Andreas Dombret: Interest rate reversal in the United States and German banks

Introductory statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the annual meeting of the Verein für Socialpolitik, Münster, 17 September 2015.

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Ladies and gentlemen

The British rock band The Alan Parsons Project charted in 1978 with a single entitled "What goes up ...", the first two lines of which read as follows: "What goes up, must come down / What must rise, must fall". These words of wisdom are also worth heeding in the financial markets – indeed, they're the secret of any successful trader. But interestingly, the precise opposite also holds true in the financial markets. So, we could equally say: "Interest rates that fall, must rise again."

But for now, the euro area is still in the midst of a protracted spell of very low interest rates. It goes without saying that this low-interest-rate environment is making itself felt on banks – particularly on those whose business models are very reliant on interest income. So it's not surprising that many a German credit institution is struggling with weak earnings. That's a topic which has been on the agenda for quite some time now. Incidentally, we will be getting a better idea of how German banks are coping with the currently low level of interest rates next week – on 18 September, to be precise, when the Bundesbank and BaFin will be releasing the findings of a joint survey on the low-interest-rate environment.

What can banks do? In a nutshell, banks should act on the meagre state of their earnings at present by reflecting on their business models and tapping fresh sources of income. While The Alan Parsons Project might have a point, living off ever-diminishing resources and simply sitting tight until interest rates reverse isn't what I would consider the right course of action. That's because interest rates in the euro area are likely to remain very low for some time to come – the low rate of inflation, the modest economic outlook and the ECB's forward guidance suggest as much.

The picture is a different one across the pond. For all extents and purposes, the United States already began edging towards the monetary policy exit back in May 2013. That was when the US Federal Reserve announced its plans to "taper" its bond purchase programme. So a possible interest rate hike would represent a return to conventional monetary policy terrain. And it is not so much the timing of the interest rate move that matters as the subsequent interest rate path which the Fed follows.

What would a return to normal policy rate conditions in the United States mean for the euro area and for Germany's banks? Since 2013 we have observed that policy divergence between the United States and the euro area has had two knock-on effects. First, the differential between US and euro-area interest rates has widened; second, the euro exchange rate has dwindled. This trend gained traction early this year when the Eurosystem announced the large-scale purchase of government bonds. That increased the spread between US Treasuries and German Bunds and sent the euro plummeting against the dollar.

So German banks need to remember that even if the Fed raises its policy rates, the spell of low interest rates in the euro area looks set to continue. Remember what I said just a few minutes ago – sitting tight and hoping for the best simply isn't an option. And as far as possible exchange rate volatility is concerned, banks might theoretically be exposed to currency risk. Two factors play a role here. The first is banks' funding gap in dollars. That gap measures the excess of a bank's US dollar assets over its US dollar liabilities. The bigger this overhang, the more exposed the bank is to exchange rate risk. The second factor is the mismatch between the maturities of assets and liabilities denominated in US dollars. This maturity mismatch measures both exchange rate risk and interest rate risk.

At the onset of the global financial crisis in 2008, both the funding gap and the maturity mismatch of German banks were very large indeed. When the forex markets dried up and German banks got cut off from US dollar funding, the central banks had to step in and lend a helping hand. Since then, the ECB, to name but one, has been providing swap facilities, but the take-up now is virtually non-existent.

German banks have reduced their vulnerability since those days, slashing their funding gap by downsizing their stock of US dollar assets. What remains substantial, though, is the scale of the maturity mismatch of their US dollar investments. However, the actual risk exposure here is relatively small, because German banks these days are much better hedged against currency risk than they were just a few years ago.

All in all, then, the expected interest rate reversal in the United States is unlikely to impact strongly on German banks – and it's not as if the move is coming entirely out of the blue. And that's a point worth noting, because there are three qualities that are crucial for any exit from an accommodative monetary policy – transparency, predictability and communication. We are unlikely to see a turnaround in euro-area interest rates in the near future. In closing, I would like to quote again from The Alan Parsons Project: "Someday, you'll know where you are".

Thank you for your attention.