Andreas Dombret: Current challenges facing central banks – The Bundesbank's stance

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the AHK (Auslandsaussenkammer) World Conference, Berlin, 11 May 2016.

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1. Introduction

Dr Wansleben,

Mr Machnig,

Ladies and gentlemen,

Before I begin, I would like to thank you for inviting me to come here and speak with you today.

In Germany, foreign trade has traditionally been a cornerstone of its economic success. Chambers of Commerce abroad make a crucial contribution to the success of German enterprises in foreign markets. You could say that, today, I am visiting the power houses of the German economy, which is why I am so pleased to be here with you in Berlin.

The motto of this event is: "Where is the global economy heading?" The answer to this question will be put together like the pieces of a jigsaw puzzle from the various reports of the speakers at your conference, who come from all over the world.

Within the space of the next 20 minutes, I will try to lay down the foundations for this jigsaw by giving you an overview of the global economic situation. I will also be elaborating on the consequences that this has for monetary policy and for banking supervision in the euro area.

2. Economic activity

The new year got off to a bumpy start for the global economy, with the economic slowdown in China dampening the New Year's spirit right at the very beginning of the year. This was compounded by the sharp decline in oil prices at the turn of the year, which was perceived as having an increasingly detrimental impact on the global economy. Furthermore, some financial market players had doubts as to whether an ever more accommodative monetary policy stance can really solve the existing problems. This explains why sentiment on the financial markets was also very nervous at the beginning of the year.

The situation has, by and large, calmed down since then, however. According to the International Monetary Fund, the global economy will continue to recover, albeit at a somewhat slower pace than at the beginning of the year. The major industrial countries remain on a moderate growth path, even though growth in the United States and Japan slowed down somewhat in the in the final quarter of 2015 and the first quarter of 2016. Nonetheless, the underlying trend is still pointing upwards and developments in the labour markets are not pointing to an economic slowdown either.

In the case of the emerging market economies there are two divergent developments. In some countries, growth is still robust, but not quite as strong as a few years ago. China, for instance, grew at an annual rate of 6.9% in 2015 and is expected to continue to grow by an annual average of around 6% up until 2020. China is, therefore, a long way off the double-digit growth figures that it had recorded in the past. This, however, is not unusual, as, typically, the catching-up process slows down as per capita income rises.

The situation is different in those countries which are heavily dependent on commodity exports. These countries are suffering from the still very low oil prices – some of these countries are on the verge of or in the midst of a recession. Last year, economic output in

Russia declined by 3.7%, for example, and by 3.8% in Brazil. In many of these countries, the boom in commodity prices, which continued up until 2012, masked the structural weaknesses in the economies concerned, which are now all the more apparent.

Looking at the big picture, the IMF has revised its economic forecast for April down slightly. IMF economists are now expecting the global economy to grow by 3.2% this year, and to accelerate slightly to 3.5% next year.

What does this mean for the euro area?

Compared with other regions, the euro-area economy is likely to have made a pretty good start to the new year. According to Eurostat's flash estimate, the pace of growth in the first quarter stood at +0.6%, compared with +0.3% in the final quarter of 2015. Eurostat did, however, present its first flash estimate just 30 days after the end of the quarter, and not after 45 days as has been the case in the past. Thus, the new flash estimate is de facto based on "hard" data taken from just two months of the first quarter, making it more prone to revision than the previous estimate. And unlike many other "hard" indicators, the sentiment indicators are not showing a pick-up in the pace of growth.

Owing to the weaker developments in other parts of the world, growth in the euro area was driven primarily by domestic demand of late, and less so by exports. The improved situation on the labour market is likely to have contributed to the positive development in domestic demand. The euro-area unemployment rate stood at 10.2% in March, which is still well above the pre-crisis level; this figure is, however, at its lowest level since August 2011.

The current economic indicators predominantly suggest that the upward economic trend is set to continue, albeit at a somewhat slower pace than at the end of 2015. The ECB revised its growth forecast down slightly in March owing, first and foremost, to the slowdown in growth outside the euro area. It is still, however, projecting euro-area growth of 1.4% for this year.

The inflation forecast was also revised downwards. This is, on the one hand, a reaction to the somewhat slower pace of growth, but, above all, the result of the fact that oil prices remain very low.

3. The Eurosystem's monetary policy

The inflation rate is currently sitting slightly below zero, and ECB economists have forecast an annual average of 0.1% for 2016, 1.3% for 2017 and 1.6% for 2018. This means that the inflation rate is only very gradually approaching the level defined by the ECB Governing Council as price stability – below, but close to, 2%.

Therefore, in March, the ECB Governing Council adopted an extensive package of measures. The move that gained the most public attention – at least in Germany – was the renewed cut in the ECB's policy rates. The main refinancing rate was lowered by 5 basis points and now stands at 0%, while the interest rate on deposits held with the Eurosystem was reduced by a further 10 basis points and is now –0.4%.

In addition, beginning in June, the Eurosystem will be providing a further set of targeted longer-term refinancing operations through which banks can acquire liquidity for a period of four years at extremely favourable conditions. Moreover, the volume of monthly bond purchases was raised from €60 billion to €80 billion. This total volume will now also include purchases of bonds issued by non-bank corporations, provided that these are investment-grade bonds issued in the euro area. It is expected, however, that government bonds will continue to account for the majority of purchases.

At the same time, the ECB Governing Council stated that it did not intend to raise its central bank rates for a relatively long period of time – not even once the asset purchase programme has come to an end.

Given that this was not the first time the inflation rate forecast needed to be revised downwards, and also that domestic price pressures – measured using the core inflation rate – have been very restrained, monetary policy intervention was required. An expansionary monetary policy stance is entirely appropriate for the euro area right now, even though people will naturally have different views about individual measures.

As many of you are no doubt aware, the Bundesbank has repeatedly stated that purchases of euro-area government bonds are not "just another" monetary policy instrument. Central bank purchases of government bonds make for a dangerous combination of monetary and fiscal policy. The central banks are becoming the euro-area countries' biggest creditors. For a significant share of sovereign debt, government financing costs have become decoupled from capital market conditions. If governments become accustomed to the favourable funding terms and don't use this time to reduce their large accumulation of debt, this may later put pressure on the central banks to put off tightening the monetary reins until a later date for the sake of their country's public finances.

I am also aware of the fact that many savers are frustrated by the low interest rates. And of course, these concerns are perfectly understandable. Their safe investments are providing them with either very little or no return at the moment. If you factor the inflation rate into the equation, however, the situation does not seem quite so bad. At present, the inflation rate is so low that the real interest rate on savings deposits is above zero. This means it is currently still higher than it was in the 1970s. To take another example, between 2011 and 2014, the real interest rate was actually negative.

Just as euro-area monetary policy cannot be focused on the requirements of individual countries, it is not its responsibility to guarantee savers a certain nominal rate of return either, especially since monetary policy is not the only reason why savers are hardly earning any interest. The low interest rates are also the result of weak growth in the euro area. And this is where policymakers come in. Through appropriate structural reforms and sound fiscal policy, it is their job to steer the economy down a path of sustainable growth.

This is not to say that the central bank doesn't care about the plight of savers. Quite the opposite, in fact – monetary policymakers protect savings from devaluation through inflation, in part by deciding on an appropriate monetary policy stance while remaining independent. Over the long term, this is also in the best interests of savers. But we shouldn't forget that citizens are not just savers. They are also taxpayers, workers and borrowers – and from this perspective, low interest rates are not always a bad thing.

It is also true, however, that ultra-accommodative monetary policy entails risks and side-effects, and these will continue to grow the longer money remains cheap. Therefore, the low-interest-rate policy must not prevail for any longer than is absolutely necessary from the perspective of price stability.

There is a risk, for example, that politicians will start to rest on their laurels because of the short-term stimulus provided by this accommodative monetary policy. Although a central bank may be able to temporarily even out weak demand in the short run, it is not able to permanently raise its economy's longer-term growth trend. However, the repeated deterioration in global growth prospects suggests that when it comes to the slowdown in the global economy, we are actually dealing more with supply-side rather than demand-side problems. And there is little that monetary policy can do about these.

4. Low-interest rate environment: challenges for banks and banking supervisors

Ladies and gentlemen, in the long run, ultra-accommodative monetary policy can also pose risks to financial stability. This can happen, for instance, if bubbles form on the financial markets as a result of the low interest rates or if the generous liquidity supply provides incentives to take excessive risks.

It can also happen if the low interest rates endanger the profitability of the banking sector. The longer the period of low interest rates persists, the greater this risk becomes.

When it comes to financial stability risks, macroprudential policy is the first tool of choice, so as not to have to water down monetary policy's focus on price stability. This would involve taking supervisory measures to ensure that banks and savings banks are sufficiently resilient to withstand financial or economic shocks. However, a monetary policy that aims to ensure price stability cannot completely ignore financial stability risks. After all, the financial crisis has taught us that financial stability risks also frequently endanger price stability. If banks' profitability suffers, the low-interest rate environment can become detrimental.

Of course, as a central banker, my concern here is not the profits generated by the banks. However, from a monetary policy perspective, it is crucial that banks transmit monetary policy stimuli – and this is partly dependent on their capital base. The fact that banks transmit monetary policy stimuli and issue loans is, incidentally, also crucial for exporting enterprises in Germany.

From the perspective of a banking supervisor, I must also note that it is above all the interest-oriented business models that are increasingly coming under pressure in the low-interest rate environment. This affects precisely those banks that are supervised by BaFin and the Bundesbank – something borne out in a survey that we conducted among 1,500 small and medium-sized banks and savings banks in Germany. The most important finding is that, according to the banks' own projections, profitability is expected to decline by around 25% by 2019. If, however, one assumes an even greater fall in interest rates and/or excludes the possibility of balance sheet adjustments, profitability could even fall by up to 75%.

The banks and banking supervisors need to examine how they are going to address this. One obvious solution is for banks to pass on the negative interest rates to depositors. However, the survey also reveals that, due to the intense competition, only a minority of institutions would consider introducing negative interest rates if the low-interest-rate environment persists.

Instead, the survey suggests that banks will try to expand their business areas that are less dependent on interest rates. This concerns, above all, the commissions business. Many institutions have used the past few years to stock up their capital buffers, so they've "fattened up for winter", as it were. This is shown, for example, by the fact that all institutions exceed the minimum capital requirements. Many institutions will therefore be able to absorb future losses by liquidating reserves.

Nevertheless, it would be disastrous if banks attempted to ride the situation out, as reserves can soon be exhausted when profitability declines. This applies, in particular, if the economic situation were to deteriorate. This makes it especially important for banks to be profitable in the long term. To achieve this, they need to review their business models, get their balance sheets in order, harness any available scope for consolidation and examine digitalisation possibilities in order to cut costs. Failing this, they may find it difficult during a protracted phase of low interest rates to retain profits with a view to further strengthening their capital base.

The institutions must also examine their business models with regard to long-term sustainability. We, as supervisors, will closely monitor this process. As supervisors, we evaluate the risks for each institution individually – but without losing sight of the financial system as a whole. In doing so, we actively seek out direct exchanges with the institutions.

If an institution stabilises its earnings by taking on greater risk, this must be reflected in its overall strategy and be backed by corresponding capital.

5. Conclusion

Ladies and gentlemen

I have tried to give you an overview of the global economic conditions. And I have pointed out that, above all, the dampened inflation outlook and the subdued growth currently justify an accommodative monetary policy – even though there are of course side effects, which increase over time, and even though opinion may be divided on individual instruments.

With that, I would like to draw my speech to a close. As the saying goes, a speaker should exhaust the topic and not the audience.

Thank you very much!