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Navigating an uncertain and challenging environment

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The crucial fiscal response to the outbreak of the COVID-19 pandemic led to significant increases in public debt levels among EMU member countries. The fiscal measures adopted since 2022 in response to energy and food price inflation have also contributed to maintaining the expansionary stance of this policy. Tighter monetary policy is increasing the cost of new public debt issuance, although its pass-through to the average cost of outstanding debt has been relatively slow due to the earlier lengthening of public debt maturity.

In any case, high public indebtedness represents a key vulnerability in the EMU, as it elevates cost sensitivity to potential new financial shocks and limits the fiscal space available. Thus, in 2024 European fiscal policies should generally adopt a tighter stance, within the new fiscal framework agreed by the Ecofin in December 2023.

Amid high inflation and rising interest rates, the debt servicing capacity of European households has been sustained by resilient employment, the recovery in real wages and the savings built up during the pandemic. In the case of non-financial corporations, the deleveraging in some countries following the global financial crisis (GFC) and the recovery in mark-ups after the pandemic have also helped to sustain their debt servicing capacity.

However, debt service-to-income ratios are being pushed upward and pressure could mount if downside risks to GDP materialise. Monitoring these risks remains a priority for financial stability authorities, even though markets are projecting lower interest rates.

At its meeting on 22 September 2022, the General Board of the European Systemic Risk Board (ESRB) pointed to the need for credit institutions to implement sound provisioning practices and capital planning and for EU and Member State supervisory authorities to monitor and address vulnerabilities, in close collaboration with each other and availing themselves of the full range of micro- and macroprudential tools. Since the ESRB issued its warning, very few of the identified risks have materialised, but the financial stability outlook is still uncertain and the warning remains relevant.

Over the period 2022-2023, the ESRB also adopted three recommendations on medium-term vulnerabilities in the residential real estate sectors of some countries, along with a

general recommendation, adopted in late 2022, on vulnerabilities in the commercial real estate sector in the European Economic Area.

The ESRB has arguably acted in an overarching, proactive and pre-emptive manner, within its mandate, in response to an environment marked by extraordinary uncertainty. In terms of delivering on its mandate, the current ESRB organisational model has proved equal to the challenge.

Turning to the broader issue of the sufficiency of the macroprudential framework in Europe, one aspect that stands out is the asymmetry in the tools available for banks and for non-bank financial intermediaries (NBFIs). The importance of NBFIs, from the perspective of systemic risk, has grown significantly since the GFC. As the ESRB warning also points out, prudential authorities must ensure they have the right macroprudential toolkit for each sector.

The recent period has been shaped by significant exogenous shocks to the financial system (e.g. the COVID-19 pandemic and the war in Ukraine). These have brought to the fore the discussion of whether to increase “macroprudential space” even beyond what would be necessary to address homegrown financial imbalances. It is argued that this could be achieved via a “positive neutral” countercyclical capital buffer (CCyB) rate, one that would be activated not only in times of excessive credit growth but also in normal times. Still work to do about the coordination of the conditions under which activation or release would take place. So far, activation of the CCyB rate is evaluated and determined nationally, but the ESRB can certainly play a helpful role by supporting and complementing the technical work undertaken by national authorities and acting as a hub for sharing experiences and identifying best practices.

Finally, the build-up of risks in the real estate sectors of several EU countries also prompted the ESRB to recommend the development of common European standards for borrower-based measures. These macroprudential tools, available under the national regulations of most countries, help to bolster bank customer resilience and banks.

We need to consider whether common European criteria should be established for the design of such macroprudential tools, including to determine when and how they can be used.