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Bundesbank warns corporate debt becoming overpriced

Claire Jones in Frankfurt

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Germany's central bank has warned that corporate debt is becoming overpriced and threatens the financial stability of Europe's biggest economy.

The comments from the Bundesbank come as the European Central Bank considers buying corporate bonds to expand its balance sheet and stave off the threat of economic stagnation in the eurozone.

"There are signs that the search for yield is leading to exaggerations in certain market segments," the Bundesbank said on Tuesday, adding that the effect was "clearly perceptible in the markets for corporate bonds and syndicated loans".

Economists from around the eurozone are investigating ways to swell the ECB's balance sheet by up to €1tn to help boost growth and inflation in the bloc.

One idea that officials are looking at is extending the central bank's asset purchases, currently limited to covered bonds and asset backed securities, to include corporate and sovereign debt. Many analysts expect policy makers to announce an extension in December or early next year.

But some economists and officials, including Mario Draghi, ECB president, have voiced concern that central banks' bond buying sprees have more of an impact on asset prices than economic activity. Jens Weidmann, Bundesbank president and member of the ECB's policy making governing council, is viewed as the staunchest objector to purchases of more public and private debt.

Claudia Buch, the Bundesbank's deputy president for financial stability, was cautious when asked about the degree by which corporate bonds were overvalued. "It's always a question of probabilities," she said.

The German central bank is particularly concerned about non investment grade, or so-called junk bonds, warning that yields on these assets were well below their historical average. Calculations by the central bank show yields on euro and dollar denominated junk bonds first fell below the 16 year average in 2011 and are now down at levels last seen in the run-up to the financial crisis.

The Bundesbank also said ultra low interest rates were weighing on German lenders' results.

"German banks' profitability remains structurally weak," the report said. "If interest rates remain depressed for the foreseeable future, banks' earnings could come under heightened pressure: higher yielding loans will then have to be rolled over into lower yielding loans, reducing income."

The ECB cut rates to their current record low of 0.05 per cent in September and started to charge 0.2 per cent on reserves held at the central bank for commercial lenders. Policy makers have signalled that rates will remain at that level until at least the second half of 2016.

Deposit rates at most German lenders are already near zero. But Andreas Dombret, the Bundesbank board member responsible for supervision, said on Tuesday he did not expect negative interest rates to be applied to the bulk of retail customers.

Commerzbank is the only big German lender to say it will charge large corporate customers for holding their deposits.

The Bundesbank reiterated that property prices in Germany's biggest cities remained overvalued by up to 25 per cent. The report said it was "striking" that in these cities a large portion of mortgages were for amounts bigger than the property's value as collateral.

"This points to structural vulnerabilities in the German banking system to urban real estate risks," the report said.

While Ms Buch said there was "no immediate need for action", the deputy president said policy makers had to be prepared to act, possibly through "macroprudential" tools which allow officials to ban mortgages with high loan to value ratios.

The Short View

November 24, 2014 6:45 pm

ECB in a quandary on asset purchase programmes

James Mackintosh

Buying gold might be ECB's most politically acceptable form of large-scale quantitative easing

Switzerland votes on Sunday on whether to force its central bank to more than double its gold holding to a fifth of reserves, and ban it from selling the bullion.

The policy is barmy and would kill the Swiss National Bank's efforts to offset demand for the safety of its currency by printing money on a Zimbabwean scale.

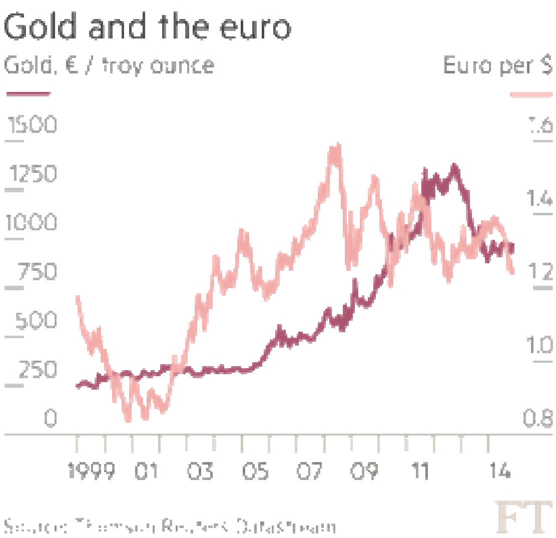
But 200 miles north, the idea of buying gold might usefully be deployed by the European Central Bank, as the most politically acceptable, if least effective, form of large-scale quantitative easing.

Mario Draghi, ECB president, made clear last Friday that further action is needed: the "more broad-based asset purchase programme" he said in April could defend inflation expectations. This Friday, eurozone inflation is expected to drop to just 0.3 per cent, far from the 2 per cent goal.

The problem is what the ECB should buy. It is already loading up on covered bonds and asset-backed securities, which have the advantage of helping banks. But not enough of them exist to give a big boost to the money supply – and even these attracted the ire of Germany's Bundesbank. Corporate bonds are a possibility, but carry even more of the credit risk the Bundesbank worries about.

Purchases would also favour larger companies able to issue bonds. Sovereign bonds are the most obvious, as in UK and US QE. Lots are easily available, but Germany is – rightly – worried about reducing the financial pressure on peripheral countries to reform. Legal issues are serious, too.

I suggested a while ago that the ECB should buy US Treasuries, boosting the money supply and weakening the euro. It would work, but Congress would surely be furious at such obvious currency manipulation.



Gold is an option that should appeal to German conservatives. It has few drawbacks, as it is basically pointless. Only $20bn or so a month is traded, so if Mr Draghi fired a €1tn golden bazooka the price would go ballistic. Busta Rhymes fans would find chunky golden necklaces more expensive, and jewellers would complain. Gold mining would benefit. Ironically, goldbugs who hate central banks would be the biggest winners.

But these distortions are small in the fight to avoid deflation and eventual debt restructuring in the eurozone.

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