Jens Weidmann: Introductory comments at the financial statements press conference 2016

Introductory comments by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the financial statements press conference 2016, Frankfurt am Main, 23 February 2017.

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1 Welcome

Ladies and gentlemen

I, too, would like to welcome you to this press conference marking the publication of the Bundesbank's annual accounts for 2016.

Some publications refer to the public sector budget as revealing the state's bone structure, since it summarises all government activities in terms of their financial ramifications.

Seeing that monetary policy is our most important line of business with regard to its financial scope, one could also see our balance sheet as an X-ray of monetary policy.

Balance sheet developments are shaped by the economic environment, but are, of course, influenced in particular by the decisions taken by the Governing Council of the ECB in setting the general direction of monetary policy. What is reflected, above all, in our balance sheet this year are the decisions to purchase bonds on a large scale and to charge a negative rate of interests on banks' deposits with the Eurosystem.

As the Governing Council of the ECB took a decision at the beginning of 2016 to expand its non-standard monetary policy measures – I am thinking here specifically of the increase in monthly purchases under the APP from €60 billion to €80 billion – the balance sheet grew even more quickly during the past year than it did in 2015.

The decision taken in December last year to extend the duration of the programme up to the end of 2017 with a purchase volume then reduced again to €60 billion from April 2017 and the buying of securities with yields lower than the deposit facility rate will also have an impact on our balance sheet – something which we are already having to take into account.

But before I explain in detail the determinants of our balance sheet and profit and loss account together with Mr Thiele, I would like to talk about monetary policy in the light of the economic setting and about the international economic system.

2 Monetary policy

Ladies and gentlemen

The economic setting differs in one essential aspect from the one we discussed at the last press conference on the annual accounts. In 2015, it was chiefly doubts about the cohesion of the euro area that kept members of the general public, policymakers and financial markets in thrall. In 2016, on the other hand, attention was focused in particular on events outside the single currency area.

Right at the start of the year, developments in a number of emerging market economies, especially in China, were a cause of disquiet. During the year, there followed, first, the UK referendum vote on Brexit and, later, the US presidential election, neither of which necessarily produced the outcome that many were expecting. Finally, in December the failure of the referendum on electoral reform brought about a change of government in Italy.

Some of these events led to the emergence of risks that economists had hitherto seen as grounds for a possible slowdown in the economic recovery. And these decisions are contributing to a situation of quite pronounced uncertainty at present with regard to key underlying economic conditions.

Even so, the financial markets and the real economy have coped pretty well with these surprises. That is all the more surprising given that uncertainty is generally regarded as the enemy of long-term investment.

Monetary policy, which is still very accommodative in many regions of the world, may also have played a part in this quite robust performance of global economy. Especially with regard to the Brexit vote, the fact that even greater turbulence did not occur in the markets was probably due just as much to the prudent conduct of banks and supervisors.

But events also show that the upturn in the euro area has stabilised and stands increasingly on solid ground.

You will perhaps remember that the projections in March last year were assuming growth of 1.4% for 2016. Despite the vote on Brexit and the outcome of the US election, the figure in the end was as high as 1.7%.

This means that the economy grew more quickly than production capacity. Enterprises' capacity utilisation is on the rise. This is also benefiting the labour market in many euro-area countries; in 2016 the unemployment rate for the euro area as a whole declined by almost 1 percentage point to 9.6%. That means it is now just a little less than 1 percentage point above its average in the pre-crisis years.

Latest economic indicators also point to a continuation of the economic recovery. Retail sales and registrations of new cars showed a marked rise in the final quarter of 2016, for example, and the underlying trend of industrial output is clearly pointing upwards. Furthermore, the EU economic sentiment indicator is currently at its highest level for almost six years.

The current Eurosystem projection from December assumes that the euro-area economy will grow by 1.7% this year and by 1.6% in each of the next two years.

Although the forecast is currently undergoing its scheduled revision by the ECB staff, I do not expect the previous picture to change very much. However, from my vantage point the cyclical downside risk has recently tended to diminish.

The German economy, too, with capacity utilisation perceptibly higher than that of the euro area, remains in good shape. Employment once again hit a new all-time high last year. Thanks, above all, to healthy domestic demand, gross domestic product was up by 1.8% after adjustment for calendar effects.

The economy looks set to remain on an upward trajectory this year and the next, with domestic demand again providing the primary impetus.

The Bundesbank's economists expect calendar-adjusted growth to come to 1.8% in 2017 and to dip slightly in the years after that.

However, this positive economic outlook should not blind us to the fact that the longer-run outlook for growth in Germany is sub-par. What I am thinking of here, for example, is that, in the coming years, the number of persons going into retirement will surpass the number of young people entering the job market. In isolation, this will cause weaker growth.

That, too, is why the OECD is projecting that, until 2060, Germany will grow more slowly than any other major industrial country.

The robust upswing and rising capacity utilisation will also drive up price pressures. According to the December projection, the euro area will see inflation rise to an average of 1.3% this year, followed by 1.5% next year and 1.7% the year thereafter.

To repeat: that was the December projection. Since then, inflation has risen even more strongly than expected, recently hitting 1.8%. And for full-year 2017, the inflation forecast will probably be lifted perceptibly. In Germany, where the effect relative to the December forecast is likely to amount to one-half percentage point, some have therefore already spoken of "the return of inflation".

This increase in prices, however, is attributable mainly to higher oil prices – since the end of November, oil has become significantly more expensive. At the beginning of the past year, its price had been exceptionally low. This results in a particularly sharp increase in a twelve-month comparison. Assuming that oil prices do not rise any further, we should therefore be back to lower inflation rates by the end of this year, if not beforehand.

Domestic price pressures, which also look through energy price fluctuations and other volatile components of the consumer price index, are currently still comparatively low. Core inflation, at last report, was around the 1% mark.

The fact that, even at the beginning of the year, the inflation rate was already above the forecast – and is likely to remain so for some time to come – clearly shows, in my view, that we are far removed from the threat of deflation – that is, a dangerous downward spiral of sinking wages and prices – that many had cited as grounds for asset purchases.

By the way, I'm not the only one who sees it this way. Financial market participants seem to have a similar take on it: the probability, derived from inflation options, that the inflation rate will be negative in the next five years was, at last report, at its lowest point since the summer of 2011.

According to Eurosystem forecasts, domestic price pressures will slowly increase, for as the euro-area economy continues its recovery, factory capacity utilisation will mount and wage growth will accelerate. This will also show up in the core inflation rate, which, according to the December projection, will reach 1.7% in 2019.

In this state of affairs, an accommodative monetary policy certainly continues to be appropriate, though opinions differ over the right degree of monetary accommodation. And it is fair to ask – as Yves Mersch did two weeks ago – when we can take our foot off the monetary policy pedal and whether or not the Governing Council of the ECB shouldn't shape its forward communications in a more symmetrical manner, such as by not indicating only that monetary policy could, if necessary, be made even more accommodative.

Especially since the ultra-accommodative monetary policy is being implemented in key measure through the large-scale purchases of government bonds, which, as you know, I am very critical of.

The line between monetary and fiscal policy is being increasingly blurred, and government funding costs are increasingly depending directly on monetary policy decisions. This is all the more problematical as, in the current low-interest-rate setting, some finance ministers might see their budgets as being more sustainable than they would be in a normal interest-rate setting. Another sign of this is that, despite debt levels already being high to begin with, some euro-area countries recently took advantage of the easing of pressure on government coffers resulting from the favourable financing terms to even accelerate their spending.

However, higher interest rates will then expose the burden of high government debt, and the markets, too, could be more sceptical of the sustainability of government budgets. I would not be at all surprised if, under circumstances like these, monetary policy makers were to come under mounting pressure to keep the monetary policy stance accommodative for some time to come out of consideration for government funding costs or to avoid risks to financial stability.

The so-called “Greenspan put” illustrates the moral hazard that can come of such an asymmetrical approach. In extremis, monetary policy can even be held hostage by fiscal policy or the markets. Yet it is only permitted to have one objective: price stability.

In addition, a central bank should not be stretched beyond the breaking point in order to accomplish additional objectives. Examples include the expectation that monetary policy makers pay attention to the redistributive effects of their measures – this is something we discussed critically and at great length in the September 2016 issue of our Monthly Report – or that it ensure more growth in the long run. Monetary policy can’t do that! It can quick-start the economy, or brake it somewhat, if necessary in order to ensure price stability. However, only politicians and governments can lead the economy back to a path of sustained, higher growth. By setting the proper gears in motion in labour market, economic, social and tax policy.

Let me give you an idea of just what could be achieved by effecting the appropriate reforms: The International Monetary Fund (IMF) conducted a study to determine which OECD countries have the most growth-friendly tax regimes, labour markets and social insurance systems. IMF economists then calculated what would happen if euro-area member states closed half of the gap to the leaders. The result is: annual euro-area growth in subsequent years would be just under one percentage point higher.[1]

And since, after all, the long-term interest rate across the cycle is largely composed of trend growth and inflation expectations, this would also contribute in key measure to pushing interest rates back up more strongly.

With that in mind, it is all the more disheartening that other studies published by the IMF, but also the OECD, conclude that enthusiasm for reform in the euro area has fallen off significantly.

3 G20 agenda: free trade and financial market regulation

Ladies and gentlemen

A number of the conditions needed for dynamic growth can only be created at the international level, however. One such condition are competitive markets which are enshrined in agreements and treaties that safeguard the free movement of goods, capital and services – and, in the European Union, of labour as well.

3.1 Free trade

And on that score, the outlook certainly grew dimmer last year.

The UK government has now announced that it is aiming to leave not just the European Union but the single market as well. As things stand, there is no visibility whatsoever as to whether, and if so, when the bilateral trade agreement the UK government is looking to conclude with the EU will come about, and what the contents of that agreement might look like. But even then, a likely outcome is that the United Kingdom will end up having looser trade ties with the EU than

Norway, which is – lest we forget – a member of the European Economic Area, or Switzerland, which has concluded bilateral treaties with the EU.

And the new administration in the United States is going so far as to make protectionist noises.

Elsewhere in the world, too, many people are mainly seeing the disadvantages which globalisation, and also technological progress, unquestionably entail for some.

The advantages of free trade are drifting ever further out of focus – perhaps that is partly because they are less immediately apparent and harder to pinpoint than the drawbacks.

But in my view, there is one thing we must not forget.

Open markets and a competitive economic system are qualities that underpin our prosperity.

In terms of national economies, international trade is most certainly not a zero-sum game in which one country wins at the expense of another.

It is safe to say that politicians and academics in the past neglected to devote enough attention to how it is precisely the less qualified members of the workforce who feel the competitive pressure stemming from international trade.

That's not to say that protectionism and insularity are a great deal of help here – especially since technical progress has much the same impact on lower-skilled workers in closed markets as well.

The right course of action is to enable citizens to participate in the rewards of globalisation. Better schools and universities, and lifelong learning, can equip people to capitalise on the benefits which an ever-changing environment can offer. And flexible labour and product markets are another catalyst that can facilitate structural change without producing stubborn unemployment because new jobs are created more quickly than the old ones are lost.

The labour market reforms implemented in the middle of the last decade offer a vivid illustration of this relationship, I feel. One major risk of sliding into poverty in Germany – being out of work – was reduced by these reforms.

I, for one, firmly believe that open markets combined with economic structures that are more conducive to growth generate stronger productivity, higher employment and rising incomes. And it also allows social hardship to be cushioned by a targeted tax and transfer system. If this model succeeds in making Ludwig Erhard's promise of "Prosperity for all" a reality, it will simultaneously boost confidence in an open and pluralist social order.

Inclusive, sustainable growth is also a major topic in the G20 process. Together with the Federal Government, the Bundesbank will reiterate its backing for open markets (and fair trade) at the forthcoming G20 meetings. In times like these, when uncertainty is rife, it is safe to say that constructive cooperation between the most important stakeholders in the G20 context is even more significant than it is in any case.

3.2 Financial market regulation

Financial market regulation is another topic that demonstrates just how important it is to cooperate internationally on major cross-border issues. The G20 countries responded to the crisis in a swift, comprehensive and coordinated fashion, eliminating key disincentives in the financial system and reducing to a minimum the risk of regulatory arbitrage or a regulatory "race to the bottom".

The regulatory agenda has kept us very busy indeed in recent years, but almost all the items have now been ticked off. The Bundesbank puts a great deal of effort into this process as a member of the Basel Committee, the primary global standard setter for the prudential regulation of banks, and of the Financial Stability Board, the European Systemic Risk Board and – at the national level – Germany's own Financial Stability Committee.

As far as banking regulation is concerned, 2016 was all about wrapping up Basel III, and especially the question of how far credit institutions should be permitted to use their own internal models to determine their capital adequacy requirements for credit risk. Supervisors are looking to reduce the risk that institutions using such models might understate their exposures – and thus their capital adequacy requirements – but without questioning the principle of the risk-based approach as such.

Much of the work needed to address this topic was wrapped up in 2016. The main outstanding issue is the calibration of what is known as the "output floor" – that is, the lower threshold for capital adequacy requirements calculated with the aid of internal models.

The Bundesbank has been involved in efforts to hammer out a compromise up until recently. But as long as the new US negotiators have not been appointed and their negotiating stance remains unclear, there is no point in conducting any further talks. And yet we all have an interest in returning to the negotiating table soon. After all, the regulatory uncertainty caused by a delay in finalising Basel III is undoubtedly a burden for banks.

I firmly believe that the coordinated international revision of banking regulations in recent years have made the financial system a more stable place. That is why a regulatory "race to the bottom" would be a dangerous thing.

The debate surrounding this topic often points to the seemingly positive impact that deregulation can have on growth. The untold damage that inadequately regulated banks and financial markets can do to growth when they precipitate a financial crisis is something we witnessed at close hand – closer than we might have liked – in recent years, if we didn't know it already.

Ladies and gentlemen

As far as free trade and banking regulation are concerned, it is still unclear at the moment what exactly the future holds in store for international cooperation.

The status quo is under the spotlight in other policy areas, too – the topic of international security springs to mind.

And Europe, in particular, faces the twin challenge of not only dealing with Brexit but also handling the sense of disenchantment with the EU in many member states.

This is the background against which some voices are now calling for the euro-area countries to close ranks.

A strong and united Europe is a goal worth striving for.

But I don't buy proposals like the ones floated recently that essentially boil down to closing ranks primarily through an increase in mutual liability.

There are two ways to put monetary union on a more stable footing for good. One is to establish a fiscal union – but there does not appear to be any great appetite to cede the necessary sovereign rights to the European level at the present time, and that appetite, assuming there is one, is more likely to have dwindled than grown.

The other is to bolster the existing decentralised framework and thus strengthen the individual responsibility of member states and investors. The Bundesbank has outlined a number of ways in which this goal could be achieved, most recently in its June 2016 Monthly Report. But again, this is an area that faces strong headwinds.

Yet even without stepping up mutual liability, there are plenty of other topics where the governments of Europe can show that Europe functions and benefits the public at large. Just take the new challenges facing Europe, such as internal and external security, or the question of shaping the digital markets of the future. These challenges can best be overcome in Europe by working together.

4 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 2016 financial year closed with a profit of €1 billion.

This was €2.2 billion less than in 2015.

In addition, part of the profit for the year is subject to a restriction on distribution, meaning that only the remaining distributable profit of €399 million will be transferred to the Federal Ministry of Finance today. That is the smallest transfer since 2004, when a distributable profit of €248 million was transferred for 2003.

The fact that we were unable to distribute the entire annual profit this year is due to the Bundesbank, like many enterprises, preparing its balance sheets in accordance with the German Commercial Code (Handelsgesetzbuch).

Last year, the Commercial Code provisions on the discounting of post-employment benefit obligations were amended. They must now be discounted at the average market rate from the preceding ten financial years – previously it was the average of the preceding seven financial years.

Post-employment benefit obligations are thus discounted at a higher average interest rate. That has resulted in a book profit but one that cannot be distributed, as we will, of course, have to pay out these post-employment benefits later nonetheless.

We have therefore transferred these gains to a reserve.

As I have already mentioned, monetary policy leaves its mark on a central bank's balance sheet. For example, the rise in banks' excess liquidity due to the ongoing bond purchases and the negative interest on deposits with us have led to year-on-year growth of €1 billion in net interest income.

Interestingly, interest is now often earned on the liability side of the balance sheet, while the asset side – where we are mostly buying low-yielding Federal bonds under the asset purchase programme – is now generating almost no interest.

Yet these interest earnings are not sustainable, at least not if interest rates start to rise again. Quite the opposite, in fact. Given the comparatively long time to maturity of instruments on the asset side, it will yield almost no earnings in the longer term, too. Meanwhile, a rise in key interest rates could rapidly result in interest expenses for deposits on the liability side. All in all, this maturity mismatch could then lead to losses.

As well as exchange rate risk, credit risk arising from refinancing operations and default risk generated by central bank asset purchases, which are already factored into our risk provisions, we now also face interest rate risk.

At last year's press conference presenting the balance sheet, I already indicated that we would need to address this issue.

Given the current interest rate exposure of around €300 billion, a rise of one percentage point in the key interest rates would lead to an annual financial burden of around €3 billion.

This is a new situation for us. Back when monetary policy only steered short-term interest rates on the money market, the Bundesbank's balance sheet was, de facto, free from interest rate risk. The vast majority of interest-bearing assets had short maturities – the lion's share were repo transactions with banks – and were balanced out by the non-interest-bearing banknotes in circulation. Where it existed at all, the volume of excess liquidity – and thus essentially banks' deposits with us – was very small. Our monetary policy operations were therefore sure to contribute to our profits.

Primarily because of the interest rate risk we now face, we have decided to increase our risk provisions by €1.75 billion.

Mr Thiele will give you more details on this in a moment.

Before he does, however, I must stress that the success of monetary policy decisions must not be measured in terms of the central bank's profit but against the objective of price stability alone.

5 Conclusion

Having provided this overview and the key data from our annual accounts, I would like to bring my introductory statement to a close.

Mr Thiele will now provide you with more detail on the annual accounts, and then you will have the opportunity to ask any questions you might have.

Thank you for your attention.

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[1] Spilimbergo A, Berger H, Schindler M (eds) (2014), Jobs and growth – supporting the European recovery. International Monetary Fund.