Jens Weidmann: Introductory comments delivered at the press conference on the annual accounts


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1. Introduction

Ladies and gentlemen, I too would like to welcome you to this press conference marking the publication of the Bundesbank’s annual accounts for 2015.

The annual accounts and underlying balance sheet of an enterprise or an institution like the Bundesbank reflect not just the setting in which it operates but also the results of its own actions. I would therefore like to begin by providing a description of this setting before going on to present the annual accounts with my esteemed colleague Dr Nagel.

2. Challenges for monetary policy

Last year, low inflation rates once again set the tone of the monetary policy debate. Consumer prices rose at a rate of just 0.2%, thus increasing at an even slacker pace than in 2014. This was compounded by economic forecasts, including Eurosystem projections, which suggested that inflation would only gradually approach the target rate of below, but close to 2% at which it should stand over the medium term according to the ECB Governing Council’s definition of price stability.

Consumers are likely to welcome this prospect because of its effect on their purchasing power, but in monetary policy terms these forecasts have stoked discussion about the credibility of this policy and a narrower safety margin to the zero interest bound, which limits the possible responses to future adverse developments. Against this background, inflation developments both at the start and at the end of 2015 triggered a lively debate among members of the ECB Governing Council.

In the upshot, the Council decided in January 2015 that for the next 19 months it would purchase not just certain private debt securities but also government bonds on a large scale. At its meeting in early December 2015, this programme was extended by an additional six months up to March 2017. Moreover, the Council lowered the deposit facility rate to –0.3%, thus obliging banks to pay a higher penalty interest rate whenever they deposit excess liquidity with the central banks.

At its monetary policy meeting at the beginning of March this year, the ECB staff will once again present an update of the projection for economic output and price developments for the period 2016 to 2018, which the Governing Council will then use to assess its monetary policy stance.

As regards developments in the real economy, doubts have arisen of late as to whether the global economy is still providing the stimulus to euro-area economic growth which had been factored into the Eurosystem’s December projection. This projection anticipated muted but steady global growth overall.

That outlook has recently been called into question, in part on account of economic data for the USA and Japan that were generally felt to be disappointing, but also due to heightened political uncertainty surrounding the future reform efforts of some euro-area countries and the future composition of the European Union.
On top of this, fears have been expressed with respect to banks’ longer-term earnings prospects and revisions to overblown expectations regarding the capacity of monetary policy to resolve structural problems. These doubts have now also spread to the international financial markets, helping to engender strong risk aversion among participants since the beginning of this year.

As a consequence, investors have shifted their focus from riskier assets to safe ones. This has caused shares, and in particular securities and corporate bonds, to sustain at times significant price losses around the globe. By contrast, US government bonds as well as bonds issued by Germany, France and other euro-area countries have been in demand.

As a side-effect, these shifts have triggered considerably elevated price fluctuations in virtually all the financial market segments. While a certain degree of volatility – also for the purposes of a functioning market – should not be viewed as an automatic cause for concern, a protracted phase of high market uncertainty could put additional pressure on the global economy. And this would make it more difficult and expensive for enterprises to raise capital.

Economic developments in China were also in the markets’ spotlight. In this context, it is right to say that Chinese growth has slowed down; however, there are currently no signs of a severe slump. Up until now, this growth shift has in fact been entirely consistent with China’s transition to a more services-oriented, domestically-driven economic model.

Even so, a valuation adjustment is on the cards for another key factor relating to current developments, that factor being the price of oil. Looking at the global economy as a whole, the continued decline in oil and commodity prices seems to be having an increasingly detrimental impact. This decline has now reached such a magnitude that it has at times led to a self-reinforcing downward spiral in prices as oil producers react to falling prices by boosting production as a way of stabilising their revenue.

Numerous countries that are heavily dependent on oil and commodity exports are on the verge of a recession or have already entered one. Their government revenue is drying up and it is becoming more difficult for the buffers that are available to cushion their worsening budgetary position. They have therefore been curbing their private and public expenditure, which has hit euro-area exporters, amongst others.

The weakened growth prospects of many emerging economies have effectively (ie in trade-weighted terms) led to an appreciation of the euro, which on the one hand puts an additional brake on exports and on the other hand dampens price inflation in the euro area.

In any case, the oil and commodity price slump is likely to continue to fuel economic activity on balance. The repeated sharp drop in energy prices compared with the level forecast in the December Eurosystem staff projection will probably also yield expenditure savings equating to just over ½ percentage point of gross domestic product (GDP) for consumers and enterprises this year – both in Germany and in the euro area as a whole.

The transfer of purchasing power from oil-exporting to euro-area countries does not translate one to one to consumption or investment. However, even if it is partially put aside for a rainy day or used to reduce debt, it can help consumers and enterprises to reduce their high level of leverage, which, importantly, can remove brakes on growth in the euro area.

There is, moreover, no need to preach doom and gloom. All in all, the economic outlook for the euro area remains upbeat. The euro area’s gradual economic recovery is likely to continue throughout the rest of this year and in 2017. At the current juncture, we expect the output gap to continue to close over the forecast period, causing domestic price pressures to increase.

However, the renewed fall in energy prices is further impeding the already sluggish rise in inflation towards the price stability target as defined by the Governing Council of the ECB. In December, we assumed that annual average consumer price inflation would amount to 1% for full-year 2016. But given falling oil prices, this forecast will probably not be feasible. In the
first half of 2016, in particular, inflation rates could conceivably drop back below zero temporarily.

However, this short-run inflation outlook is less decisive for monetary policy – especially if it reflects, above all, energy price movements. If we factor out such energy price fluctuations, the relevant inflation rate in the euro area currently stands at 1%.

Even though this indicator of domestic price pressure is below the medium-term target for price stability, it will rise over time and is far removed from the territory of deflation, in which monetary policy would be much more constricted and a self-reinforcing downward spiral could be set in motion.

It is the medium-term price outlook which is decisive for monetary policy. And the key factor in this outlook is how big the risk is of second-round effects caused by the fall in oil prices and low inflation rates.

Such a loss of confidence could make it difficult for the Eurosystem to execute its monetary policy mandate going forward.

Lower inflation expectations mean that, at a given level of nominal interest rates, real interest rates will rise, causing monetary policy to have a less expansionary effect.

We are now seeing that longer-run inflation expectations have fallen since the beginning of the year. The financial market data-based indicators of inflation expectations have even fallen markedly.

One of the factors behind this fall could have been that the already-mentioned increase in risk aversion in the financial markets resulted in safe haven capital flows to the euro area.

In addition, the indicators of market-based longer-run inflation expectations also always contain a hedging premium for inflation surprises. Since investors are currently keen on hedging particularly against a period of surprisingly low inflation rates, the inflation expectations derived from financial market data, which currently stand at 1.4%, could actually understate the price increase expected by market players over the longer run.

Certainly, this is what is suggested by a comparison with survey-based longer-run inflation expectations – according to an ECB survey, they have most recently dropped only very little, to 1.8%. The Consensus Economics surveys are even showing a slight pick-up.

One possible sign of a de-anchoring of longer-run inflation expectations might be if market-based inflation expectations were to respond more strongly than before to surprises in the published inflation figures or other economic indicators. This would cause the central bank definition of price stability to lose relevance as an anchor of expectations. A forthcoming Bundesbank study,¹ however, finds no statistically significant indication of such a loss of confidence among market players in the ECB’s stability orientation.

However, any second-round effects could also be reflected in lower wage agreements. Indeed, some believe that the current wage growth rates in the euro area are already sounding warning bells. But I have a different take on the wage growth, which is indeed moderate.

It is more likely to reflect a necessary employment-oriented wage policy. For some euro-area countries will have to increase their price competitiveness further in order to recoup global market share lost in the run-up to the crisis. Although this wage moderation is dampening wage growth, it is promoting competitiveness and employment in the affected countries and is thus sustainably supporting aggregate demand.

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Ladies and gentlemen, the risks to economic growth have undoubtedly risen, and this is, per se, reducing price pressures. A further easing of the already very accommodative monetary policy stance is therefore on the table. However, such a monetary policy response could have longer-run risks and side-effects that it would be dangerous to simply ignore.

Even the volume of sovereign bond purchases currently planned under the programme will make the Eurosystem the member states’ largest creditor. For a significant share of sovereign debt, government financing costs have become decoupled from capital market conditions: for this share, governments pay interest to central banks; they then transfer these funds, which constitute part of their profit, back to their respective government coffers. The bottom line is that governments are obtaining funding for this share at the deposit rate, since these purchases are ultimately increasing banks’ surplus liquidity. For these bonds, naturally, no distinction is being made any longer between these types of interest rates in terms of the soundness of government finances. This undercuts market discipline, the intent of which is to secure not only compliance with fiscal rules but also sustainable budgets.

Once governments have become accustomed to historically favourable funding terms for a considerable portion of their debt, pressure could subsequently mount to keep the programme alive longer than advisable from a monetary policy perspective, especially if the exceptionally low funding costs are not used for fiscal consolidation but more to dilute the fiscal policy.

And this is precisely the case: if the lower interest expenditure is factored out of the euro-area countries’ structural budget deficits, these deficits have seen no improvement for two or three years or have even become worse. The opportunity opened up by the low interest rates to bring down budget deficits particularly quickly is being squandered.

Moreover, an accommodative monetary policy can, in and of itself, encourage financial actors, especially banks, to more eagerly take on risk. If low-risk investments generate lower and lower yields, at least nominal yields, financial actors will tend to add higher-risk, but higher-yielding investments to their portfolio.

A survey of 1,500 small and medium-sized banks conducted by the Bundesbank and BaFin has shown that these banks are, on the whole, responding to the low-interest-rate setting not only by shifting their assets to higher-risk forms but also by expanding their average residual maturity.

To a certain degree, a greater risk propensity is also desirable, since investments which are profitable and sensible from an economic and business perspective are frequently also associated with somewhat greater risk.

Using monetary policy to foster a risk appetite, however, is a fine line. As we now know, in the run-up to the crisis, capital in many countries was invested in a too high-risk or unproductive manner given interest rates which, at the time, were regarded as exceptionally low.

A new Bundesbank study\(^2\) looks at this risk-taking channel and shows, like work by other economists,\(^3,4\) that it can indeed make sense to pursue a somewhat less accommodative monetary policy. For such an approach, according to the analysis, dampens banks’ tendency to take excessive risks.

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Of course, whenever financial stability risks are looming, this represents a challenge, above all, to macroprudential policy. However, a monetary policy which is intended to ensure longer-term price stability cannot completely ignore these risks, for generally financial stability risks ultimately also threaten price stability – as was clearly shown by the financial crisis.

In addition, we should not ask too much of macroprudential policy: in the euro area, we have only just begun to develop its instruments and acquire initial experience of its efficacy.

3. The current banking environment

The low-interest-rate environment is placing a particular strain on credit institutions’ earnings prospects. This has also been reflected in the acute fluctuations in some bank share prices over recent weeks and raises questions as to how effectively monetary policy stimuli are transmitted via the banks.

Admittedly, banks are benefiting from lower interest rates in the short term as their liabilities tend to have shorter maturities than their assets. In other words, funding costs are falling before there is a dip in income from assets.

But the more protracted the period of low interest rates and the steeper the decline in interest rates, the sharper the drop in interest income and the lower the profit. This is especially the case in the current low-interest-rate environment as, for business policy and competitive reasons, it is difficult for banks to introduce negative deposit rates.

In any case, this was the takeaway from the survey of 1,500 small and medium-sized banks conducted by the Bundesbank and BaFin that I mentioned earlier. Looking at their own calculations and forecasts, the banks reported a total drop in pre-tax profits of one-quarter up to 2019. If the low-interest-rate environment persists until 2019, profits could slump by up to 50% – worse still, if interest rates experience a further decline compared with last autumn and total assets remain unchanged, the plummet could be as great as 75%.

As central bankers, our concern here is not the profits generated by the banks per se; instead, it is the banks’ ability to transmit monetary policy stimuli. German banks have balance sheet reserves and are well capitalised. Even so, the average tier 1 capital ratio was recently raised to 15.6% – having stood at 8.2% in 2006, it is now almost twice as high as it was prior to the outbreak of the financial crisis. Institutions should therefore be able to withstand macroeconomic shocks and economic slowdowns.

Despite this, the banks have to position themselves such that they remain profitable in the long term. To achieve this, they need to review their business models and utilise any available scope for consolidation in order to cut costs. Failing this, banks may find it difficult in the face of limited access to the capital markets during a protracted phase of low interest rates to retain profits with a view to strengthening their capital base, if necessary. Furthermore, banking supervisors from BaFin and the Bundesbank will be keeping a watchful eye on those institutions that were revealed in the survey to be particularly vulnerable with respect to the low-interest-rate environment.

In addition to general as well as country and institution-specific strains that have made themselves increasingly felt, a key regulatory change came into force on 1 January 2016 that likely had an impact on banks’ funding costs. I am talking here about the important and absolutely vital regime shift from a bail-out regime to a bail-in regime. If a bank fails in future, shareholders and certain creditors will henceforth be systematically called upon to foot a greater share of the resulting bill. This is the right course of action as it ensures that risks are borne by the investors who ultimately also took the risks.

The new regime reduces the incentives for banks to take excessive risks and then pass them on to taxpayers – the taxpayers now represent the last line of defence rather than the first. However, this has also caused the interest rates on debt instruments that are eligible for bail-
in to rise. The fact that the prices of these instruments, known as CoCos, have contracted across the board – irrespective of whether they were issued in core countries or crisis-hit countries – is a sign that banks in Europe are now clearly judged less based on the solvency of their home country. And that sums up the aim of banking union perfectly.

If the outlook for the banks is to be improved, the process of overhauling Basel III also needs to be brought to a swift close this year. First, the revised framework will provide banks with greater stability. Much has already been achieved in this regard, as I have already pointed out. Second, the regulatory debate should not become a source of uncertainty in and of itself. Financial institutions need to be able to adapt to the new regulatory regime, and they require a reliable basis for planning to make this happen. This will also quash market uncertainty over regulatory requirements, as the financial strains associated with regulatory change are then easier to calculate.

4. The state of play in Germany

Yet for all the challenges facing the banking sector, we should not lose sight of the fact that the German economy is in good shape overall. That’s allowing domestic banks to keep their risk provisioning low, lifting their profitability.

Last year saw employment reach yet another record high and unemployment diminish further, again reflecting the healthy macroeconomic situation in Germany. Wage growth was marked, while inflation remained subdued, leading to a distinct rise of 2.2% in real disposable income.

It was not surprising, then, that private consumption was the main engine driving the economy last year. This year, too, brisk domestic demand will probably fuel economic activity, which is set to follow a clear upward trajectory despite the slight upturn in risk.

Activity will be stimulated by both the very low energy prices and expenditure on accommodating and providing for refugees. But considering these tailwinds and the fairly favourable conditions overall, the projected growth rates aren’t actually all that strong. And that’s down to the unsatisfactorily low long-term growth trend in Germany, which has been sapped over the past few years by demographic developments and policy decisions. This firmly underscores the need to permanently strengthen growth forces within Germany, too.

On top of the prevailing uncertainty, the bleak growth prospects are another major factor inhibiting private investment and the reason why it has stalled despite low financing costs and capacity utilisation running at more or less normal loads.

This year and next, expenditure on refugees could account for around ½% and ¼% of GDP, respectively. Nonetheless, we expect the government budget to be broadly balanced in both years.

But when it comes to immigration, it’s the longer-term outlook that counts. Over the next decade, more and more baby boomers will be moving into retirement, leaving gaps in the labour market. Immigration that is geared to the needs of the labour market could at least partially plug this gap.

But for now, we are taking in refugees for different reasons altogether – to offer them safety. The qualifications they have are not always suited to the needs of our labour market. But the more we help them acquire the language skills and qualifications they currently lack, the better equipped those who are able to remain in Germany will be to earn a living here.

Not only does this boost these individuals’ self-esteem, it also goes a long way towards integrating them into society. And of course, successful integration also reduces the cost involved in this humanitarian cause.
But it will take time and patience to integrate these people into the labour market. And even if we succeed, it would be illusory to believe that the influx of refugees alone will solve our demographic problems.

5. A consistent framework for monetary union

But it’s not just Germany that is facing its own national challenges. Every single euro-area country must continue to make every effort to strengthen their growth forces still further and thus make the euro area less vulnerable. At the European level, too, there is untapped potential. Besides the capital markets union, the creation of a common digital market and the completion of the single market for services spring to mind.

Yet there is no doubt that the stiffest challenge lies in underpinning monetary union with a robust and consistent structural framework. The structural integrity of the euro area has been found wanting. A decision needs to be taken, because, in a vulnerable currency union mired in stagnation, the onus is repeatedly put on monetary policymakers to paper over the structural cracks with cheap money.

In a monetary union it all boils down to preventing unsound developments in one member state from jeopardising the stability of the union as a whole. There are two ways that this objective can be achieved. The first is to ensure, via a framework based on national responsibility, that unsound developments in a member state are prevented from occurring in the first place and that any developments that do occur cannot destabilise the entire currency union. The second is for member states to transfer much of their responsibility for fiscal and economic policy to the supranational level, essentially creating a fiscal union. Both ways are suited, in essence, for restoring the equilibrium between action and liability.

A genuine fiscal union would mean that action and liability in the euro area would be united at the European level. A fiscal union would undoubtedly be the largest step in the European integration process since the launch of the euro. But it would be impossible to transfer sovereignty to the extent required without making substantial amendments to the EU Treaty and national constitutions.

So, the political obstacles on the path to a genuine fiscal union are very high. If this course of action fails to attract sufficient political support, the only other option to make the monetary union more stable in the long run would be to eliminate the weaknesses and contradictions of the Maastricht framework and its core principle of national responsibility as it stands today. I have stressed this point repeatedly in the past, most recently in a joint article with my French counterpart François Villeroy de Galhau.

There are many ways to bring about such improvements, and there are two I would like to highlight in particular: first, automatically extending the maturities of government bonds if a member state applies for an ESM programme, and second, abolishing the preferential regulatory treatment of government bonds.

Government bonds could be structured in such a way that their terms are automatically extended by three years as soon as a government applies for ESM assistance. That would dramatically reduce the financing requirements under a potential adjustment programme. European taxpayers’ money would then only be needed to spread the fiscal adjustment over a longer period and thus make the impact more bearable for the people in the country concerned. It would not, however, be needed to replace maturing government bonds with ESM loans, a step that would absolve investors of their responsibility.

The second area of reform, namely the abolition of the preferential regulatory treatment of government bonds, ultimately boils down to the nexus between banks and sovereigns – that is to say, the overly close relationship between the soundness of a member state’s public finances and the stability of its banking system.
This nexus fanned the flames of the crisis. The incentives banks currently have to fund their sovereigns to an unhealthy extent must be reduced by requiring banks to set aside capital for government bonds, too, and to observe corresponding ceilings. If the preferential regulatory treatment were done away with, this would increase banks’ incentives to take greater account of the differing risk profiles of the individual states, which in turn would strengthen the disciplinary function of capital markets. Countries that pursue unsustainable policies would then face rising risk premiums.

It is an encouraging sign that the regulatory treatment of sovereign debt is now on the agendas of various bodies and that it will also attract intense debate this year at both the global and European levels.

6. Restrictions on cash usage

Ladies and gentlemen, the current monetary policy environment is fuelling the imagination of some academics with regard to how the “leg room” of monetary policy could be increased. Their proposal is to do away with cash entirely.

The interest rate policy currently pursued by the Eurosystem, and also by the other European central banks, shows that the zero lower bound is not a fixed floor for central bank interest rates. That said, there is no disputing the possibility of a “flight to cash” if interest rates venture too far below zero. If cash were to be abolished, central banks would be able to broadly enforce negative interest rates.

But as I see things, that would be wrong and an entirely disproportionate response to the monetary policy challenges close to the zero lower bound. I believe that the right approach is more a question of strengthening the growth forces in the euro area, thereby a return to higher nominal interest rates.

A clear distinction should, however, be made between the discussion motivated by monetary policy about abolishing cash and the current debate about imposing restrictions on cash usage. Both the proposal to impose caps on cash transactions as well as the initiative to do away with the €500 banknote would, it is claimed, help to combat terrorist financing and money laundering.

The aims pursued by these measures are certainly worthy of support. I, however, am doubtful as to whether terrorists or criminals can really be deterred from illegal activities by imposing a cap on cash transactions or doing away with large-denomination banknotes – just take the calls now being raised in some quarters of the USA to abolish the USD100 note because it is still considered to be “too big”.

The Bundesbank takes a neutral stance with regard to the various forms of payment. It sees its role in assisting and supporting the general public in using those payment methods which they wish to use. To this end, we have made it our job to ensure that the cash in circulation maintains its high quality and that the supply is sufficient. At the same time, the TARGET system that we operate is pivotal to the handling of cashless payment transactions.

German citizens value cash very highly, and that’s quite simply a fact. For them, it offers a whole range of advantages. These merits, alongside many other interesting findings, are described in detail in an article in the Annual Report. On balance, cash is still the most popular means of payment in Germany, with just under 80% of all transactions at the point of sale being settled using cash.
A study conducted by the Bundesbank shows that Germany, together with Austria, are at the vanguard by international standards when it comes to paying by cash.\textsuperscript{5} Incidentally, we will also be publishing a research newsletter on this study today. These research newsletters are a new series of publications by the Bundesbank, which, in future, will present important research findings, at regular intervals, to a specialist audience in a brief and concise manner.

Although the significance of cash payments has decreased in recent years, payment behaviour itself is only changing gradually. Payments by card or by smartphone, as well as online purchases appeal to the young, technology-savvy generation in particular. These means of payments are on the increase, but they are by no means undergoing rapid growth.

One factor that probably plays a role here is that, in contrast to what some believe, cash is not a particularly expensive means of payment. In terms of costs per transaction, cash payments are much cheaper than both debit card and credit card payments. As for costs in relation to the transaction amount, which generally tends to be higher when making payments by card, cash is admittedly more expensive than debit card payments, but is still cheaper than making payments by credit card.

As you can see, there are a number of strong arguments that speak in favour of cash. It is hardly surprising, then, that surveys show that more than three-quarters of the population – or even more – state that they could not do without cash. Bearing that in mind, I would consider it disastrous if the general public were to be given the impression that the mooted abolition of the €500 note and imposition of caps on cash usage were the first steps towards abolishing cash entirely.

All eyes may be on cash right now, but it would be unwise to ignore the far-reaching changes that may well transform the area of cashless payment systems at some point in the future.

Blockchain technology is seen as the key innovation in this regard, allowing as it does values to be transferred cheaply and comparatively anonymously, while bypassing centralised authorities such as banks, card companies and clearing houses.

Similarly, I can also well imagine that it will soon be possible to use digital currencies, such as bitcoins, which are based on this technology, to trade in financial products, such as shares, bonds or derivatives in decentralised systems. This would, of course, present a challenge for the existing payment and settlement systems.

It therefore stands to reason that not only financial service providers, but also central banks are investigating whether this very interesting technology is actually suitable for mass use. This is why the Bundesbank is, inter alia, also a member of a working group on this topic at the Bank for International Settlements in Basel.

7. Bundesbank’s profit and risk provisioning

Ladies and gentlemen, in closing I would now like to come to our annual accounts and thus also to the Bundesbank’s profit last year. The profit and loss account for the 2015 financial year closed with a net profit of €3.2 billion. That’s €0.2 billion up on the previous year’s figure.

The drop in net interest income was more than offset by the improved net result of financial operations, write-downs and risk provisions, hence the slight increase in the Bank’s profitability on the year.

This was mainly due to a tentative reduction in risk provisioning. Foreign currency holdings have traditionally been the chief source of risk in the Bundesbank’s balance sheet, but

between 2010 and 2012, the SMP holdings, refinancing assets and euro securities portfolios (CBPP/CBPP2 and own funds portfolio) also emerged as major risk items. This explains why risk provisioning was increased in three steps to an overall €14.4 billion between 2010 and 2012.

Since then, the risk stemming from the refinancing loans and SMP securities, which used to be in the focus of the Bank’s risk provisioning, has diminished as the volume of securities has shrunk. Moreover, unlike in the previous two years, the annual result expected for 2016 and thus the Bundesbank’s available financial resources don’t look set to decline any further.

At the same time, however, the ABSPP, CBPP3 and PSPP purchase programmes have created additional credit risk, albeit less than had been assumed one year ago. These securities holdings are also a source of interest rate risk. We chose not to set aside any risk provisions in this regard this year, but we are aware that the risk factor will become significantly more important in the future. All in all, risk provisioning was reduced by €0.8 billion to €13.6 billion.

8. Conclusion and handover to Dr Nagel

Ladies and gentlemen, this overview and the key data from our annual accounts bring my introductory statement today to a close.

Dr Nagel will now explain the annual accounts in greater detail before you have the opportunity to ask any questions you might have. Thank you very much for listening.