Jens Weidmann: Opening statement at the 2018 press conference on the annual accounts

Opening statement by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the 2018 press conference on the annual accounts, Frankfurt am Main, 27 February 2018.

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1 Introduction

Ladies and gentlemen

Welcome to our press conference to present our annual accounts.

Before I discuss the most important points of our annual accounts with you, I would like – as is my custom – to say a few words about economic developments and monetary policy. I will also talk about the institutional architecture of the monetary union, which is the backdrop to monetary policy in the euro area. As you know, the debate on developing the monetary union gained a lot of traction last year as a result of the proposals put forward by Emmanuel Macron and the European Commission.

Following my introductory words, Mr Thiele will discuss in greater detail selected aspects of our annual financial statement. After that, we will, as always, be happy to answer your questions.

2 Review of 2017

As you know, 2017 was the year of the German G20 presidency. We managed to put important issues, such as the impact of digitalisation on the financial sector as well as cyber risks, on the international agenda. Finance ministers and central bank governors are now aware that cyber risks pose a potential systemic risk. The WannaCry attack that took place in the summer of 2017 drove home the fact that supervisory authorities need to keep a very close eye on this subject.

In addition, we were able to finalise the Basel III negotiations last year. That was another step towards a safer banking system. It also gives banks planning certainty, as they can now gauge what capital requirements their credit and investment decisions, for instance, involve.

In macroprudential supervision, German legislators created new macroprudential instruments for the residential property market last year. This, too, was an important contribution towards greater financial stability, as it established the legal basis for supervisors to step in to prevent overly lax lending standards for loans for house purchase should financial stability risks emanate from the residential real estate market.

Another important issue for us last year was, of course, Brexit. This was particularly true of our banking supervisors, who are working closely with BaFin and the ECB to ensure a smooth transition for the financial industry. In particular, that means providing information and being available to answer questions from banks that have, to date, operated their European business from London and now wish to establish offices or expand their presence in Germany.

Currently, the European Union and the United Kingdom are negotiating their future relationships and a possible transition period. However, it is impossible at the moment to predict what the future relationships will look like and whether there will, indeed, be a transition period.

Financial institutions should therefore not be lulled into a false sense of security. Banks that wish to continue to do business in the other economic area – that is, in an EU 27 country or in the United Kingdom, respectively – should at least establish the necessary base units there. And for

the European Union, base unit means more than just a “letterbox” company. It means that there must be enough qualified staff at the respective location in the EU to support critical operations at all times.

Last year also saw us complete our gold transfers. You may remember that the Bundesbank’s Executive Board decided back in 2012 to repatriate by 2020 some of the gold reserves that are stored abroad. These transfers have now been concluded successfully and well ahead of schedule.

German gold is now stored in only three locations: half of the gold reserves are held at the Bundesbank in Frankfurt. The other half is stored with our two partner central banks, the Federal Reserve Bank in New York and the Bank of England in London. The fact that the gold holdings were spread across the individual storage sites was mainly due to historical reasons. With the transfer of the gold to the remaining storage locations, the Bundesbank has adjusted to the changed environment in terms of the objectives of safety, liquidity and cost efficiency.

Ladies and gentlemen

Although this list is not exhaustive, you can see that we faced challenges across the breadth of our tasks in 2017 – and these tasks comprise more than just monetary policy.

But when it comes to the presentation of our annual accounts, the central bank balance sheet and thus the profit and loss account are, of course, very much influenced by monetary policy.

3 Monetary policy

And that brings me to economic developments and monetary policy.

Economic performance was very satisfactory last year – in Germany, the euro area and beyond – and the recovery accelerated further in the second half of the year especially. The upswing now rests on a broad base everywhere.

Year-on-year growth in 120 countries accelerated last year. That includes the vast majority of euro area countries.

Economic activity expanded at a far brisker pace here in 2017 than it had one year earlier. An annual average growth rate of 2.5% was achieved – the best figure in ten years.

This is partly why the unemployment rate fell to its lowest level, 8.7%, since early 2009.

A host of sentiment indicators for the euro area are at their highest levels in many years. The favourable developments in economic activity are therefore expected to continue in the first instance. In December last year, Eurosystem economists thus again raised their growth forecasts for this year and the next. They now expect growth rates of 2.3% this year and 1.9% next year.

Of course, not all euro area countries are experiencing the same pace of growth. But the good news is that the range of growth rates recorded in the euro area narrowed last year, meaning that here, too, the upturn is broad-based.

The German economy is even booming now. Employment hit new record highs in 2017, and year-end joblessness was at its lowest level since reunification. The healthy labour market situation was a boon to private consumption and housing investment; heavy capacity utilisation led to a strong increase in industrial investment, too. Overall, the German economy expanded by a seasonally and calendar-adjusted rate of 2.5% in 2017, with a similar growth rate expected for this year.

In both the euro area and Germany, the economy is therefore growing at a faster pace than potential output, and this has already been the case for some time. Enterprises are seeing increasingly heavy capacity utilisation.

What this also means is that the real economic situation and the monetary policy stance have rarely diverged as much as they do now.

This is because price pressures in the euro area remained relatively sluggish in 2017, too, even though economic conditions have picked up. However, the higher oil price and the strengthened upswing helped make inflation much stronger in 2017 than in 2016. The slight drop in the headline rate in the past two months is due not only to one-off factors, but also to the oil price effect now being washed back out of consumer price inflation.

The subdued domestic price pressures reflect the fact that some countries are still trying to boost their price competitiveness by keeping wages down. And in Germany, the migration of workers from other EU countries over the past few years has suppressed wage pressures and hence domestic price pressures.

The Governing Council of the ECB was therefore agreed that expansionary monetary policy is still necessary. At the same time, we agreed that the more dynamic upturn allowed for the monthly asset purchases to be scaled back.

As you will also know, this prompted the Governing Council to decide in October 2017 to reduce the Eurosystem's monthly asset purchase volume from €60 billion to €30 billion, starting in January 2018.

But I'm sure you will also be aware that I believe there would have been a good case for reducing the asset purchases sooner and setting a clear end date.

After all, a number of signs are suggesting that the tendency towards increasing domestic price pressures is likely to be sustained. The robust state of the economy confirms the consensus view on the ECB Governing Council that inflation will move towards the inflation target of below, but close to, 2%. This can also be seen in the latest Eurosystem price forecast, as it happens.

And it is also demonstrated by the current pay agreement in the metalworking and electrical engineering industry in Germany. The agreement is not only consistent with the expectations underpinning our forecast, but also shows that the Phillips curve certainly retains its validity in Germany.

In October last year the markets, too, expected the asset purchases to be terminated by the end of 2018. A point that is also worth noting in this regard is that monetary policy will remain very expansionary even after the end of the net asset purchases.

After all, the degree of monetary policy accommodation in the euro area is determined not so much by what volume of assets are purchased each month as by the stock of assets held on the Eurosystem balance sheet. And that stock comes to around €2.3 trillion in the meantime.

This stock of assets will, of course, remain constant even after the net purchases have been terminated, because the ECB Governing Council long ago decided to reinvest the proceeds of maturing assets in bonds even after the end of the net purchases, and to do so until further notice.

Ending the net purchases, then, won't fully put the brakes on monetary policy. It will simply mean not running at full throttle any more.

By the way, the recent appreciation of the euro doesn't change the very accommodative monetary policy stance in the euro area either. This is because the euro's price trend is – at least

partly – a reaction to the euro area's improved growth prospects. What is more, there are indications that exchange rate movements are having a smaller impact on the inflation rate today than they did in the past.[1] But it's clear, of course, that the Governing Council will always keep a close eye on the impact of exchange rate changes on the objective of price stability.

Ladies and gentlemen

There's another thing that seems clear to me: the normalisation of monetary policy in the euro area will take quite some time. That's why I believe it is also important to gradually and dependably reduce the degree of monetary policy accommodation when the outlook for price developments in the euro area permit us to do so.

The stock market turbulence at the start of the month shows that dependability in communication plays a particularly significant role in this regard. Of course we don't tie ourselves to the mast like Odysseus, in monetary policy terms; instead, we always make our decisions on the basis of current data and projections. But there needs to be clarity about our monetary policy reaction function.

Although the current low-interest-rate environment is supporting the upswing in the euro area, it also makes it vulnerable should there be another economic cool-down.

The low interest rates create a kind of illusion of sustainability, for example with regard to public finances. Against this backdrop, I find it very troubling that many finance ministers aren't seizing on the savings they have made from the low interest rates and favourable developments in economic activity and using them to put their public finances on a sound longer-term basis.

The key metrics for government budgets improved in the past year – both the government debt ratio and the deficit ratio are likely to have shrunk in the euro area overall – but the outturn is not yet available. Yet this budgetary improvement is not down to consolidation efforts.

The cyclically adjusted primary surpluses – which reflect the consolidation efforts – have remained steady or even declined of late.

Favourable economic developments should not obscure the fact that there is still some way to go if we are to safeguard public finances. It is crucial for the sustainability of public budgets to remain beyond reproach, even if the interest rate setting returns to normal or the economic situation takes a turn for the worse and, for instance, the automatic stabilisers take effect.

However, finance ministers are not the only ones being called upon to take action in the current phase of low interest rates. The banks, too, need to make efforts to ready themselves to weather changes in the macroeconomic climate. After all, an economic slowdown might also be accompanied by a renewed rise in credit risk.

One of the side-effects of ultra-accommodative monetary policy is that the longer the low-interest-rate environment persists, the greater the strain on banks becomes. An abrupt rise in interest rates would then take a particularly heavy toll on banks' earnings – such is the finding of our low-interest-rate survey that we, together with BaFin, conducted once again last year among the banks that we supervise.

The survey also revealed that small and medium-sized German banks and savings banks plan to expand alternative sources of income – commission business, say – as a result of shrinking margins in interest business. In addition, they want to roll out cost-cutting measures. On balance, however, most of the institutions are expecting their annual profits to contract further on average until 2021. This also means that, within the scope of their own planning, they have less leeway to further build up their capital buffers, should they need to.

As the majority of institutions are currently well capitalised, they will be able to withstand many of the future stresses and strains arising from a potentially protracted spell of low interest rates. Nevertheless, the longer the low-interest-rate environment persists and the quicker monetary policy then has to be normalised, the greater the provision banks will need to make.

4 Use positive economic climate as an opportunity for reform

Ladies and gentlemen

The economy may be booming right now, but that should not blind us to the fact that there is still a need for action – and that doesn't just apply to fiscal policymakers and the banks.

It is true of other policy areas as well.

The recent improvement in the economic situation is largely a cyclical phenomenon. Long-term growth prospects have not improved.

According to the latest calculations from the European Commission, potential growth will remain lower over the next years than it was prior to the onset of the financial crisis.

Relying on monetary policy to move the euro area economies up to a persistently higher growth path would be a risky undertaking, as monetary policy holds no sway over long-term growth. Only governments can put economies back on a path of persistently higher growth – and they do so by setting the proper gears in motion in labour market, competition and social policy.

This is why the ECB Governing Council frequently points out that the highly expansionary monetary policy needs to be flanked by growth-enhancing structural reforms.

That goes for Germany, too, where the current upbeat state of the economy is no reason for the country to rest on its laurels. That's because, there is a trend in Germany, too, towards lower average growth rates, which will likely culminate in Germany having the second-lowest rate of economic growth of all 42 OECD countries until 2030.

First, average productivity growth per hour worked has been contracting since 1970.

To make matters worse, a large number of skilled workers will leave the labour market in the years to come. Both of these developments will put a damper on potential growth.

Thus, the challenge for Germany, too, is to boost productivity growth. This it could achieve, for instance, by tapping into the opportunities provided by digitalisation and technological advances.

For one thing, Germany needs a state-of-the-art digital infrastructure and an education system that gives as many people as possible the necessary skills to make the most of the new technologies.

For another, flexible labour and product markets combined with a fit-for-purpose social safety net will actually enable workers to switch to the most productive areas of the economy.

Furthermore, it will be imperative over the coming years to increase labour force potential.

This could be achieved by, say, boosting the participation of women in the labour force and, at the very least, creating no further incentives for early retirement.

The foreseeable decline in the labour force could also be lessened by the influx of skilled workers from abroad.

5 Developing monetary union

The institutional architecture of monetary union likewise needs to be overhauled.

Setting up the European Stability Mechanism (ESM) and the Single Supervisory Mechanism (SSM) has rendered the euro area more resilient to crises. However, it would be a mistake to believe that the euro area is now equipped to deal with all eventualities.

In that respect, I was pleased to see the debate on the future of monetary union gain renewed traction last year.

In a speech he gave in September, the French President Emmanuel Macron proposed, for instance, communitising more policy areas such as defence, immigration and climate protection. In other words, he advocates taking joint decisions in these policy areas and financing them jointly.

Towards the end of last year the European Commission presented proposals of its own on deepening European integration.

Ladies and gentlemen

Challenges such as combatting climate change, securing external borders and developing common communications, energy and transport networks can probably be handled more efficiently at the European than at the national level.

But in my view, further integration depends crucially on the order in which the steps towards it are taken. It makes sense to begin by agreeing on what policies should be formulated jointly. Only then should we address the issue of joint financing.

Conversely, however, in the interests of efficiency, thought also has to be given to what areas under EU responsibility might be better dealt with by the individual member states themselves. After all, the principle of subsidiarity, which remains the guiding principle of the EU, states that responsibilities should only be transferred from the local, regional or national level to the EU if they can be carried out more efficiently there.

If tasks are tackled jointly, then it stands to reason that they should be financed jointly as well. And if the joint financing of these tasks is based on each member country's ability to pay, this can also act as something of a stabiliser in the event of what are referred to as asymmetric shocks.

On the other hand, I consider a dedicated stabilisation facility tasked with cushioning asymmetric shocks to be unnecessary and inexpedient. Under the present institutional architecture of the euro area, a member country with sound public finances can use fiscal mechanisms to take effective measures against downturns or crises, without breaching the fiscal rules or having to resort to outside assistance. And according to the advocates of such a stabilisation facility, countries with unsound public finances should not be permitted to avail themselves of it in any case.

And if a crisis threatens to overwhelm a member state financially, it can always turn to the ESM. The ESM, of course, only grants assistance if conditions are met that are intended to eliminate the country's economic problems. In my view, we need to stick to this practice, since ESM assistance means that extensive risks are communitised.

For the very good reason that it is difficult to distinguish in practice between country-specific shocks and structural problems, there is always a danger that such a stabilisation facility may ultimately lead to permanent transfer payments.

6 The Bundesbank's balance sheet and profit for the year

Ladies and gentlemen, the question surrounding the road ahead for monetary union is of great

significance to the work of the Bundesbank and of the entire Eurosystem.

For me, it is crucial that the institutional architecture of monetary union is designed in such a way that monetary policymakers are freed up to concentrate on their objective of safeguarding permanently stable prices.

First and foremost, this means staking out the framework conditions so that that monetary policymakers do not come under pressure to make high levels of debt sustainable, to compensate for low potential growth with an accommodative monetary policy, or to rush to the aid of banks with liquidity assistance.

It would be good to see the institutional architecture evolve this year in a way that renders monetary union more stable. Among others, steps towards this goal would include completing the banking union – though subject to the condition that legacy assets are not communitised as a result, that the sovereign-bank nexus is broken, and that the protection systems which function successfully, like the institutional protection scheme, remain intact. This would probably also have a positive effect on monetary policy going forward, as it would reduce the likelihood of monetary policymakers having to act as a “crisis response unit”.

But for now, monetary policy is what it is – and it played a major part in shaping last year’s balance sheet.

And this brings me to the third item I want to discuss: our annual accounts and the central bank profit.

The accommodative monetary policy that was pursued in 2017 once again led to an expansion of our balance sheet. The assets side grew primarily as a result of the bond purchases and the targeted longer-term refinancing operations (TLTRO II).

Under the asset purchase programmes we bought bonds with a net value of around €160 billion over the course of last year. A further €30 billion or thereabouts was added to this amount under the longer-term refinancing operations.

On the liabilities side, the largest increase was recorded for deposits by credit institutions and resident and non-resident depositors. Our excess liquidity totalled around €575 billion at year-end.

The lengthening of the Bank’s balance sheet also drove up its profit, which stood at €2.0 billion for the 2017 financial year. This is roughly €1 billion more than one year before.

Around €100 million of our profit is attributable to the fact that pension obligations are discounted at a higher average interest rate following an amendment to the German Commercial Code. As in the year before, however, the difference resulting from this is subject to a statutory restriction on distribution.

The remaining distributable profit of €1.9 billion will today be transferred to the Federal Finance Minister and used for budgetary financing.

The Bundesbank’s profit is higher due, in particular, to the rise in deposits of credit institutions on the liabilities side of our balance sheet. As you are aware, we currently charge a negative interest rate of –0.4% for these deposits.

By contrast, given the current low-interest-rate environment, there is de facto no interest income on the assets side. This applies, in particular, to our bond purchases.

This means that our usual income situation has been reversed. In “normal times” it is the assets which generate income, notably refinancing operations with banks. Now it is the opposite way

around.

As I pointed out in the last two years, this creates considerable interest rate risk for the Bundesbank.

The interest income on the liabilities side can quickly turn into interest expenditure if the policy rates pick up. However, given the comparatively long time to maturity of its investments, we will also generate almost no income on the assets side in the longer term.

The continuation of the asset purchases has driven up interest rate risk. This is why we raised our provisions for general risks by €1.075 billion.

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

But first, I would again like to stress the point I made on this occasion one year ago. It would be wrong to benchmark the monetary policy decisions against the central bank's profit or loss. The sole benchmark is whether our monetary policy succeeds in preserving price stability. And as far as this is concerned, we are on the right track. If the upturn continues and prices rise accordingly, I see no reason why the ECB Governing Council should not end the net asset purchases in the current year.

7 Conclusion and handover to Mr Thiele

With that, I will now hand over to Mr Thiele, who will provide you with more details on the annual accounts.

We will then be happy to answer your questions.

Thank you for your attention.

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[1] See European Central Bank (2016), Exchange rate pass-through into euro area inflation, Economic Bulletin 7/2016, pp 27 ff.