Jens Weidmann: Opening statement at the 2019 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 2019 press conference on the annual accounts, Frankfurt am Main, 27 February 2019.

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1 Introduction

Ladies and gentlemen,

A very warm welcome to our press conference, at which we will present our annual accounts.

You could say that the annual accounts represent the essence of a year – 365 days condensed into a set of figures occupying just two A4 pages. Drawing up the accounts means looking back over past events. But I know you are also very keen to hear about current developments and the outlook for the future, and I don't want to disappoint you there.

So, as usual, I will first say a few words about economic activity and monetary policy before moving on to the key points of our annual accounts.

Mr Beermann will then discuss selected aspects of our balance sheet with you in more detail.

2 Economic situation

Ladies and gentlemen,

Economic activity lost momentum last year – in Germany, the euro area, and around the world.

After fairly dynamic growth in 2017, the pace of expansion slackened at the global level. For Europe and Germany, this translated into weaker stimulus from foreign business.

This was compounded by more subdued activity in the euro area's export markets than in the international environment as a whole. Turkey's economic problems played a role here, for instance.

Additionally, however, there were specific developments in Germany, in particular. All in all, the slowdown in Europe was far more significant than it was at the global level. Euro area GDP expanded by 1.8% last year. Although this is a slower rate than in 2017, it is still higher than the potential growth rates according to conventional estimates.

In 2018, the German economy grew by 1.5% in calendar-adjusted terms, which was roughly in line with the increase in its capacity rates. Aggregate capacity utilisation therefore remained high.

However, the annual average figures mask the slowdown in economic growth over the course of the year, especially in the second half.

Reports from the German economy have generally been disappointing over the last few months. German economic output even contracted in the third quarter – primarily due to the difficulties which car makers encountered with the new vehicle emissions test procedures.

The motor industry took far longer than expected to resolve this problem. Besides this, production in other industrial sectors dipped in the final quarter. As a result, the German economy as a whole remained stagnant during the last few months of 2018.

New manufacturing orders stabilised at a significantly lower level. And at the current end, the relevant sentiment barometers are pointing to a pronounced cooling of the business climate.

There is plenty to suggest, then, that the dip in growth will continue into this year. As a result, Germany's economic growth will probably lag well behind the potential rate of 1½% in 2019.

We cannot sugar-coat these facts. But nor do I think we should use them to paint too bleak a picture of the outlook for the economy.

The domestic economy depends in large part on the situation in the German labour market. And, as before, this market is in excellent shape.

Unemployment has fallen to 5% (in seasonally adjusted terms) over the last few months – its lowest level since German reunification.

What's more, employment is constantly hitting new record highs: in December, the number of people in employment surpassed the 45 million mark.

And demand for labour by enterprises is still high. For instance, the Institute for Employment Research (IAB) reported a new record last week of around 1.5 million job vacancies.

The sustained improvement in the labour market was also reflected in wage growth – wages rose sharply last year, even after adjustment for inflation.

And inflation was the strongest it has been since 2012. Consumer prices (as measured by the HICP) climbed by 1.9%.

However, the short-term fluctuations in industry or other sectors have only a minor impact on labour market developments, which are influenced more strongly by the underlying cyclical trend over the medium term. As a result, the rise in employment and stronger wage growth will probably continue this year.

Economic growth in Germany is solidly underpinned by favourable financing conditions, rising employment levels and increasing wages. Fiscal easing this year will provide additional stimulus.

In other words, the economy is unlikely to go into reverse; it will probably just not accelerate as quickly in 2019.

I see this as the most likely scenario at present. All the same, this outlook is subject to a fair amount of uncertainty.

3 Uncertainty and risk

Over the past few months, many people have begun to worry that increased uncertainty in the economy could curb investment activity, in particular.

One argument is that it might make sense for enterprises to delay investment decisions until they have a clearer idea of the situation.[1]

It's difficult to gauge effects like these accurately. Although various measures have been pointing to a rise in uncertainty over the last few months, some of the indicators remain below their long-term average or do not display any close correlation to aggregate output in the past. This suggests there are no significant dampening influences on economic activity at present.

Even so, uncertainty is always a key issue these days, especially when I meet with entrepreneurs. Perhaps it's affecting business sentiment because it has prevailed for so long.

Added to this, two political developments with an uncertain outcome could very well end up placing a real burden on the economy.

The first is that the global trade dispute still hasn't been resolved. So there is a continued risk that protectionism might spread worldwide.

What this means is illustrated by the trade dispute between the United States and China. A model-based analysis by the Bundesbank suggests that the already adopted trade barriers could, on their own, shrink both countries' respective output levels by 0.5% over the medium term and diminish world trade by 1%.[2]

And there is still a threat of extra tariffs on vehicle imports.

The United States has at least joined China and the EU at the negotiating table. If markets are more open after these talks than they were before, this would, in fact, be real progress.

Perhaps these bilateral agreements can prevent the harmful cycle of tariffs and countermeasures from spiralling into a larger conflict. But they certainly can't replace what we've achieved through a rule-based, multilateral trading facility. So it's essential that we maintain and enhance the global trade regime.

The second factor adding to the atmosphere of uncertainty is Brexit. As things stand, the United Kingdom might leave the European Union on 29 March – and it's not yet clear whether this will be with or without a withdrawal agreement.

The Bank of England (BoE) has simulated a large number of different scenarios,[3] which also reflects the wide range of potential macroeconomic effects.

If the close economic partnership between the UK and the EU can be maintained, the British economy could actually perform better than is generally believed at the moment.

On the other hand, the BoE is warning that a disorderly Brexit could trigger short-term trade disruptions and the risk of a severe recession in the UK. In the worst case scenario, UK GDP might slump by as much as 8%. This would also affect the economy in the euro area and Germany.

Early on in the process, German banking supervisors strongly urged credit institutions to prepare for a disorderly Brexit. And this has paid off – as far as we are aware, institutions have made good progress with their preparations and some have already successfully completed them.

Most British banks that need a licence for their units based in the euro area have received them or are likely to do so by 29 March. This will allow them to maintain their business relationships with their EU customers.

A total of 16 credit institutions have decided either to relocate units to Ger-many or to significantly expand their existing business here.

4 Monetary policy

Let's move on to monetary policy.

The biggest decision of last year was made in December, when the ECB Governing Council decided to cease net asset purchases at the end of the year. This decision marks the first step on the long road towards monetary policy normalisation.

Under the asset purchase programme (APP), the Eurosystem purchased securities worth a total of just under €2.6 trillion.

While net asset purchases may have come to an end, the programme itself is still ongoing. This is due to the fact that principal payments from maturing securities will be reinvested in full until further notice. As a result, the total volume of securities on the Eurosystem's books will remain steadfastly high. And it is this stock of assets that gives the programme its economic impact.

On top of this are the persistently low key interest rates. The ECB Governing Council expects these to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary.

Having interpreted the data, market participants currently believe that the ECB's first key interest rate hike may be delivered later than was anticipated even in early December. Taken in isolation, this expectation is depressing capital market rates, thus supporting financing conditions for enterprises.

This also shows that our state-contingent forward guidance serves as an autopilot of sorts: more or less automatically, it triggered a response from market participants – all without monetary policymakers getting involved.

All in all, then, monetary policy in the euro area remains exceptionally ac-commodative. This is shown by various measures of monetary policy ac-commodation, such as short-term real interest rates or the divergence of Taylor interest rates from the policy rate. At present, they are close to the values measured at the height of the crisis.

The next steps towards normalising monetary policy will depend on how the inflation outlook evolves in the euro area.

ECB staff will present their macroeconomic projections next week. I will leave it to them to say more on this topic.

However, it is clear to me that short-term fluctuations in the oil price – such as the sharp decline at the end of 2018 – as well as revised growth expectations for 2019 may have a temporary impact on the inflation outlook.

Remember, though, that the ECB Governing Council defines price stability as a medium-term measure, so we would do well to look beyond these fluctuations. As things currently stand, the persistently upbeat labour market conditions and strong wage growth will strengthen the underlying upward price pressures in the euro area in the medium term.

The question currently at the forefront of monetary policymakers' minds is how to make decisions in the face of uncertainty.

The recommendation typically made in the academic literature is to exercise caution when conditions are uncertain. If very different scenarios appear plausible, monetary policymakers need to make sufficiently robust decisions and not overreact in their response to the ups and downs of isolated indicators.

If, however, there is a risk of a scenario materialising that would have devastating consequences, it may be appropriate to take preventive policy-based action to avert the threat. For example, monetary policymakers made the right move during the financial crisis when they responded swiftly and decisively to stave off a deflationary downward spiral of declining prices and wages.

But deflation is not a cause for concern at this time. According to our calculations, the market-based probability of deflation is a mere 1.5%. While market-based, long-term inflation expectations for the euro area may have dipped in recent months, survey-based measures remain in the range of below, but close to, 2%.

Risks that should not be ignored also include the adverse side effects of exceptionally expansionary monetary policy. During the financial crisis, we witnessed the way in which the risks to financial stability can affect economic development and ultimately take their toll on price stability, too.

In all likelihood, the normalisation of monetary policy will be a gradual pro-cess lasting several years. From my point of view, this makes it important to continue along this path, should the inflation outlook permit it.

In this context, we need to keep an eye on more than just the risks to financial stability which can build up in a persistent low interest rate environment. Going forward, monetary policymakers' capacity for effective intervention should not be ignored, either.

If, contrary to expectations, there is a significant deterioration in the outlook for inflation, the Eurosystem has a range of monetary policy instruments at its disposal. However, this non-standard toolkit's cost-to-benefit ratio differs from that of standard monetary policy. In this respect, the trade-off between the effectiveness of certain instruments and their side effects may be worse than it was in the past and could ultimately leave little room for manoeuvre.

5 Public finances

Furthermore, it needs to be clear that monetary policymakers' focus is on safeguarding price stability. In the event of a major economic shock, fiscal policymakers would doubtless also be called upon to take action.

Under existing fiscal rules, euro area countries with sound public finances would likewise have the opportunity to do so.

Unfortunately, many countries have failed in recent years to take advantage of the low interest rates and favourable economic conditions to sufficiently improve the sustainability of their government finances and scale back their high debt ratios. I fear that this has been a missed opportunity to make hay while the sun shines.

Failure to comply with the ceilings for the deficit and debt ratios defined in the Stability and Growth Pact has been a far-too-frequent occurrence:

- Since the introduction of the euro, participating countries have exceeded the reference value of 3% for budget deficits in just under 40% of all cases.
- When it comes to the debt ratio, the results are even more sobering: euro area countries failed to comply with the limit of 60% of GDP in well over half of all cases.

In 2018, too, euro area government debt fell only moderately in spite of the favourable economic environment and extremely low interest rates. Only ten euro area countries achieved a debt ratio of below, or at least close to, the 60% ceiling.

Sound public finances are a key foundation for a stability-oriented monetary policy. They are also vital in tackling the substantial, foreseeable impact of demographic change.

In Germany, the statutory pension insurance scheme, in particular, is coming under pressure.

Right now, the issue frequently at the heart of the debate is the pension level. The consensus previously reached on the topic involved cutting state pensions over time while encouraging the adoption of supplementary private pension provisioning. In principle, I still believe this to be a sensible approach and would like to caution emphatically against allowing today's highly favourable financial situation to cause us to lose sight of tomorrow's problems.

In particular, a sustainable overall concept needs to take account of both social contributions and the tax burden. Excessively high tax and social contribution rates stunt employment. In this context, the labour supply is already being negatively affected by demographic trends.

In future, the priority must be to boost employment. In view of this, the Bundesbank has been signalling for quite some time that, given increasing life expectancy and improved physical health in old age, it would make sense to further raise the statutory retirement age.

If the ratio of time in employment to time in retirement were to be kept broadly constant, this would not put future pensioners at a disadvantage. It would simply mean that static contribution periods are not accompanied by longer and longer pension-drawing periods.

All in all, I believe that the current basic tenet of the statutory pension insurance scheme – the principle of equivalence – is the best way forward here. The more an individual pays in, the bigger their pension will be. Social benefits independent of pensions should be financed out of general taxation in a transparent and comprehensible manner. The same applies to any top-up of the basic pension, which forms part of the coalition agreement and was recently the subject of discussion.

6 Stoking the engines of economic growth

Ladies and gentlemen,

Alongside sound public finances, stoking the engines of economic growth should be right at the top of the political agenda.

In this regard, too, Germany is faced with particular challenges due to demographic change. The Bundesbank estimates that the labour supply (labour force potential) will already be in decline as of 2022. At that point, the migration gains will no longer be sufficient to compensate for the effects of ageing.

In recent years, labour has supported potential growth by around 1½% – also due to high levels of immigration. However, from 2021, it is likely that labour will cause potential growth to gradually decline – to as low as just under 1% by 2028, to be precise.

One possible lever that policy-makers could adjust is the labour force participation rate. By having a higher propensity to work, older people, in particular, as well as migrants can help to stabilise the overall supply of labour.

Furthermore, the ratio of women working part-time in Germany remains considerably higher than the EU average. Better provisions for supervising children or people in need of nursing could promote a greater supply of labour.

In the light of an ageing population, it will be even more important in the fu-ture than it is today for each potential worker to be able to bring their skills onto the labour market.

Beyond the labour supply, the welfare of our society is vitally dependent on how much each individual worker can produce.

In my opinion, the role of the state is to create favourable conditions for private enterprises to offer innovative and consumer-oriented products and services. Not least, competition ensures that consumers and employees can also share in the gains in prosperity that have been generated.

Competition for customers leads to lower prices; competition for labour to higher wages. Competition also fuels innovation, as enterprises can – at least for a time – gain an edge over competitors by creating new products. This widened offering in turn benefits the consumer.

Open markets foster competition. The European single market is the best example of this. Studies show that prosperity in Europe has risen substantially.[4]

For this reason, the state should eliminate competitive distortions and rectify market failures. In the past, however, governmental control and insulation have not proven themselves to be good levers for increasing productivity and prosperity. The state is certainly not the better entrepreneur.

I believe that the size of enterprises is also the result of private sector deci-sions and market forces. Small and medium-sized firms, in particular, with their "hidden champions" are one of the strengths of our economy.

They do not owe their success to governmental guidance. Incidentally, this also applies to the awe-inspiring rise of certain international tech companies.

And, finally, we should not jeopardise the prosperity gains that result from the close economic integration with our partner countries. This also includes international value chains in which enterprises focus on products with manufacturing processes that offer them comparative advantages.

The German economy in particular thrives on openness. Last year, German businesses exported goods and services with a total value of almost €1,600 billion around the world. This corresponds to nearly half of the country's GDP.

The counterpart to the export of goods is the export of capital.

The level of German direct investment abroad rose in 2016 to around €1,100 billion. More than half of this total was invested in our partner countries outside of the EU. This also has positive repercussions for economic growth in Germany. Studies show that investment abroad leads to additional investment at home.[5]

Conversely, there were almost 17,000 companies with foreign capital interests active in Germany in 2016. Foreign investors held direct investment stocks totalling nearly €500 billion. They generated turnover of around €1,500 billion and employed 3 million people.

Direct investment coming from Germany and coming into Germany are essential to prosperity in our open economy.

In sensitive sectors, there may be legitimate security concerns. However, US foreign trade policy in particular shows that the line between these concerns and protectionist motives is not always objective and clear-cut.

And, of course, state-owned businesses can distort international competition. But we must respond by strengthening market forces and not by weakening them at home as well.

7 Annual accounts – profit and risk provisioning

Ladies and gentlemen,

I would now like to move on to our annual accounts.

On the assets side, the monetary policy purchase programmes were again the key driver of balance sheet growth, followed by liquidity inflows from other European countries.

On the liabilities side, the euro balances of resident and non-resident investors recorded the largest increases.

The profit and loss account for the 2018 financial year closed with a net profit of €2.5 billion. This is roughly half a billion euros more than in the previous year. This rise is driven by higher interest income due to the negative interest rates on increased deposits.

Following allocation to the reserves, we have today transferred the remaining distributable profit of €2.4 billion in full to the Federal Government. According to the 2019 budget plan, it will be used to finance the budget.

With regard to the elevated interest rate risk, we had already increased our risk provisioning in two tranches in the previous two years – by €1.75 billion in 2016 and €1.075 billion in 2017. And, one year ago, I indicated that a third tranche would follow. On that basis, the Executive Board has reviewed both the scope of our general risk provisions and the Bundesbank's foreseeable risk situation, while also taking into account our current risk coverage potential. As a result, the general risk provisions will be increased by an additional €1.475 billion, bringing the total to €17.9 billion.

General risk provisions are traditionally used to hedge against exchange rate risk, but, due to the non-standard monetary policy measures, also against default and interest rate risk. The latter are largely a result of the wide discrepancy in maturities: we have very substantial holdings of low interest-bearing assets, with very long residual maturities in some cases; our liabilities, however, are mainly in the form of short-term deposits.

With that, I will now hand over to Dr Beermann, who will provide you with more details on the annual accounts. We will then – as always – be happy to answer your questions.

Thank you for your attention.

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1 See B. S. Bernanke (1983), Irreversibility, uncertainty and cyclical investment, The Quarterly Journal of Economics, Vol. 98, pp. 85–106;

2 See Deutsche Bundesbank, The potential global economic impact of the USA-China trade dispute, Monthly Report, November 2018, pp. 11–13.

3 See Bank of England, EU withdrawal scenarios and monetary and financial stability, November 2018

4 See, for example, H. Badinger (2005), Growth Effects of Economic Integration: Evidence from the EU Member States, Review of World Economics, Vol. 141, pp. 50–78

5 See S. Goldbach, A. J. Nagengast, E. Steinmüller and G. Wamser (2019), The effect of investing abroad on investment at home: On the role of technology, tax savings, and internal capital markets, Journal of International Economics, Vol. 166, pp. 58–73.