Finance Group
German Savings Banks Association

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Statement by

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Ladies and Gentlemen,

A warm welcome to the press conference of the German Savings Banks Association today, during the Annual Meeting of the International Monetary Fund and the World Bank Group here on Bali.

For years, questions relating to financial market stability have been discussed at this Meeting in a variety of forums and one-on-one meetings between government representatives, central banks, supervisory authorities and representatives of the financial sector. This is why this Meeting is so important, above and beyond the actual encounter between ministers of finance and central bank governors.

Our customers – and we, as the Savings Banks Finance Group – are critically dependent on financial market stability. For this reason, we support this stability – mainly through our local business activities in practice. However, due to the global interdependence of economies, but also as a result of financial market regulation, it has become more and more important to rally support – also at international level – for our understanding of stability. This is one of the reasons why we have travelled to Bali to attend this year's IMF Meeting.

We will have a whole series of bilateral and multilateral talks with other financial market players. There is no other place and no other time in the world where this is possible in such a condensed form.

I would like to inform you about the five key points that will be addressed in these talks:

<u>First:</u> One of the major concerns at this Meeting is international <u>over-indebtedness</u>.
About 10 years after the beginning of the financial crisis, we must unfortunately note that the world has not become fundamentally safer since then. It is true that significant efforts have been made nearly everywhere to make financial institutions – in particular banks – more resilient to crises. While I think that these efforts have been successful overall, regulation has been exaggerated in some areas.

However, the effective regulatory measures adopted after the financial market crisis – which were the right thing to do in terms of the underlying idea – do not only affect globally operating banking groups, which were the original addressees. They also affect small Savings Banks and co-operative banks that are rooted in their respective regions. This is the core of our business model: serving our customers locally. However, if smaller and commercially sound credit institutions have to merge to form ever larger entities because of unsuitable and burgeoning regulation, this cannot be the right conclusion to be drawn from the financial crisis. In my view, it would noe be appropriate for financial market regulation to focus more attention on non-banks and near-banks. This also applies to FinTechs, whose importance is growing.

In this context, regulatory deficits are apparent, compared with the treatmet of banks. While this has been clearly identified by the IMF, we have seen very little progress in this respect. And the incentives created by the central banks through the low-interest-rate policy have obviously been misunderstood, not least by governments.

Today, the average government debt ratio has increased to approximately 86 percent worldwide; it amounted to roughly 60 percent before the financial crisis. It cannot be denied that the necessary crisis management measures made a major contribution to the increase in the debt ratio, but they were not the only drivers.

Of course, the large central banks had to reduce interest rates significantly in response to the financial crisis to keep markets functional and liquid. However, this was associated with the risk that public budgets might become accustomed to, and increasingly dependent on, cheap money. In the past few years, we have warned again and again at IMF Meetings that this might happen. After the first acute phase of the crisis, the right conclusion to be drawn for public budgets would have been to use the exceptionally favourable financing terms in order to reduce excessive debt. By and large, however, this did not happen. Instead, more than 60 trillion US dollars in new debt has been accumulated worldwide in the past 10 years, the lion's share by business enterprises and governments. This corresponds to as much as approximately 75 percent of the global gross domestic product in 2017.

Unfortunately, the euro area has not performed any better: The debt accumulated since 2008 has grown from 32 trillion euros to 44 trillion euros. This is nearly four times the GDP in 2017, which – in turn – is approximately one-fifth higher than the global debt ratio. One country that stands out with its particularly negative performance is Italy, not least because of its current government debt ratio of approx. 150 percent of GDP – along with an unfavourable outlook for the future. However, we are even more concerned about the emerging economies.[1] In these 27 countries, bonds and loans with a volume of approximately nine trillion USD will fall due in the next seven years. This corresponds to three times the GDP of Germany. About one third of this debt will have to be repaid in US dollars. Rising US interest rates will have a very unfavourable impact on the exchange rates of these countries against the US dollar. The debt burden in real terms will therefore climb even higher, while interest rates in the United States continue to rise. I will return to this point in a moment.

In 2017, more loans were granted worldwide to enterprises with high levels of debt or low credit ratings than in 2007, the year before the onset of the financial crisis. In the United States, the portfolio volume of these high-risk loans has doubled in the past 10 years. While I certainly do not want to imply that there is a risk of a new financial crisis, all the players should realise that the situation can be at least described as being "unstable". Sometimes – and this is something else we learnt in 2008 – a small spark is enough to ignite a wildfire. And more than one spark may appear in the next few months.

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[1] EM-27: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Ghana, Hong Kong, Hungary, India, Indonesia, Israel, Kenya, Malaysia, Mexico, Nigeria, Pakistan, Poland, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Thailand, Turkey, Ukraine.

Secondly: We have to be prepared for a further tightening of the US interest-rate policy. The Federal Reserve is already quite advanced in terms of monetary policy normalisation and therefore significantly ahead of the euro area and Japan. The portfolio of government bonds purchased by the central bank is already gradually being reduced. A few days ago, the US central bank took another step as planned to increase the key interest rates. The money market rates now range between 2.0 and 2.25 percent. Another step of 25 base points might be taken by the end of the year. Given the strong economy and the high level of employment in the United States, this normalisation of monetary policy is a logical step. After all, US consumer prices increased at an annual rate of 2.7 percent and at a core rate of 2.2 percent in August. The fact that the upswing is a "flash in the pan" caused by the tax cuts of the Trump administration and that it will probably not be sustained in the medium term does not change anything. However, this flash in the pan already poses risks for the rest of the world.

One risk is that capital flows into the United States may change significantly in the next few months, probably induced by higher interest rates and the strong economy. This will particularly affect the emerging markets, which are highly indebted in US dollars. A second risk concerns Europe. So far, the ECB has made almost no effort to phase out its extremely expansionary monetary policy. Some time ago, we had suggested that the ECB should start phasing out its expansionary monetary policy early on and in very small steps. In view of the ever greater interest spread between the United States and Europe, the challenge for the ECB will now be staying both resolute and very cautious when it flips the interest-rate policy lever. If the ECB introduced interest-rate hikes too abruptly, this would be as dangerous as a continuation of the period of low interest rates.

For the first time in 10 years, we will enter into a new phase in Europe, which will probably be characterised by a very cautious phase-out of bond purchases and a large number of extremely small interest rate moves, spread out over a medium-term period. The motto for the ECB should be: not too fast, but also not too late.

The third big issue these days is the upcoming Brexit. The big day is expected to take place on 29 March 2019 at 11:00 p.m. That leaves no more than 168 days. I'm afraid that the time left is now too short to negotiate reasonable exit conditions. In view of the complexity, this could probably only be achieved if both parties engaged in constructive negotiations. However, this is not seem realistic, which is a tragedy. Of course, it is true that the U.K. has much more to lose than the remaining European Union. However, we should not deceive ourselves. If Brexit was implemented without any agreement, this would be even worse than a hard Brexit.
In this case, we expect growth in the U.K. to decline by 2 percentage points, while growth in the remaining EU Member States would decrease by 0.5 percentage points.

Something which is perhaps more serious than the decline in growth is the legal uncertainty that this would create for the market players. Nearly all the current contracts in the financial sector and in the other economic sectors that relate to the U.K. contain legal provisions whose interpretation would be unclear in the event of Brexit. In many cases, such references are also included in contracts that have no direct link to the U.K. In a worst-case scenario, there is a risk that legal uncertainty – or somewhat exaggerated, it might also be called chaos – would continue to prevail. In a systematic survey conducted among our business clients in the past few weeks, we found that Brexit is one of the four major concerns of German enterprises, for these very reasons.

I realise that now is the time to put on a poker face and that the players do not want to reveal the cards too early. The whole thing is gradually developing into a chicken run, such as the one ín the well-known film classic starring James Dean. In Germany, the film was appropriately entitled "For they know not what they do" (The original English title was "Rebel Without a Cause"). What we expect of the actors is that at least one of them will jump off the moving car before it reaches the cliff. It's better to be a coward than to fall off a cliff. The least that should be done is to ensure that the U.K. will continue to comply with the current EU rules for a transitional period of two years. If need be, a moratorium will have to be imposed on the negotiations. However, one point should not be negotiable. To a large extent, derivatives denominated in euros are currently cleared by the London Clearing House. To maintain financial stability, it is indispensable for the European supervisory authorities to have sufficient access to the Central Counterparty (CCP) in London. And in the medium term, clearing must be moved to the European Union. However, we believe that insisting on an abrupt switch would not be right. Current contracts should be continued until the end of the contract term (grandfathering), and sufficiently long transitional periods should be agreed.

<u>Fourth:</u> Growing protectionism, which has been mainly initiated by the United States, poses another major risk to the world economy. This problem is not only of a cyclical nature, but will primarily have long-term structural effects. In the meantime, the United States has concluded a new free trade agreement with Canada and Mexico, and Germany and Europe no longer seem to be in the direct line of fire. This also seems justified if attention is rightly not focused exclusively on the U.S. trade deficit in the bilateral relationship, but if capital flows and the substantial direct investments of European companies in the United States are also taken into account. The U.S. conclusion to the effect that Europe benefits disproportionately from mutual trade relations has never been true. However, in the relationship between the United States and China, the commercial confrontation is more than just posturing. High customs duties have been imposed on a large part of the trade flows between the two countries, and further escalation levels have been prepared. This problem is not limited to these two countries. Instead, the whole world – including Europe and Germany – is affected by these developments.

Frst of all, if the United States and China harm each other, this will slow down global growth. Secondly, production and value chains have been internationally interlinked for a long time now. In the era of globalisation, it is anachronistic to believe that trade is only a matter of importing products from one country into another. In global markets, the impact of protectionism is that entire supply chains no longer work efficiently.

In my view, the international community should joint forces to support free world trade. In saying this, I realise that the scope for influencing the current U.S. administration is limited. This should be all the more reason for Europe to remove its own trade barriers and to conclude additional free trade agreements.

Fifth: In conclusion, I would like make a few comments on the perennial issue of financial market stability, and I would like to do so from a rather German perspective. There are growing concerns that stability risks are becoming manifest in the real estate markets and in lending to enterprises. We do not share either of these two concerns – at least not with regard to Germany. In the past few years, there has certainly also been a significant increase in real estate prices in Germany. This has mainly affected big cities such as Berlin or Frankfurt/Main, where real estate prices have increased by more than 30 percent in some cases. However, this is not a real estate bubble. Instead, this development has been triggered by factors relating to the real economy.

Favourable financing terms for real estate loans, as well as a strong economy with rising employment rates and growing household incomes have led to the significant increase on the demand side. In addition, the scarcity of building land, as well as increasing administrative and bureaucratic hurdles and capacity bottlenecks in the construction sector have been factors on the supply side, as a result of which there is still not enough housing development in Germany. With 3.3 completed dwellings per one thousand inhabitants per year, Germany currently lags far behind countries like Sweden (7.4), Finland (7.2) and France (6.0).

The German government has adopted first measures to move forward – additional steps will have to follow. However, the data available to us show that there has been no easy lending, nor has there been an exceptionally rapid growth of corresponding loan portfolios. The Savings Banks' aggregate real estate lending portfolio in 7 major German cities, for instance, did not increase from 2007 to 2017. And Savings Banks have made no changes whatsoever to their responsible lending standards. This applies not only to lending to individuals, who are expected to contribute approximately 20 percent of the capital required and make high repayments in the first few years.

It also applies to their lending to commercial investors, which continues to be based on rigorous credit rating criteria. Here too, there is no evidence suggesting that business enterprises in Germany are over-indebted. We are in a position to assess this because our Group accounts for 41.6 percent of loans to enterprises and self-employed persons in Germany.

Of course, loan volumes have increased significantly in the recent past. The latest analyses of extensive balance sheet data furnished by German enterprises have shown that their liabilities to banks have recently increased by approximately 6 percent. At the same time, however, their equity increased by 4.5 percentage points – their equity ratio now amounts to 39 percent, which is quite high. Although the growth of lending volumes has recently been slightly above average, the debt levels of German enterprises are currently much lower than in the periods of much higher interest rates. On average, the interest expense of German enterprises currently amounts to only 1.2 percent of their sales revenues.[2]

More than 80 percent of loans to enterprises have fixed interest rates and run over long periods. This means that it would take approximately six years for a rise in interest rates to have a full impact on business enterprises. In other words, the global diagnosis made at the beginning of my statement does not apply to Germany: The market players are not over-indebted, nor would rising interest rates have an excessive impact on German enterprises. In addition, Germany's financial system is stable. Recently, this was rightly emphasised by Deutsche Bundesbank, the Financial Stability Board, and the German Council of Economic Experts.

And this assessment applies in particular to the German Savings Banks Finance Group:

- So far, we have coped much better with the decline in earnings due the low-interest-rate policy than most external observers had previously expected. This was mainly due to cost savings and improvements in net commission income.
- We manage our risks diligently. This is underlined by low default rates and the fact that the credit ratings of our borrowers continue to be very good.
- We have successfully managed the foreseeable interest rate risks.
- Savings Banks and Landesbanken will have complied with all the regulatory capital and liquidity requirements before the deadline.
- According to the rating agency Fitch, the Savings Banks' presence in a wide range of regions implies a strong capacity to show solidarity by assuming liability in the event of a crisis.

We understand that the IMF is arguing at this Meeting that the financial market rules should not be watered down.

However, we advocate greater differentiation and proportionality because the post-crisis measures adopted by the G20, the Financial Stability Board (FSB), and the Basel Committee on Banking Supervision (BCBS) were not designed for locally based banks focusing on the real economy business. Due to their low-risk business model, Savings Banks in Germany, for instance, are completely different from the original addressees of international regulation.

Basel III was finalised nearly one year ago. It is now time to consolidate the measures adopted, to allow them to take effect, and to remedy any inconsistencies that have been identified.

In our view, one of the most important conclusions 10 years after the financial crisis must therefore be:

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[2] Compared with 1.8 percent in 2011

Good financial market regulation will have to remain effective in the areas for which it was originally designed. However, it needs to be fine-tuned in areas where the wrong players were impacted.

Thank you very much for your attention.