Andreas Dombret: A brighter global economy and its downside risks

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a reception to bid farewell to Mr Alexander Sattler and to welcome Mr Peter Kern as the Bundesbank's representative in Mumbai, Mumbai, 30 October 2017.

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1. Introduction

Governor Patel

Mr Consul General Morhard

Ladies and gentlemen

I am pleased to be here with you at this reception to bid farewell to Alexander Sattler and to welcome Peter Kern as the Bundesbank's representative in Mumbai.

Some may still wonder why the Bank's representative in India isn't located in your capital, New-Delhi. But a prime objective for us as a central bank is to stay close to our community. With the Reserve Bank of India based here in Mumbai, we have our peers and representatives of the financial community close by.

Mutual exchange is necessary in a globalised financial world. We all know that. But when it comes to issues we all currently face, we can sometimes focus so much on our own situation that we blank out the views and experiences of others. I therefore wish to take this opportunity of speaking before representatives of the Indian financial community to share my views on current financial matters that should be of concern for both Europe and India.

2. Monetary policy change and consequences

It is a rather gratifying task to talk about challenges when the global economy is actually in an encouraging state. We are seeing a sustained, broad-based upturn in industrial countries and consolidated growth in emerging markets. That was also one of the crucial takeaways from the IMF meeting in Washington. There was a unanimous view that the world economy has continued to strengthen. On top of this, the economic upswing is broadly based. Virtually all the industrial countries are performing somewhat better now than was expected at the beginning of the year. Having witnessed the global financial crisis and subsequent downward spirals, there is currently a feeling of relief. For the financial sector, growth typically provides new business opportunities and typically decreases credit risks.

The good thing about a stronger, brighter global economy is that this gives actors room for manoeuvre. Indeed, there is no better time to fix a leaky roof than when the weather conditions are fair.

And while we're fixing the roof, we might want to carry out some additional precautionary measures to prepare us for the next storm. And indeed we should feel obliged to do so. While it can be easy to be carried away by the idea of an upward spiral where problems will miraculously fix themselves, good weather, unfortunately, doesn't last forever.

We should therefore use this sunny spell not only to make important fixes – like accomplishing the full set of reforms initiated after the financial crisis – but also to carry out routine precautionary measures.

As far as monetary policy is concerned, we need to make sure that everyone is able to cope with a rise in interest rates. Given a strengthened macroeconomic environment and the expectation of higher inflation the Federal Reserve System has already increased its monetary policy rate. Both led to a rise in the long-term interest rates in the United States in the past twelve months.

And even in the euro area capital market rates went up – but less than in the US. One reason is that financial markets already expected that the ECB Governing Council will prolong its ultra-loose monetary policy. Indeed, the Governing Council has decided last week to reduce the monthly volume of its net asset purchases from 60 bn to 30 bn euro beginning in January and lasting at least until September 2018. But with this decision, ladies and gentlemen, the Governing Council has by no means slammed on the brakes. It has rather layed off the gas pedal somewhat. Given the favourable current macroeconomic outlook and the upwards trend for domestic price pressure in the euro area a clear end time of net purchases would have been appropriate.

And so, in principle, the low interest rate environment in the euro area will be lasting. This intensifies the revenue problem of euro area banks. But even if longer-term interest rates in the euro area would rise in the tow line of US capital market rates, this would imply a challenge for euro area banks. Given my current role in the field of banking supervision, I am quite concerned about banks' management of these interest rate risks. The key risk is then the so-called interest rate risk in the banking book. Only a few weeks ago, we published our 2017 survey of over 1,500 small and medium-sized German credit institutions. In a scenario of rising interest rates, while institutions would initially and on average face a sharp decline in profits, they would be better off in a medium-to-long-term. A comparable stress exercise has been done for large euro area banks as well. With respect to a change in the interest rate environment, a key lesson was that risks depend to a large extent on how banks are set up. Have they agreed on floating rate loans with their customers or on fixed rates? How long is their average asset duration? For a majority of large European banks in the test, higher interest rates would lead to largely contained risks and also a higher net interest income in three years' time. An interest rate hike therefore poses individual challenges for banks and requires individual remedies.

Problems caused by the monetary policy change particularly in the US are, of course, not confined to financial institutions. There is a general and empirically tested idea that emerging countries may also suffer. Historically, we have witnessed large capital inflows to emerging countries in so-called "risk on" periods, where capital was abundant in advanced economies and when conditions nurtured the "search for yield". Flights to safety or monetary tightening of the US dollar have led to capital outflows from emerging countries, currency depreciations, and financial crises. Recently, in the spring and summer of 2013, talks about monetary tapering led to sharp exchange rate reactions.

However, emerging countries are not completely at the mercy of global factors such as the monetary policy of large economies or international economic cycles. One obvious precautionary measure is to build up foreign exchange reserves. This "safety shield" allows these countries to dampen depreciation pressure. Indeed, emerging economies have accumulated a large stock of foreign exchange reserves in the last 15 years. Recent empirical research by the Bundesbank[1] indicates that foreign exchange reserves are indeed an effective tool to counter depreciation pressure. But it also shows that the monetary "safety shield" is not a cure-all. In order to keep private investors in the country, a country should rather strive for a healthy policy mix that targets domestic economic development.

3. Bundesbank representatives in Mumbai

Ladies and gentlemen

Our concern for financial stability requires us to cast our net wide and always keep track of the latest developments in the most important economies of the world. For the Bundesbank, our representatives and representative offices abroad fulfil an important role in this respect.

I would like to first thank Mr Alexander Sattler for his service in Mumbai from October 2014 until September of this year. He has been here during eventful times. Among other things, India has seen a strong reform momentum – the reform of tax on goods and services being the most recent result. India's reforms have received a lot of international attention. Throughout this period, the Bundesbank has benefited from our reliable hotline to Mumbai.

I would also like to warmly welcome his successor, Mr Peter Kern. The job at our representation requires not only all the professional knowledge, which he – like Mr Sattler – of course brings along. But this job is also a lot about personal contact, as I said in the beginning. For example, our Bundesbank representative in Mumbai always stands ready to present our views regarding current developments in the euro area and in Germany.

I can only encourage everyone here in this room to get in contact with Mr Kern whenever needed. Mr Kern may be new to India, but he is not new to this position. From December 2008 to January 2012 he was in our representative office in Sao Paolo, Brazil – which means he even stayed one year longer than the usual three-year term. He is a very open-minded person. One of his first preparations was to sign up for a Hindi language course.

I am convinced that Peter will – like Alexander Sattler – do a very good job sharing knowledge between India and Germany.

Thank you for your attention.

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[1] Bundesbank Monthly Report, October 2017.