Joachim Nagel: Stocktake - the state of the economy and banks in Germany

Speech by Dr Joachim Nagel, President of the Deutsche Bundesbank, followed by a discussion Verbandstag der Sparda-Banken, Frankfurt am Main, 21 September 2023.

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Check against delivery

1 Words of welcome

Ladies and gentlemen,

The many contributors ahead of me have set the stage well for the topic of "renaissance and transformation". In my speech, I will shed light on both these aspects: with regard to banks, there is the renaissance particularly in interest business, coming after so many years of low rates. And with regard to the economy and society, there are the transformations – and I am using the plural deliberately here – that will need to be mastered and shaped.

I will begin by briefly taking stock of our current position. Where do we stand right now? What's the state of the economic environment?

2 Economic activity and price developments in Germany

Much has been said and written about the deterioration of the German economy. Indeed, Germany's economy is currently treading water. Following a technical recession in the last quarter of 2022 and the first quarter of 2023, activity levelled off in the second quarter. Lacklustre foreign demand weighed on industry, primarily on account of the weak Chinese economy. And increased financing costs meant that demand for construction and capital goods was moderate at best.

But there were positive aspects, too. High order backlogs across parts of industry and construction combined with easing supply bottlenecks buoyed aggregate output. Private consumption also found its feet, having contracted significantly in the winter half-year. There was a sharp rise in wages. This meant that employees' purchasing power was not eroded any further, despite the current inflation. And the labour market, too, was still in very robust shape. While employment growth flattened slightly and unemployment picked up moderately until the middle of the year, there is also still a relatively large number of job vacancies. For the third quarter, we at the Bundesbank are currently expecting economic activity to decline again somewhat. And that means we are expecting a small – less than one percent – decline for full-year 2023 as well.

Given this state of play, describing Germany as a "sick man" seems excessive to me. After all, the current lull in growth is being driven by special factors. Subdued global activity is having an outsized impact on Germany, with its strong export base. The country has found the restructuring of the energy supply triggered by the Russian war of aggression against Ukraine particularly challenging. Unlike in other euro area countries,

government consumption in Germany is likely to decline sharply this year. Once we have put the worst effects of these special factors behind us, the bout of weak growth should also subside. We are expecting the economy to grow again in 2024.

As we are the Bundesbank, we keep a particularly close eye on how prices evolve. Inflation remains high despite the weak German economy. Inflation stood at 6.4% in August, according to the Harmonised Index of Consumer Prices (HICP). That is significantly down on the 11.6% peak recorded in October 2022, but it is still far too high and well above the Eurosystem's 2% target. And for the next two years, too, we at the Bundesbank are expecting to see rates well above 2% for Germany, namely 3.1% next year and a still-above-target 2.7% in 2025, according to our June forecast. A look at core inflation, which excludes energy and food, shows just how persistent inflation in Germany is. In June, we forecast a rate of 5.2% for 2023 – a level of core inflation that's actually higher than in the previous year, when it stood at 3.9%. We do not expect core inflation to weaken noticeably until 2024 and 2025.

3 Economic activity, price developments and monetary policy in the euro area

The economy in the euro area is performing somewhat better than in Germany. The latest macroeconomic projections by ECB staff see the economy expanding by 0.7% this year. They have thus lowered their economic growth projections from June. Exports will contract somewhat, as will services activity. By contrast, conditions are still good in the labour market, alongside a strong uptick in wages, a far stronger one than in previous years. After all, collective wage agreements are also measured in terms of previous real wage losses.

Price dynamics, then, remain high. The inflation rate is not moving towards 2% at the desired pace in the euro area, either. The August rate of 5.2% was only slightly down on July's 5.3%. We did at least see a decline in core inflation, from 5.5% in July to 5.3% in August. Nevertheless, core inflation remains persistently high and is expected to decline only gradually. This is because it is increasingly being driven by domestic factors. The latest ECB projections from last week see core inflation coming in at 2.2% in 2025.

The ECB Governing Council is therefore facing a persistent inflation environment. That's why it maintained its consistent monetary policy stance and raised the key ECB interest rates yet again at its most recent meeting. This is the tenth interest rate step in a row since July 2022. It took the interest rate on the deposit facility, which is key to the monetary policy stance, up to the current rate of 4%. Is that it now for key interest rate increases? Have we reached the "high plateau"? That's too early to say for sure. It's still the case that inflation is too high. And it's still the case that the projections are showing only a slow decline towards the target rate of 2%. Key ECB interest rates will have to be maintained at a sufficiently high level for a sufficiently long duration. What that means exactly is not yet clear as things currently stand: it depends on the data. What is clear, though, is the objective, which is that the inflation rate should fall to 2% as soon as possible. The Eurosystem has also been downsizing its balance sheet since March of this year in an effort to tame inflation. As of July, the asset purchase programme (APP)

has stopped replacing maturing bonds. This policy stance means that the Eurosystem's balance sheet will shrink by an average of around €25 billion each month through to the summer of 2025.

All our monetary policy measures are dedicated to achieving our objective: price stability. We must prevent the high inflation rate from becoming entrenched. This could happen if households, enterprises and wage bargainers expect sustained higher inflation rates and change their behaviour to match, for example when setting prices or negotiating wages. If monetary policy were to fall behind the curve, interest rates would need to be raised more quickly or more sharply in order to bring inflation back under control. That would put even more of a strain on the economy. It's a scenario I would like to avoid at all costs.

Ladies and gentlemen, as you can see, monetary policy remains challenging. On the ECB Governing Council, we pay particularly close attention to the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. You, ladies and gentlemen, have an important role to play in the latter – in the transmission of monetary policy. You see, decisions on the interest rate for loans and deposits are made at each and every Sparda-Bank. In the following, I will therefore discuss the current situation facing banks in Germany.

4 Current situation facing banks in Germany

When it comes to the environment that banks are operating in, much has changed since July 2022, when the ECB Governing Council set the reversal of monetary policy interest rates in motion. For a start, the turnaround led to a significant improvement in net interest income for institutions, both large and smaller ones. This is because lending rates were raised swiftly and sharply. At the same time, we're still seeing a great many institutions today remunerating sight deposits at rates close to zero, just as we were used to during the 12-year period of low interest rates.

Since the ECB first raised its key interest rates in July 2022, it has mainly been the smaller lenders that have put up the interest rates they pay on overnight deposits. Today, they are passing on just under one-third of the increases in the market interest rate that have happened since July 2022 – in some cases, significantly more, even. Given the low level of remuneration, it is not surprising that the volume of sight deposits is gradually going down overall. Ultimately, this is bringing normality to the portfolio structure. You see, in the low interest rate environment, more sight deposits were being held than ever before in the Federal Republic of Germany. Up to 2010, time deposits dominated in this country. Then came a reversal in the ratio: at the end of 2021, sight deposits as a proportion of banks' total deposits peaked at just under 70%. And it is precisely here, with these sight deposits, that institutions are proving much slower to pass on the rise in interest rates than one would expect, based on earlier episodes of rising interest rates.

So with interest rate pass-through in this segment playing out more slowly than was usual in the past, institutions have been able to bolster their earnings. In the meantime, though, competition for deposits has been hotting up. The market is doing its job. Customers looking for better rates can stick with their current bank and shift their money from sight deposits into time deposits. Or they can switch between institutions.

And one thing is certain: the more banks there are that pass higher interest rates on to their customers, the more this will force the hands of others. And so the turnaround in interest rates is now increasingly arriving at savers' doors – which, in turn, is putting pressure on banks' earnings situation.

Bank profitability already came under pressure last year due to developments in capital markets. Large and small institutions alike were forced to write down their securities portfolios owing to the rise in interest rates and due to market corrections. At savings banks and credit cooperatives, write-downs on securities in the first half of 2022 amounted to around 5.6% of Common Equity Tier 1 capital, while at the large, systemically important banks, they came to 3.7%. This has left hidden reserves depleted at many institutions.[1]

The gloomier economic setting has pushed mounting credit risks to the fore this year. Credit defaults could increase. And the number of corporate insolvencies is likely to keep rising. At present, however, it is still below the pre-coronavirus level. In addition, lending volumes are shrinking. Lending to non-financial corporations has been anaemic since the fourth quarter of last year, with both supply-side and demand-side factors to blame for this. Financing needs for commercial real estate have contracted, for instance, dampened by vacant properties and lower commercial real estate prices. And if we turn to households, real estate business is faltering there, too. Amidst economic uncertainty, high inflation, increased financing costs and gloomier prospects in the housing market, housing loans saw only slight growth last quarter. The sluggish real estate business is likely to hit smaller banks particularly hard.

At the same time, the macroeconomic setting led banks to further tighten the reins when it came to lending in the second quarter. They are seeing more elevated credit risk and are generally less tolerant of risks. Working, as they are, with a smaller business volume, it is now harder to generate income. With that in mind, institutions will need to get creative and strengthen those parts of their business where profit margins are high in order to stabilise their earnings situations in the near future.

5 Banking supervision

The importance of a broad business model and a varied funding mix was demonstrated by the turmoil that shook the banking industry in March of this year. The Federal Reserve Bank has produced a review of the collapse of Silicon Valley Bank (SVB). Its report does not mince its words: SVB's board of directors and senior management failed. The bank ran into difficulties because it had a business model with multiple points of vulnerability: its customer base was highly concentrated, while the majority of liabilities were uninsured. Added to this, there were grave deficiencies in risk management practices. But the Federal Reserve Bank is also frank in its self-criticism – something which does it credit, in my view. Supervisors failed to pick up on many of the problems at SVB, despite the fact that some were public knowledge. While supervisors had been aware of unhealthy developments in risk management and governance, there was a lack of assertive intervention and, not least, of ways for supervisors to step in.

I welcome the fact that the Basel Committee is analysing recent events in the banking sector with a view to assessing whether the regulatory framework and its scope should be adjusted in the light of what has happened. In any case, any adjustments should be

discussed and agreed at an international level. It might make sense to probe both crisis prevention and crisis management instruments as part of this process. But, even as things stand today, the Federal Reserve Bank's report can serve as encouragement to supervisors everywhere to apply supervisory instruments in a timely and consistent manner. This is in everybody's interests, including banks.

It is important to keep an eye on the full gamut of risks: I've already mentioned interest rate risk and credit risk, but there's also operational risk to consider. As cyberattacks become increasingly frequent and we become ever more reliant on IT services, more and more attention needs to be paid to sound crisis prevention. But, if the worst does end up happening, institutions need to know precisely what measures need to be taken after a cyberattack. And that's why we supervisors have, for some years now, been stepping up our ad hoc inspections focused on cyber and IT risks. This involves shining a light on how hardy the banks are when it comes to these issues – i.e. their digital operational resilience.

Well-tuned risk management helps ensure that banks know where they stand at all times. This allows institutions to quickly spot mounting risks and potential losses and take appropriate action. At the same time, we all know that even well-tuned risk management cannot completely prevent stresses and strains. So it's important that institutions have sufficient capital buffers to enable them to keep on lending even in the event of a crisis. This is why BaFin – with whom we share the responsibility for supervising small to medium-sized banks here in Germany – opted, in consultation with the Bundesbank, to raise the countercyclical capital buffer in February 2023. A specific assessment of individual interest rate risk at these institutions also led to two-thirds of them being required to build up additional capital buffers. After all, what we want is for things to continue the way they are: we have a banking sector in Germany that is well capitalised and in a position to absorb shocks. The regulatory reforms in the aftermath of the financial crisis have had a major hand in that. Regarding the large institutions, this was one outcome of the recently published EBA and ECB stress testing exercise. Even in the particularly tough adverse scenario of a global recession hitting Germany particularly hard, the German institutions proved to be robust.

Irrespective of this current assessment, provision must be made at the European level for a crisis event, including one involving smaller institutions. After all, recent years have shown that when smaller banks have run into difficulties, the promise made to European taxpayers to no longer use their money to support or rescue banks has not always been kept. The European Commission has put forward proposals on how the European bank crisis management framework could be revised. At the Bundesbank, we support the objective of strengthening and improving the current European bank crisis management framework. I hope that the negotiations at European level will be wrapped up as soon as possible.

6 Challenges

On the whole, banks in Germany are in good shape. They can play their part in ensuring that Germany steps up to the challenges facing our society. This is particularly true from an economic perspective, as securing the energy supply, adapting to climate change and transitioning to a climate-neutral economy by 2045 all require a large amount of funding.

And funding is needed for the urgently required digital transformation as well. We need to go digital to drive innovation, harness efficiency gains and leverage the productivity potential of our economy. Digitalisation is a key element in safeguarding prosperity in Germany. You would think that everyone in Germany would see these opportunities presented by digitalisation. But this does not yet appear to be the case. According to a recent survey on digitalisation, only 29% of respondents cited future prosperity as coming to mind when they were asked about the term digitalisation.[2] And yet it is plain to see that the digital sectors play a major role in macroeconomic productivity gains.[3]

This is the context that comes to mind when I think of central bank digital currency, i.e. the digital euro. Our lives are becoming increasingly digital, and in my opinion it is only logical that the central bank should also offer a digital product. This is why the Eurosystem is working hard on this issue, as are 93% of all central banks according to a recent survey by the Bank for International Settlements.[4] A digital euro would complement cash, and it would be provided to the general public free of charge. People's privacy would be protected and Europe's sovereignty in digital payments would be supported, as a digital euro would be built on European infrastructure.

In the financial industry, this kind of proposition is increasingly meeting with approval. A survey of experts and managers in this sector by the Germany-based Center for Financial Studies shows that most respondents consider the introduction of a digital euro to be desirable, with almost half (45.9%) of the respondents expressing this view. 53% of respondents think that a digital euro should only be issued via credit institutions. Only 28% say that this should be done directly via the ECB. A remarkably high share of 19% have not yet formed an opinion on the matter. And more than one-quarter of them (around 26%) think the euro area risks weakening its economy if the digital euro were not to be introduced.[5]

When assessing a digital euro, the question of who would issue it is of particular interest. In my view, there is a strong case for maintaining the tried-and-tested roles of the central bank and commercial banks, namely that banks and other payment service providers – and not the central bank – are the point of contact for citizens. In any case, legislators will also play an important role in the question of whether a digital euro will be introduced. That said, the ECB Governing Council will decide in the next few weeks whether to soon continue working on the digital euro project in a preparatory phase.

In addition to the green and digital transformations, the restructuring of international supply chains is another major challenge. The advantages of an international division of labour should not be abandoned here. However, given the evident fragility of supply chains, the latter should be made more robust. Stronger economic relations with countries such as Vietnam, Australia or Greenland could make us less dependent on other countries, such as China. This restructuring, too, entails a need for capital, with the focus on banks increasing here as well. This is because, in Germany, most debt financing of smaller enterprises comes from banks. With this in mind, I am pleased that the French and German finance ministers have recently given fresh impetus to the preparations for a European capital markets union – especially with regard to the financing of the green and digital transformation.[6]

Finally, in view of demographic developments, I would like to mention labour shortages as another major challenge facing this country. These are making themselves felt throughout the economy. And by the way, at the Bundesbank, too, we are noticing that it is becoming increasingly difficult to attract junior staff. Labour shortages are weighing heavily on medium-term economic growth in Germany and are already dampening growth potential in the current decade.

Many actors need to play their part in ensuring that our economy has sufficient suitable workers in the years ahead. Policymakers and administrations could facilitate the immigration of skilled workers, strengthen the provision of childcare and nursing care, and adjust the statutory retirement age in the light of increased life expectancy. Schools and training centres can play their part in reducing the number of people who have to get by in life without qualifications. Many measures are urgently needed – even if they will only be able to soften the blow of demographic developments. For example, employers will probably have to adjust more to the fact that the labour market is becoming less and less of an employer's market – with employees increasingly having a stronger position.

Yes, some of the changes need to be so fundamental that it is appropriate to speak of transformations – as I did at the beginning of my speech today. Transformations are rarely linear because they involve learning processes, and trial and error. The faster we embrace this, the sooner we will make progress. With this in mind, I wish you a successful conference. Thank you for your attention.

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[1] Bundesbank-Vize: "Deutsche Bankenaufsicht gut gerüstet" - WDR 5 Profit aktuell - WDR 5 - Podcasts und Audios - Mediathek - WDR

[2] European Center for Digital Competitiveness (2023), Digitalreport 2023, p. 28.

[3] Deutsche Bundesbank (2023), The impact of digitalisation on labour productivity growth, March 2023.

[4] Kosse, A. and I. Mattei (2023), Making headway – Results of the 2022 BIS survey on central bank digital currencies and crypto, BIS Papers No 126, July 2023, p. 1.

[5] Center for Financial Studies (2023), CFS survey on the necessity of a "digital euro", 24 August 2023.

[6] Le Maire, B. / Lindner, C. (2023), We must close the EU capital markets gap, in: Financial Times, 13 September 2023