. Implicit subsidies and bail-out expectations have to be a thing of the past. As Bank of England Governor Mark Carney has put it: "To make the system fairer, the days when banks privatised gains but socialised losses must end." Eventually, this means tackling the overly tight embrace of banks and sovereigns, as this compounds the issue of systemic relevance.

The Basel III liquidity and capital requirements as well as the recently introduced resolution regimes are major steps towards cutting off the channel of contagion from banks to sovereigns.

In Europe, the banking union that includes the SSM and the SRM goes a long way towards making it more likely that stumbling banks will not be rescued at the taxpayer's expense.

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[10] Balli, F. S.; Kalemli-Ozcan, S.; Sørensen, B. E. (2012), Risk Sharing Through Capital Gains. In: Canadian Journal of Economics, Vol 45(2), pp. 472–492

[11] Afonso, A.; Furceri, D. (2007), Business Cycle Synchronization and Insurance Mechanisms in the EU. ECB Working Paper No 844, December 2007

In Germany, the government has presented draft legislation specifically designed to boost German banks' bail-inable debt and steps in this direction are welcome.

But if we want to sever the link between banks and sovereigns for good, we need to stop contagion from sovereigns to banks as well. And this means ending the preferential regulatory treatment of sovereign debt.

In the past, the call to end the preferential treatment of sovereign debt was dealt with in the same way as some people see taking out the garbage. We all know it has to be done some time, but for now, let's pretend the chore doesn't exist. Unfortunately, at least in the euro area, things have started to get smelly.

In contrast to other jurisdictions, the Eurosystem is, for good reason, forbidden to act as lender of last resort for governments. The risk profile of euro-area sovereign debt is therefore different – and Greece illustrates that. Acknowledging this fact with regard to regulation would make the monetary union more stable, as sovereign restructuring would cease to be a systemic event.

To achieve this aim, 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 the fact that the regulatory treatment of sovereign debt was acknowledged as a major topic by the G7 finance ministers and central bank governors at our meeting in Dresden and that it is now being discussed by the Basel Committee. While it is sensible to conduct this review in a "careful and holistic manner", this should not be allowed to lead to procrastination.

5. Banker's code of conduct

Adequate regulation is crucial if we are to strengthen the leg on which Europe's financial system has hitherto rested. But not everything can be dealt with by regulation. It is a bank's culture that lays the ground for misdemeanour. And the influence of regulation on a bank's culture is indirect and limited at best.

Out of enlightened self-interest, banks should take the initiative and do everything possible to establish a culture in which responsibility is rewarded and recklessness rejected. A banker's code of conduct, for instance, might be helpful in this respect. Introducing a voluntary self-commitment might overcome banks' qualms about embracing cultural change within their respective institutions.

Still, Mark Carney is also right in saying: "This is a major opportunity for the industry to establish common standards of market practice. But if firms and their staff fail to take this opportunity, more restrictive regulation is inevitable."

6. Conclusion

Ladies and gentlemen, let me conclude.

The crisis has shown that Europe's one-legged bank-based financial system could do with another fully developed leg – market-based finance.

Doing away with the impediments that hamper the full integration of European capital markets is key not only to diversifying sources of funding in a crisis, but also to strengthening the risk-sharing arrangements a monetary union requires.

By the same token, the regulatory gaps that still amount to implicit subsidies for banks must be removed once and all without allowing the emergence of unregulated systemic entities elsewhere.

Banks provide important services to society, and many banks do not deserve the reputation the banking industry has gained during the crisis. However, unless banking becomes an industry that is more similar to others with regard to market entrance, exit, and power, further regulatory steps are necessary, especially in terms of resolving the “too big to fail” issue.

Thank you for your attention.