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Simon Potter: Reducing the size of the Federal Reserve's balance sheet - the benefits of moving gradually and predictably

Remarks by Mr Simon M Potter, Executive Vice President of the Markets Group of the Federal Reserve Bank of New York, to the National Association of Securities Professionals, New York City, 16 November 2017

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Good afternoon and thank you for the kind introduction. I would also like to add my warm welcome to the New York Fed. We very much value the National Association of Securities Professionals' (NASP) efforts to promote professional excellence and encourage economic empowerment for people of color and women on Wall Street, and for our community, and are pleased to host this year's kickoff to the NASP's 21st Annual Symposium.This year's symposium is organized around the timely theme of "Keeping Pace when Market Dynamics Shift". In that vein, I welcome the opportunity to discuss with you some important changes that are in train with respect to the Federal Reserve's balance sheet, and how these may impact financial markets.

As always, the views I will express today are mine alone and do not necessarily reflect those of the New York Fed or the Federal Reserve System. [1]

Before I discuss the Fed's balance sheet I would like to briefly review some pilot programs we conducted over the last few years and their impact on our counterparty policy. As a number of you are aware, between July 2013 and December 2015, the New York Fed conducted two counterparty pilot programs with small firms, the first focused on treasury operations and the second on mortgage operations. As we announced at the time, we initiated these programs to explore ways to broaden access to open market operations and to determine the extent to which firms beyond the existing primary dealer community could augment the New York Fed's operational capacity and resiliency in its monetary policy operations. We very much appreciate the NASP's efforts to encourage eligible firms to participate.

The experience gained through these programs informed changes in the New York Fed's eligibility criteria for primary dealers, which were announced in November 2016. At that time, the minimum net regulatory capital (NRC) threshold for broker dealers was reduced from $150 million to $50 million. And to better align the capital threshold for banks with the new NRC thresholds, the minimum Tier 1 capital threshold for banks was raised from $150 million to $1 billion. At the same time, a 0.25 percent minimum Treasury market share threshold was introduced to more directly quantify the business capabilities of firms expressing interest in becoming a primary dealer.

Through these changes, the New York Fed is seeking to expand and diversify the pool of firms eligible to apply for primary dealer status, while also recognizing that a certain scale of activity is needed in order to be able to meet the many business obligations to which primary dealers must commit, in supporting the operations of the Federal Reserve and the Treasury.

These changes offer the opportunity to increase capacity and further support competitive pricing for the Fed's open market operations. Going forward, the New York Fed will periodically review its counterparty policy.

Turning to monetary policy, at the conclusion of its September policy meeting, the Federal Open Market Committee (FOMC) announced that it would begin to reduce the size of the Federal Reserve's securities portfolio. [2] Over the past month, the Fed took the first steps in a multiyear effort to bring the Federal Reserve's balance sheet to its longer-run size, by not reinvesting a portion of the securities repayments it received. In the remainder of my prepared remarks today, I will offer my views on this policy from a financial markets perspective, drawing on a fuller set of remarks I delivered last month, which can be found on the New York Fed's website. [3]

The message I'd like to leave you with today is one of confidence. I am confident that the FOMC's plan will reduce the size of the portfolio in a gradual and predictable, "no surprises" manner; that the FOMC's plan will promote good market functioning in the Treasury and agency mortgage- backed securities markets as the portfolio declines; and that it will not prove disruptive to the U.S. mortgage market or the U.S. Treasury's debt management program. And I am also confident that the plan's design, and the FOMC's clear communication prior to the plan's implementation, will mitigate the risk of sharp or outsized asset price reactions to the decline in the portfolio's size over time.

Of course, we cannot and should not prevent Treasury and agency MBS prices from reacting to relevant economic and financial developments, or indeed from gradually moving over time in response to the progressive decline in the size of the Federal Reserve's holdings and consequent increase in the amount of securities held by the private sector.

In fact, we very much want asset prices to respond appropriately and fully to economic and financial news. Over the coming years, such news could span a wide variety of topics, such as central bank policy in this country and abroad, the ongoing debate over fiscal policy, and the evolution of expectations for the longer-run neutral rate of interest.

That said, we do seek to mitigate the risk that our operational actions contribute to unnecessary surprise, disruption, or volatility.

There is of course always a risk that events could unfold differently from expectations. In particular, central banks have had little direct experience with the impact of such a reduction in holdings of domestic securities and in reserves. One relevant experience, of course, was the so- called "taper tantrum," in 2013 which showed that markets can have outsized reactions to changes in balance sheet policy even before they happen.

More generally, experience with asset purchase programs, both here and abroad, clearly demonstrates that market volatility can ensue from balance sheet policy changes that market participants perceive as surprising, unclear, or rapid, or are not adequately distinguished from short-term interest rate policy intentions. All of this indicates to me that, at policy turning points like these, central banks should carefully and clearly communicate their intentions, provide as much transparency as possible, focus on one tool at a time, and make transitions in policy implementation as slowly as overall macroeconomic policy objectives permit. [4]

The rest of my remarks will go as follows. First, I'll provide an in-a-nutshell summary of the structure of the Federal Reserve's balance sheet. Then, I will discuss why it is important that the decline in the balance sheet be gradual and predictable, and explain how the FOMC's plan provides this gradualism and predictability. I will then talk briefly about how the Federal Reserve is ensuring it is prepared for unexpected developments. We will then open things up for questions you may have.

The Fed's balance sheet, in a nutshell

Let's begin by reviewing, at a high level, where the Fed's balance sheet is today. Panel 1 shows a summary of the Fed's assets and liabilities, as they are today. Substantially all of the $4.5 trillion of assets consist of Treasuries and agency MBS. On the other side of the balance sheet, the Federal Reserve has three main categories of liabilities: $2.6 trillion of bank reserves and other deposits, $1.5 trillion of paper currency, and about $400 billion of reverse repos.

Before the crisis, the balance sheet was much smaller, at around $900 billion. It reached its present size as a result of the FOMC's large-scale asset purchase programs. Those programs were undertaken to support the economic recovery by easing financial conditions to a greater extent than could be achieved solely through reducing the federal funds rate, once that instrument became limited by the zero lower bound on interest rates. These asset purchases greatly increased the size of the asset portfolio, and equally increased the size of the Federal Reserve's liabilities, largely through growing the stock of bank reserves. [5] The composition of the

balance sheet also changed. On the asset side, the most important compositional changes were the addition of agency MBS and a substantial increase in the maturity of the Fed's Treasury holdings.

For many years, the FOMC has made it clear that it did not intend for these changes to the balance sheet to remain forever. [6] Instead, through its statements and its September 2014 Policy

Normalization Principles and Plans, the FOMC indicated its intention that, in the longer run, the Federal Reserve will hold no more securities than necessary to implement monetary policy efficiently and effectively, and that it will hold primarily Treasury securities.The FOMC also communicated its intention to reduce the Federal Reserve's securities holdings in a gradual and predictable manner, primarily by ceasing to reinvest repayments of principal on its securities holdings.

Starting in its December 2015 statement, when the FOMC first started to raise its federal funds target range away from zero, the FOMC also indicated that it anticipated continuing reinvestment until normalization of the level of the federal funds rate was well under way.

The FOMC's strategy of waiting to begin reducing the balance sheet until normalization of the federal funds rate was well under way has had several advantages. Most importantly, it reduced the likelihood that an unexpected adverse shock to the economy would have necessitated a return to the zero lower bound on the federal funds rate and potentially a reversal in balance sheet normalization. Second, the FOMC's approach promotes the use of the federal funds rate as the active monetary policy instrument, an instrument with which the FOMC has much greater experience. In addition, delaying balance sheet normalization allowed the FOMC to meaningfully assess the efficacy of its tools to control short-term interest rates with a large balance sheet, and thereby judge how patient it could afford to be in reducing the balance sheet to its longer-run level. [7]

Reducing the balance sheet's size

Over the past year, as the FOMC came to judge that normalization of the policy rate was well under way, with another rate increase in December 2016, and further increases in March and June 2017, FOMC deliberations turned to how balance sheet normalization might best be done.

As I noted earlier, for some time the FOMC has underscored that the balance sheet will be reduced in a way that is gradual and predictable, so as to avoid risks of surprise, disruption, or volatility, and would be achieved primarily by not reinvesting maturing principal. The FOMC's recently initiated plan does exactly this. [8] Principal reinvestment will decline in a phased manner, an approach which provides for an appropriate pace of reduction in the balance sheet, and is quite straightforward to communicate.

Specifically, principal maturities will be reinvested only to the extent that they exceed gradually increasing caps. [9] For Treasuries, the cap initially will be $6 billion per month, and will increase in steps of $6 billion at three-month intervals over 12 months until the cap reaches $30 billion per month. Agencies follow a similar pattern, with a cap starting at $4 billion and rising in three-month steps to reach $20 billion. The FOMC also indicated that it anticipates that these caps will remain in place once they reach their respective maximums. Over time, as the Fed holds fewer securities, the private sector will gradually hold more. At the same time, Fed liabilities held by the private sector, in particular reserve balances, will decline equivalently.

Panel 2, which draws on a July 2017 update to the System Open Market Account annual report, illustrates how the caps will evolve in relation to anticipated maturities of Treasuries, on the left hand side, and agency MBS on the right. As can be seen, once the caps are fully phased in, in many months the caps are not expected to be binding, and so there would be no reinvestments in those months. However, the caps will be exceeded in months with large Treasury maturities, and we would reinvest the amount above the cap. For agency MBS, a change in conditions could encourage faster MBS repayments than are shown here, producing monthly paydowns larger than the 20 billion cap and thus some reinvestments—an issue I will return to later.

Policymakers have indicated that they want the portfolio's size to decline "in the background," and that the federal funds rate will be the primary instrument of monetary policy. Balance sheet normalization is expected to continue until the FOMC judges that the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively.

The FOMC has not specified how large the balance sheet should be at that point, other than an expectation that the level of reserve balances will be appreciably below that seen in recent years, but larger than before the financial crisis. My colleague Lorie Logan spoke in May on the many technical drivers of this ultimate level, which include the mode of policy implementation that the FOMC chooses in the longer run, possible increases in recent years in the financial system's demand for reserves and Federal Reserve reverse repo liabilities owing to new financial regulations and other factors, and the long-term evolution of demand for paper currency. [10]

Let me spend a few minutes discussing the importance of gradualism and predictability.

Gradualism

The case for gradualism in reducing the Fed's securities holdings rests on evidence, as well as potential risks, that an overly fast flow of securities into private hands could be disruptive to market functioning, as well as the FOMC's confidence that it can adjust its policy stance as needed through changes in the federal funds rate. In particular, there is evidence that the agency MBS market, due to the nature of its trading conventions, is prone to dislocation when market participants expect large transitions in central bank agency MBS flows. [11] Such concerns can be self-fulfilling: if market participants are concerned that an abrupt shift in flow might be disruptive, they might, for example, withdraw from liquidity provision. An overly fast redemption flow of Treasuries could also create challenges in the government's management of public debt auctions and result in communication challenges. [12]

Rapid portfolio declines also could have unforeseen impacts on overnight money markets, for example by creating significant shifts in dealers' demand for overnight repo financing. We have seen such impacts in the past. This sort of volatility did not, and would not now, pose a major problem to markets or policy implementation, but it is something worth avoiding if possible. Rapid portfolio runoff could also make it more likely that bank reserves become scarce unexpectedly or more quickly than policymakers had anticipated.

Finally, overly fast portfolio runoff could introduce undesired noise into financial conditions. This could complicate policymakers' economic forecasting and make it more challenging to determine and communicate the appropriate monetary policy stance.

Predictability

Predictability complements gradualism by promoting stability in market estimates for the future size of the balance sheet, and confidence that the FOMC will not unintentionally create market stress. It involves assuring the public that the flow of balance sheet reduction remains gradual across a range of economic scenarios, including ones quite different from our central forecast. Achieving predictability is complicated by uncertainty about agency MBS principal repayments, an issue I'll summarize briefly.

To an extent, unexpected changes in the pace of existing home sales contribute to uncertainty about MBS repayments. But by far the greatest source of aggregate uncertainty relates to refinancing. When homeowners get a new mortgage with a better interest rate, and pay off their old higher rate one in the process, existing agency MBS are paid off more quickly, and replaced with greater issuance of newly-minted agency MBS containing the new, lower-rate loans.

The benefit of the FOMC's redemption cap is that it limits the pace at which securities will flow back into private hands under scenarios in which interest rates fall much more than expected. To illustrate this, projections for agency MBS repayments under a scenario of lower interest rates are shown in Panel 3—as you can see, in this low rate scenario, the caps would still be exceeded even when fully phased in.

By providing market participants some certainty that the pace of balance sheet decline will be gradual across economic scenarios, this plan should help mitigate the risk of unexpectedly sharp shifts in asset prices, liquidity, or market functioning should markets begin to put greater weight on lower interest rate scenarios. Indeed, by promoting greater confidence in the stability and liquidity of the Treasury and agency MBS markets across economic outcomes, the FOMC's plan should result in lower risk and liquidity premia on these assets, relative to normalization plans that do not promote such confidence.

Being prepared for the unexpected

While I am confident that the FOMC's plan will work well, there's always the risk that events unfold differently than expected. In my view, we best prepare for the unexpected in two ways: we need to be operationally ready to change course when needed, and we need to remain analytically focused so we know when to recommend to policymakers that they do so.

For example, the FOMC has made it clear that it stands ready to resume reinvestment if a material deterioration in the economic outlook were to warrant a sizable reduction in the federal funds rate. The FOMC also indicated that it would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate.

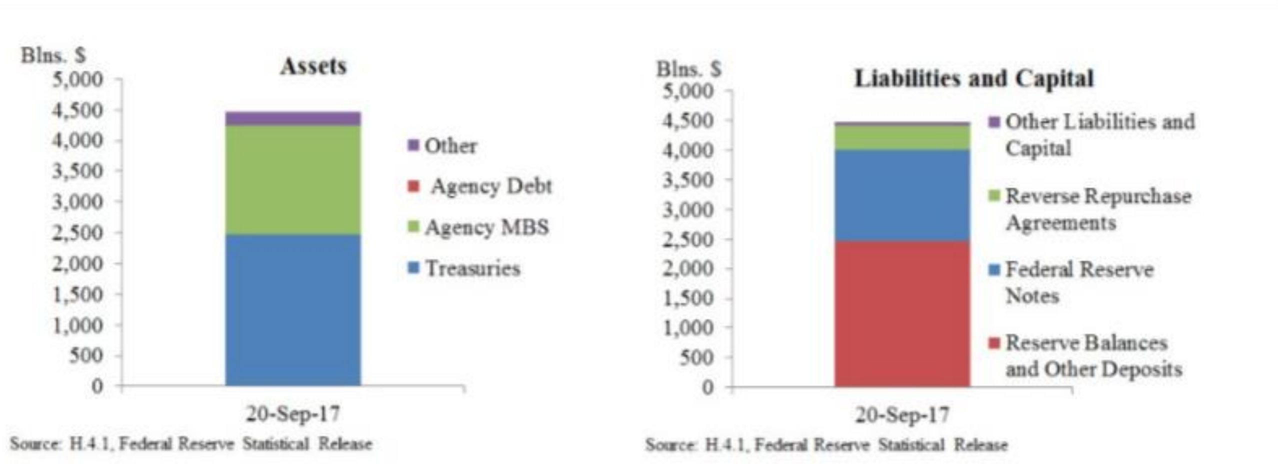
Also, unexpected operational demands could emerge from technical developments within the Treasury and agency MBS markets. Even though it is shrinking, the Federal Reserve's portfolio is and will remain large, and market participants will look to the Federal Reserve to lend out on a collateralized basis some of its holdings of Treasuries and MBS from time to time in order to facilitate settlement, as is done by most other large fixed-income investors.13

Conclusion

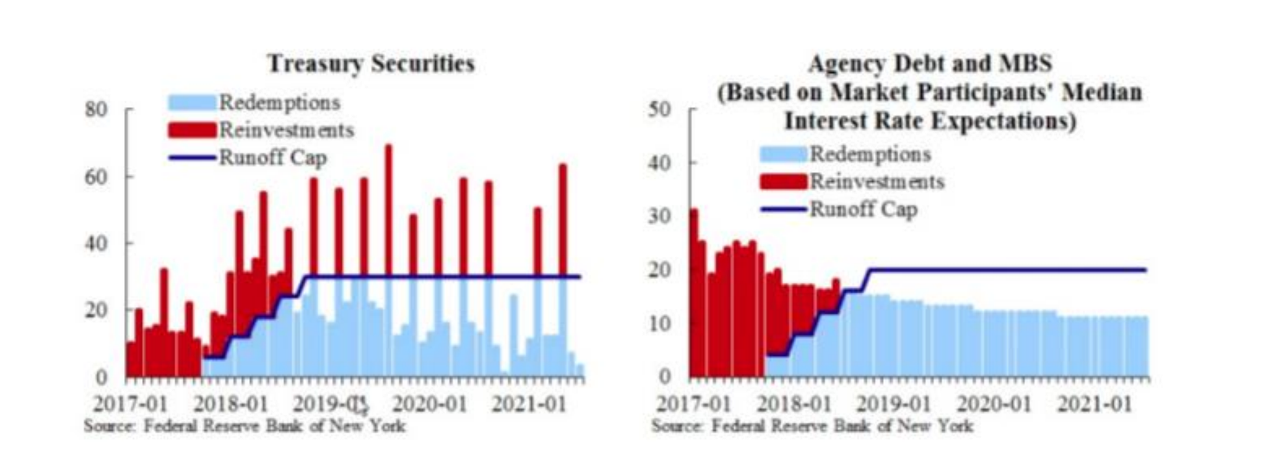
Let me conclude now by reiterating the message of confidence with which I began my remarks. I am confident that the FOMC's gradual and predictable plan to normalize the balance sheet will reduce the balance sheet's size at an appropriate pace, that it will promote good market functioning, that it will not disrupt the mortgage market or Treasury debt issuance, and, importantly, that it will mitigate the risk of sharp or outsized asset price reactions. I am also confident that the Federal Reserve is well prepared, both operationally and analytically, to identify, understand, and address unforeseen circumstances over normalization as directed by the FOMC. Finally, by accomplishing all these things, I am confident that the FOMC's policy normalization plan should help promote the ongoing economic expansion.

Early signs on this front are encouraging, with no to very modest financial market volatility around balance sheet announcements and the reduction in the balance sheet to date. It's too early to declare success. However, should this stability continue, I believe the FOMC's approach may offer useful lessons to other central banks which anticipate reaching a time of transition in their policy stance. Thank you for your attention. I would welcome your comments and questions.

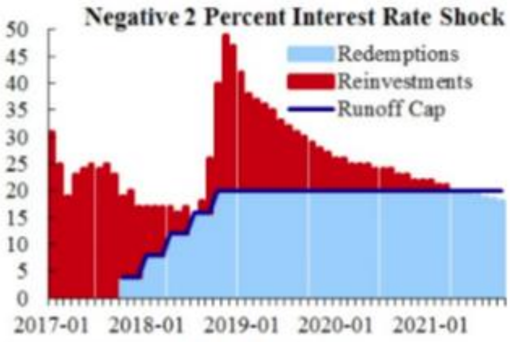
Panel 1: Federal Reserve Assets and Liabilities



Panel 2: Projected Repayments on SOMA Securities



Panel 3: Projected Repayments on SOMA Agency Debt and MBS



Source: Federal Reserve Bank of New York

[1] I would like to thank John Clark, James Egelhof, and Deborah Leonard, for their assistance in the preparation of these remarks, Adam Biesenbach for his assistance with the data, and colleagues in the Federal Reserve System for their insightful comments and suggestions.

[2] The FOMC reaffirmed this policy in its November 1, 2017 statement and implementation note.

[3] Potter, Gradual and Predictable: Reducing the Size of the Federal Reserve's Balance Sheet, October 11, 2017.

[4] See Potter, Implementing Policy with the Balance Sheet, November 6, 2017, for further discussion of lessons from experience with balance sheet policy.

[5] The maturity structure of the balance sheet was only loosely incorporated into the purchase plan. Purchases of Treasury securities were targeted at maturity sectors; within each sector, specific issues were selected for purchase using a relative-value approach based on a spline fitted to market prices. Sack, Implementing the Federal Reserve's Asset Purchase Program, February 9, 2011. Treasury securities acquired through reinvestment are purchased in proportion to issuance. Agency MBS purchases are distributed across instruments roughly in proportion to anticipated gross issuance of those securities at the time. Potter, The Implementation of Current Asset Purchases, March 27, 2013.

[6] Early FOMC discussions of balance sheet normalization, then referred to as an "exit strategy," were predicated on an intention to return to, as put in the January 28, 2009, meeting transcript, "a more normal framework for conducting monetary policy," which meant a return to an asset and liability structure closely resembling that which prevailed before the financial crisis. Normalization-related matters were discussed in the minutes to most of the FOMC's 2009 meetings. In a January 2009 speech, The Crisis and the Policy Response, Chairman Bernanke provided extensive detail on the eventual normalization strategy, as

envisaged at that time, including his expectation that the balance sheet would be reduced “to the extent necessary at the appropriate time.”

[7] See Potter, Money Markets at a Crossroads: Policy Implementation at a Time of Structural Change, April 5, 2017, for an assessment of the efficacy of these tools.

[8] The Policy Normalization Principles and Plans indicates that the Committee did not anticipate selling agency mortgage-backed securities as part of the normalization process, although limited sales might be warranted in the longer run to reduce or eliminate residual holdings, and that the timing and pace of any sales would be communicated to the public in advance. Portfolio projections released in July 2017 do not include sales of any type over the forecast horizon.

[9] Statement Regarding Reinvestment in Treasury Securities and Agency Mortgage-Backed Securities , September 20, 2017.

[10] Logan, Implementing Monetary Policy: Perspective from the Open Market Trading Desk, May 18, 2017.

[11] Kandrac, The Costs of Quantitative Easing: Liquidity and Market Functioning Effects of Federal Reserve MBS Purchases (2014).

[12] The Treasury Borrowing Advisory Council considered this topic in its third-quarter 2017 meeting, including the potential impact of changes in central bank policy abroad. See the August 1, 2017, presentation by TBAC to the U.S. Treasury.

[13] In addition to these topics, we at the Federal Reserve are following closely the potential for the decline in the balance sheet to affect other aspects of the structure of financial markets or the banking industry. As one example, we are paying attention to the possibility that a decline in the size of the balance sheet puts downward pressure on bank deposits. As discussed earlier, in general, balance sheet normalization removes an asset from the private sector that can be held only by banks (reserves) and replaces it with an asset that can be held by anyone (securities). It is possible that, on net in equilibrium relative to a counterfactual in which the balance sheet does not decline, (a) banks will hold fewer reserves; (b) banks will offset some of this decline by holding securities instead, and some by taking in fewer deposits; and (c) non-banks will replace those deposits with securities. Theextent(ifany)ofanysuchdeclineindepositactivityondepositandloanpricingwilllikelydepend on a variety of factors, including the extent to which the decline comes from wholesale institutional deposit activity motivated by interest rate arbitrage. See Ihrig, Mize, and Weinbach, How does the Fed adjust its Securities Holdings and Who is Affected?, September 22, 2017

Fonte: Bank for International Settlements (BIS)

https://www.bis.org/review/r171121b.pdf

Andreas Dombret: The German economy and the demographic factor

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the forum WHU - Otto Beisheim School of Management, Vallendar, 17 November 2017

* * *

1. Welcome

Ladies and gentlemen, dear students

Thank you very much for inviting me to this event examining Germany's future on the world stage.

One key factor which is set to have a huge bearing on Germany's economic future is the impact of demographic change. In my speech here today, I will therefore be discussing the outlook for the German economy, focusing some of my remarks on the implications of demographic change.

I'm a baby boomer, a member of the generation born prior to the "baby bust" – the sharp decrease in the birth rate attributed to the introduction of the contraceptive pill in the second half of the 1960s.

In actual fact, the pill was arguably less to blame for the decline in the birth rate than economic and societal developments were.

For example, women's increasing desire to have a career of their own at a time when it was difficult to balance professional and family commitments resulted in fewer children being born.

By the end of the next decade, most of the baby boomers will have retired, and this will have grave implications for our social welfare systems.

It will add substantially to the number of people already drawing a pension, while the number of people whose contributions are expected to fund these pension entitlements will remain static or decrease. On top of this, life expectancy is climbing ever higher, which means that the average pension-drawing period is getting longer.

Whilst insured persons who retired in 1960 at the age of 65 could look forward to living a further 13½ years, this figure now stands at almost 20 years. And medical advances suggest that this figure will rise still further in the decades to come.

The gradual increase in the statutory retirement age to 67 by 2031 has made the pension insurance scheme more sustainable, but it hasn't put the scheme on a sound footing once and for all. That's why it is not necessarily pessimistic to believe that further reforms are required to address the post-2031 period. It’s safe to say that the reforms enacted during the last legislative period – I’m talking here about full pensions for persons with an exceptionally long insurance record, and mothers’ pensions – did nothing to boost the sustainability of the statutory pension scheme.

Assuming a far lower pension level and a far higher contribution rate are out of the question in the future, policymakers will probably have no option but to push retirement age higher still.

The pension system and other social security funds aren’t the only areas where demographic change is making itself felt; it also weakens the forces of growth in our economy.

So the positive state of the economy right now should not blind us to the huge challenge which demographic change is also presenting in the sphere of economic policy. In any case, the upbeat economy is no reason to be patting ourselves on the back or resting on our laurels.

2. The German economy

The German economy is currently in very good shape. Sentiment is also fine: the Ifo business climate index rose to a new all-time high in October. Businesses are looking ahead with great optimism.

According to the latest projection of the German Council of Economic Experts, the German economy will experience real growth of 2% this year and 2.2% next year.

The Council of Economic Experts thus finds itself in line with other institutions which have made similar predictions.

Economic output, then, is outpacing production capacity, which means that utilisation is continuing to increase.

A positive factor is that the upturn in Germany is not only ongoing, but also becoming broader: besides private consumption, export demand and investment are also making a contribution to growth.

The German economy is benefiting from the fact that the global economy, including the countries in the euro area, is regaining momentum following years of crisis-induced sluggishness.

According to IMF forecasts, the global growth rate, which was 3.2% last year, will go up to 3.6% this year and 3.7% in 2018. This means that world trade, too, will finally gain more impetus, with growth accelerating from 2.4% last year to 4.2% this year.

That is good news for German exporters. The debates on trade restrictions, which are being conducted in some countries, are causing headaches for export-oriented enterprises, however. Protectionist tendencies, alongside geopolitical conflicts, are among the most significant downside risks to global economic activity.

Economic activity, especially in the euro area, is also being buoyed by what remains a very accommodative monetary policy.

And let me add that, with inflation still muted, I believe that an accommodative monetary policy stance is still appropriate for the euro area. Views can differ over the correct degree of monetary policy expansion and the proper instruments, however.

As you know, the Governing Council of the ECB has decided to halve its monthly bond purchases from January 2018 onwards, but to continue them until at least September 2018.

Furthermore, the Governing Council has announced that interest rates will remain at their present levels "well past the horizon" of its net purchases.

It is clear that monetary policy will remain very accommodative even after the net purchases have ended, as the Eurosystem already has a very large volume of bonds and the Governing Council of the ECB has taken the decision to reinvest the proceeds of the bonds as they mature.

Given positive economic growth in the euro area and gradually increasing inflationary pressure, the Bundesbank believes that discontinuing the net purchases more rapidly and with a clearly communicated end-date would have been appropriate. The main reason I say that is that purchasing sovereign bonds in the monetary union is something we have been viewing critically for a long time anyway: in a single currency area, sovereign bond purchases blur the very important distinction between monetary policy and fiscal policy. The Eurosystem central banks have now become the countries' biggest creditors. That could ultimately lead to political pressure being exerted on the Eurosystem to persist with the very loose monetary policy and low interest rates for longer than would be appropriate with regard to price stability.

Low interest rates are designed to encourage consumers to save less and consume more for a temporary period.

German consumers are, in actual fact, in a first-class mood for spending. It is true that the propensity to spend, as measured by the market research institute Gesellschaft für Konsumforschung (GfK), has declined slightly of late, but it is still at a very high level.

This is due chiefly to the positive situation on the labour market and income trends in Germany, which are also being favoured by the very accommodative monetary policy: households' disposable income went up by 2.8% in 2016 and by as much as 3.6% in the first half of 2017.

The number of people in employment is at an all-time high. The unemployment rate has fallen to its lowest level since 1991; the seasonally adjusted unemployment rate stood at 5.6% in October.

In some industries and regions, enterprises are finding it increasingly difficult to fill vacancies. The shortage of labour in manufacturing and the main construction sector has worsened noticeably of late: the percentage of firms whose output is being hampered by a labour shortage has climbed to its highest level since German reunification. This is a trend that is likely to go on intensifying as demographic change takes hold.

Against this backdrop, it may be somewhat surprising that wage growth has so far not been stronger in Germany.

The increasing scarcity of labour would normally suggest that wage growth should be stronger.

Obviously, countervailing factors are at play here.

One of the main factors dampening wage growth is net immigration of labour from other EU countries. Another is that it is evident from pay negotiations that the labour side is setting somewhat different priorities than it did earlier. Employees are now placing greater value on more flexible or fewer working hours, for example.

The most recent collective bargaining agreement for the railways, for instance, gave employees a choice between 2.6% more pay or six additional days of holiday: more than half (56%) opted for more holiday.

Given a continuing decline in unemployment for the coming years, the pace of wage growth may nevertheless be expected to accelerate.

But public finances, too, are benefiting from positive economic growth and low rates of interest. Demographic change is not yet making itself felt here, especially since it is still those born in the post-war era in years that tended to have lower birth rates who are now entering retirement.

The aggregate general government budget is running a surplus, and that will remain the case in the coming years, as long as the new Federal Government does not embark on a noticeably more expansionary fiscal course.

The government debt-to-GDP ratio, which went up to more than 80% of GDP in the wake of the financial crisis, has now gone down to 66%. It could therefore soon, in a few years' time, fall below the reference value of 60% enshrined in the Maastricht Treaty.

Regrettably, the majority of euro area countries are unable to claim that about themselves. In France and Spain, government debt stands at almost 100% of annual economic output, with the figure for Italy being as high as over 130%.

Debt-to-GDP ratios provide no more than limited information on the sustainability of public finances, however. That is because, behind explicit government debt, there is concealed government debt in the form of pay-as-you-go social security funds, principally in pension and long-term care insurance. But the pension rights of civil servants also represent implicit government debt if no reserves are formed for them.

Experts estimate that the German government's implicit debt is more than twice as high as its explicit debt. These are burdens that we are shifting onto the taxpayers of tomorrow and the day after tomorrow. With this in mind, a further reduction in debt is especially important.

3. How demographic change affects potential output

Demographic change is not just an issue of interest for public finances, however. It will also act as a drag on the medium to long-term growth prospects of the German economy.

The declining population and rising average age of the labour force will cause the potential growth rate to shrink.

An economy's potential output is determined by its inputs of labour and capital as well as production technology. Potential output is understood to mean the highest possible level of economic output that can be achieved with a given level of technology using the available production factors of labour and capital at normal capacity.

The percentage change in potential output therefore denotes an economy's trend rate of growth.

I am telling this even though I expect you will have already heard about it in one of your economics lectures, but you know, you can't always remember everything ...

Graphically, this change is usually illustrated as follows: a line shows trend GDP growth over time, while actual GDP sometimes grows faster and sometimes slower, which is shown by a cyclical curve along the trend line. If the potential output growth rate increases, the line becomes steeper, and if it decreases, the line runs flatter. The latter is what happens when demographic change takes hold.

Bundesbank economists estimate that demographically-induced trends in the potential number of hours worked are a major factor in the slowdown in potential growth: from a mean of almost 1¼% over the last five years to just over ¾% in the first half of the 2020s.

Now that doesn't sound all that remarkable, but in the long run, it will make a considerable difference to output, particularly since most other industrial countries, not to mention the emerging market economies, will be running at significantly higher trend growth rates over the coming decades.

According to a long-term OECD forecast for 42 economies, by 2060 not a single country will be growing at a slower pace than Germany, and this is mainly down to the demographically-induced decline in the number of hours worked. Per capita growth looks somewhat better because of the shrinking population, but here again, Germany ranks no better than mid-table compared with its European peers, according to the OECD.

Our economists' estimate of potential output I mentioned just now is based, then, on the best possible forecast of how the labour supply will develop in the years ahead.

Notable shifts in the composition of the labour supply will be evident within the space of just a few years.

The working-age population is a relevant factor for determining potential output. This labour force potential is defined relatively broadly, with ages ranging between 15 and 74.

Depending on which net immigration flows one assumes, this potential will pass its peak between 2020 and 2023.

Given cumulative net immigration of 2.5 million people, the labour force potential in 2025 will be roughly as high as today's.

The age structure will have changed considerably, however.

The number of people aged between 60 and 74 will have risen by more than three million, but the number of employed people will have increased by just one million, assuming that labour force participation in this age cohort remains unchanged.

By contrast, the 45 to 54 age cohort will have fallen by 3½ million. Because labour force participation is very high in this age group, the decrease will push down the labour force to almost the same degree. This can be blamed on the decline in the birth rate in the 1960s that I mentioned earlier, so it has long been expected.

Another population decline has been forecast, this time in the under-35 age cohort, though much of this particular effect will be offset by immigration.

Migrants tend, on average, to be far younger than the existing population. One out of two migrants since 2010 has been aged between 20 and 30 years old.

The strong influx of refugees to Germany in 2015 even caused the average age of the population in Germany to fall for the first time since reunification: from 44 years and four months to 44 years and three months.

Labour force participation will presumably continue to rise in certain age groups. Increasing the statutory retirement age should therefore see to it that the actual age when people retire goes up as well. The proportion of physically demanding jobs is also on the wane, so older people will be able to stay in work for longer. The "flexi retirement" scheme launched this year is also making it easier for retirees to earn additional income and thus encouraging them to keep working.

Yet another area offering potential is the participation of women in the labour force, where improved conditions for balancing work and family commitments have already sent participation levels sharply higher. The difference between the ratios of women and men in employment has more than halved within the space of two decades, and the higher the level of education, the narrower the gap between women and men.

However, there continues to be a much higher proportion of women who work part-time compared to men. Almost half of all women work part-time, compared with just one in ten men.

Because age cohorts with a stronger tendency to work part-time will be larger, the average weekly working hours per employed person are likely to decline slightly by 2025. The potential number of hours worked, then, is likely to be somewhat lower, and this will likewise drag on potential growth in the German economy.

The projected potential growth rate of just over 3⁄4% will originate primarily from productivity growth, where it is assumed that labour productivity will move at a less dynamic pace as demographic change makes itself felt. This means that productivity growth will mainly be propelled by technological progress.

One factor to be considered when it comes to labour productivity is that physical and cognitive capacities deteriorate after a certain age, though this can be offset by experience. As the saying goes: young people run faster, but seniors know the shortcuts.

Another factor is that as society ages, parts of the value added chain will shift from goods production to the services sector, moving chiefly into the long-term care sector.

This also tends to dampen productivity growth, however, because experience has shown that service providers are less productive than the production sector.

Of course, potential output depends not just on the number of hours worked and labour productivity, but also on capital investment, and at the end of the day, demographic trends also impact on fixed capital formation.

So the investment restraint observed in recent years might have something to do with the impending demographic change.

Put more simply: why should a company invest in new machinery if, looking ahead, it won’t have the employees it needs to operate this machinery? And wouldn’t it make more sense to invest in regions with more vibrant economies where the relevant end customers can also be found?

It’s also worth considering the German economy’s high current account surplus in a demographic context.

At €260 billion, Germany ran the biggest current account surplus in the world last year.

This was primarily down to the large surplus in the goods account. And yet you can also interpret a current account surplus as a savings surplus, as saving up abroad.

And for a rapidly ageing society like ours, that makes perfect sense: assets accumulated abroad by way of a current account surplus enable the German economy to share in what are potentially more dynamic economic developments in other countries.

Those external assets can be run down at a later point in time as more and more employees retire and draw on their savings. This is how Germans are providing for their old age.

But still, demographic trends can’t explain a current account surplus of over 8% of GDP. That needs to be stated quite clearly.

Other forces have been driving the surplus higher in recent years, above all the much lower oil price, which has diminished the cost of imports.

The jury is out on the extent to which Germany should embrace an activist policy stance to reduce this surplus. There have been repeated calls from abroad for Germany to adopt a more expansionary fiscal or wage policy, but Germany regularly sweeps them aside.

The Bundesbank also sees little logic in them, particularly since simulations show that measures designed to bolster demand in Germany would have negligibly small spill-over effects on countries saddled with chronic current account deficits.

A more prudent course of action would be to introduce policies that make Germany more investment-friendly. If businesses had incentives to boost domestic investment, this would act to temper the current account surplus, while at the same time increasing potential growth.

4. Consequences for economic policy

Which brings me to the concluding question: what can policymakers actually do to stem the decline in potential growth driven by demographic change?

As I pointed out earlier, improving the framework conditions for investment is a good place to start. Here I am thinking in particular about digitalisation, which holds many a promise – especially in the face of demographic change. As far as digital infrastructure goes, some countries are way ahead of us.

According to OECD figures, in 2016 only 2% of all broad-band connections in Germany were based on glass fibre technology, while the average was 20% in the OECD countries with the figures in Japan and Korea even exceeding 70%. The demographically-induced decline in the potential labour force can be counteracted by measures to further increase labour force participation.

Incentives to stop working early, such as the option to retire on a full pension at 63, are no longer in keeping with the times and should be phased out. At the same time, employers have to create suitable conditions and lay the right groundwork to enable people to actually work for longer. This includes measures for promoting health management or providing an appropriate workplace, for instance. We also have to commit to a culture of lifelong learning so that people can adapt more quickly and more successfully to an ever changing environment.

This would make it easier for employees who lose their job at 50 plus to find new employment. In times where specialised labour is in short supply, older employees should be held in higher esteem anyway – and I'm not just saying that because I am one of them.

The participation of women in the labour force can be increased by further improving conditions for balancing work and family commitments. Expanding the provision of all-day schools across the country would enable more women to work full time.

But that's not the only reason why investment in education is essential. When, in future, fewer young people join the workforce, it will be all the more important for them to be trained as well as possible. For this, we need an education system that meets high standards and gives young people the opportunity to realise their full potential.

By choosing to attend an internationally renowned business school, you, of course, have already heeded Benjamin Franklin's advice: "An investment in knowledge always pays the best interest."

But this does not just apply to investment in academic training. Studies have shown that educational achievement in Germany is still closely correlated with social background, and this also has a negative impact on subsequent employment prospects. Because educational achievement in later life is often decided to a significant degree at the pre-school stage, society as a whole would reap the benefits of investing in education for infants and pre-school students.

Education also plays a key role in the integration of immigrants.

But immigration is certainly not the answer to our demographic problems. Yet, it helps to curb the decline in the potential labour force. That is why a systematic approach to attract labour from abroad with the qualifications that are needed here would go a long way towards cushioning the impact of an ageing society on the labour market.

To sum up, it is essential that the German economy's current excellent condition does not blind us to the major challenges that lie ahead.

The demographic factor will increasingly take a toll on growth and welfare. Softening this blow, at the very least, will be a key task over the coming decades.

Thank you for your attention.

Fonte: Bank for International Settlements (BIS)

https://www.bis.org/review/r171120b.pdf

Jens Weidmann: Keynote speech - "Europe into a new era - how to seize the opportunities"

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the Frankfurt European Banking Congress "Europe into a New Era - How to Seize the Opportunities", Frankfurt am Main, 17 November 2017

* * *

1. Introduction

Ladies and gentlemen

Central bank communication can certainly be tricky. That is why Bank of Japan Governor Haruhiko Kuroda said three days ago, during an ECB conference on this very issue, that the message needs to be simple. "It should better be straightforward," he told the audience. "That's the best way."

As was also alluded to at the conference by moderator David Wessel, there might now be a new option that would allow Governor Kuroda to be taken at face value – in the truest sense of the word.

Artificial intelligence researchers claim to have found clues in the facial expressions of the Bank of Japan Governor. Supposedly, Kuroda showed "fleeting signs of 'anger' and 'disgust'" at news conferences that preceded changes in monetary policy in 2016.

This raises important questions: Can we now make monetary policy changes with the blink of an eye? And will botox injections be the only way to uphold the maxim "we never pre-commit?"

On a more serious note: Artificial intelligence is a fascinating subject, with wide-ranging implications not least for economics and finance. But today I will confine myself to more everyday matters for a central banker – matters which definitely also have wide-ranging implications for our monetary union.

"Restoring the European project", the title of the upcoming panel, calls for policymakers to live up to their respective responsibilities. What is required of monetary policy, national governments, and European institutions? In the next 15 minutes, I will try to briefly sketch out some possible answers to this question.

2. Monetary policy

Let me start by having a short look at the Eurosystem's monetary policy.

The Eurosystem's expansive monetary policy has contributed significantly to the recovery in the euro area. Growth rates have been positive for more than four years. The unemployment rate has almost been reduced to its pre-crisis average. And economic indicators all point to a continued economic up-swing.

In Germany, indicators now suggest even stronger growth than outlined in our June projection. Over the last four years, capacity utilisation has steadily increased. And since 2016, the economy is even running above capacity. The duration and strength of the current recovery is impressive, especially against the background of high political uncertainty globally.

Inflation, however, has not quite kept pace with the recovery. Price pressures are expected to remain rather subdued.

Multiple factors seem to be at play here. The recovery has certainly been aided by the fact that most of the crisis-hit countries have strengthened their competitiveness and turned their current account deficits into surpluses. But improving price competitiveness through wage restraint is, naturally enough, also dampening domestic price pressures.

This factor is euro area-specific. But price pressures have been subdued in other countries, too, in spite of very low unemployment rates. It seems that global factors are affecting inflation as well. Research at the Bank for International Settlements suggests, for example, that greater labour market contestability as a result of global value chains are putting a lid on wages and thus price pressures. [1]

Given the rather subdued inflationary pressure at present, an accommodative monetary policy stance remains appropriate in the euro area. But we must be attuned to the fact that the economic recovery has progressed further than inflation figures currently suggest, and that domestic price pressures will gradually increase in keeping with a path towards our definition of price stability.

This is why, in my view, a less distinct loosening of monetary policy in the next year and setting a clear end date for net asset purchases would have been justified – also against the backdrop of increasing risks and side-effects, the longer monetary policy remains ultra-loose.

Euro-area monetary policy will remain highly accommodative even after net purchases under the asset purchase programme (APP) have been discontinued.

First, what is crucial for the overall effect of the APP is not so much the amount of monthly additional purchases but, above all, the total outstanding volume of sovereign bonds on our books. And the APP stocks held by the Eurosystem will remain at a very high level even after net purchases have been discontinued, as the Governing Council of the ECB has decided to reinvest the proceeds from the maturing bonds.

Second, the Governing Council has decided not to raise interest rates until well after the net purchases have ended.

Setting a clear end date to net asset purchases would have merely meant refraining from pushing down on the accelerator even further – not putting the brakes on monetary policy.

One thing has to be clear in any case: As Mario Draghi has pointed out: Monetary policy alone cannot bring lasting prosperity for our economies. [2] That is the task of governments and parliaments.

3. Economic challenges in Germany

In the wake of the sovereign debt crisis, many member states indeed introduced far-reaching reforms which allowed swifter macroeconomic adjustment. Some of them led to a better labour market performance. And some improved competition, thus providing new impetus for innovation.

But more measures are needed, not least in Germany. The challenges Germany faces might seem more latent than those of other member states. But even if the consequences of an aging society might present themselves less abruptly than a sovereign debt crisis, the challenge is no less real. Without policy action, Germany's growth potential is expected to fall below 1% within the next decade due to the reduction in labour supply.

It would therefore be sensible to modify provisions that discourage participation in the labour market. To further support the participation especially of women in the workforce, continued investments in childcare remain imperative as well.

However, Germany's growth potential cannot be strengthened simply by limiting the losses in labour supply. Germany's economy also has to become more productive.

Here, digitalisation holds untapped potential. Studies show that removing bottlenecks in broadband connection can raise economic growth, as this increases competition and induces innovative products and processes. [3]

To be able to fully capitalise on the digital dividend, investments in skills and education are key. This would not only boost labour productivity, but also enhance job security. And this, in turn, would in my view be the most effective antidote to the feeling many have of being threatened by globalisation and technological progress, both of which are at the root of our economic prosperity.

By the way, even within the European Union there is not yet a common market for digital products and the single market for services still has to be completed.

4. Strengthening the euro area's resilience

Facing economic challenges head-on will not only prove a boon to citizens' prosperity: it will also raise the equilibrium real interest rate. And this will make the job of a central bank substantially easier, as it adds distance to the lower bound of interest rates.

But while raising growth potential in Germany and the other member states will go a long way towards strengthening the euro area, it is not the last word in making our monetary union more resilient.

When it comes to resilience, the question of risk sharing has to be addressed. How can shocks that hit individual member states particularly hard be cushioned?

In the United States and other large currency areas, shocks are spread through the distribution of business profits and losses throughout the currency area, because company owners are often resident in other states. The sharing of losses across state borders in the United States absorbs around 40% of an economic shock. [4]

Saving and lending could represent another channel of private economic risk sharing. Enterprises and households take out loans in different US states during an economic downturn to bridge a slump in earnings. In the United States, this type of risk sharing smoothes something like 25% of a shock. To some extent, this includes a contribution of the Federal Deposit Insurance Corporation to this form of risk sharing. In Europe, however, the conditions for putting in place a similar euro-area-wide deposit insurance mechanism are not yet met. I will come back to this point in a few moments.

By comparison, risk sharing through fiscal policy takes a back seat. Only between 10% and 25% of all risks are shared by a common fiscal policy in federations like the US or Canada. [5]

It is thus clear that much could be achieved in the euro area if cross-border corporate funding were strengthened, particularly in the form of equity capital.

A raft of measures would be needed to tear down the walls in European capital markets. Standardising national insolvency regimes is just one especially important step worth mentioning. After all, investors need to count on having the same level playing field throughout Europe. Not only would that promote private risk sharing; it would also reduce capital flows into less productive businesses and stimulate flows in more productive ones. That, in turn, would boost economic momentum, as a recent OECDresearch paper confirms. [6]

On a general note, the development of equity capital markets, including in Europe, is suffering from the preferential tax treatment given to debt over equity capital. [7]

Interest payments can be deducted from taxable income; equity costs cannot. Eliminating this bias would encourage businesses to make greater use of equity capital as a funding instrument. And that would facilitate greater private risk sharing whilst at the same time reducing the debt bias.

Another way in which risk could potentially be shared in times of crisis might be for enterprises and households to take out cross-border loans. Yet this mechanism hardly worked during the crisis in the euro area. Even worse: Depositors in crisis-hit countries lost confidence in their domestic banking systems and withdrew their deposits. Banks in the euro area also lost confidence in each other and reined in their lending.

The Banking Union was created in part to overcome the financial fragmentation triggered by the sovereign debt crisis. With its Single Supervisory Mechanism and rules on bailing-in creditors in the event of bank failures, the Banking Union bolsters the banking sector's resilience. This makes a loss of confidence in national banking systems less likely. And less danger of a fragmented financial system stabilises cross-border lending, particularly in turbulent times.

A common European deposit guarantee scheme could, in theory, even heighten this confidence. However, as with any insurance policy, one would have to make sure in this case, too, that the insurance does not encourage imprudent behaviour.

Such risks can arise from carelessly granting credit to the private sector. But they can also result from providing sovereigns with too much credit. Since the onset of the sovereign debt crisis, at the latest, we know that loans to general government are not risk-free either.

Banks in the euro area have a sizable share of sovereign bonds on their books. To insure euro- area bank risks in such a situation would be tantamount to insuring fiscal risks.

Given that the member states themselves still decide freely and independently on the level of government expenditure and taxes, this ultimately sets the wrong incentives: finance ministers would see less of a need to pay adequate attention to the sustainability of public finances.

The precondition for a European deposit insurance scheme, then, is that the size of government bond portfolios that banks hold on their books is limited. Loans to sovereigns should not be treated any differently from loans to enterprises or individuals.

Another precondition concerns the stock of non-performing loans in the European banking system. Insurance usually covers future damage, not damage that already exists. Hence, in order to be eligible for a common deposit insurance, banks in the euro area have to either fully provision for non-performing loans or divest them.

Non-performing loans not only constitute an obstacle to a common deposit insurance scheme. They also weigh on financing conditions and, ultimately, growth prospects in the member states concerned. Banks need to clear up existing non-performing loans. And we need to establish rules that ensure the prudent management of non-performing loans in the future as well. The proposals that were recently made by the ECB in this regard strike me as a sensible way forward.

5. Conclusion

Ladies and gentlemen

Let Me conclude.

After all, I would not want to evoke the feelings that a doctor once gave to a patient who craved immortality.

The doctor informed the patient that immortality was beyond the reach of medicine, but the patient was insistent: "Is there nothing I can do?" The doctor replied: "Well, there is one thing. You could marry an economist and move to North Dakota." "And that will make me immortal?" "No. But that way, even six months will seem like an eternity."

I thank you for your attention and wish you all a stimulating discussion.

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Fonte: Bank for International Settlements (BIS)

https://www.bis.org/review/r171120a.pdf