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Monetary policy and financial stability*

Speech based on the closing address delivered at the UIMP seminar "The new economic model"

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* Translation of the original in Spanish.

Thank you for your introduction, Miguel Ángel. Once again, it really is a pleasure to participate in the closure of this seminar organised by APIE at UIMP.

This is the third time I have attended this forum as Deputy Governor of the Banco de España. Since the last occasion, you will agree with me that one of the key developments in the euro area, in addition to the start-up of the Single Supervisory Mechanism and the Greek crisis, has been the continuous easing of monetary policy. Interest rates have fallen to levels not previously seen and the ECB has resorted to relatively unconventional instruments, although these had already been used in other jurisdictions.

These measures must be understood against the background of the weak economic growth and the significant risks that inflation would hold at levels not consistent with price stability. Indeed, the ECB's actions are already proving effective in sustaining growth and shoring up the stabilising nature of its policy.

At the same time, it is true that the indefinite maintenance of interest rates at very low levels – even with negative figures in certain financial transactions – might ultimately prompt certain undesirable effects on the functioning of the economy and, potentially, generate certain risks to financial stability. Accordingly, against a backdrop of extreme monetary looseness, close monitoring is required as regards the effects on both the real economy and on the financial system.

I should like to develop this idea further today. To do so, I shall review the monetary policy of the main central banks in response to the financial crisis, with particular attention to the ECB; I shall then analyse the attendant effects on the economic and financial outlook; and finally, I shall discuss some of the challenges this policy entails for the Spanish financial system.

1 The emergence of non-standard monetary policies

During the early stages of the global financial crisis that brought the "Great Moderation" to an end, making way for the "Great Recession", the reaction by the leading advanced economies' central banks was substantially uniform. The initial bouts of tension translated into a rapid and widespread loss of confidence in the soundness of banks, making the proper functioning of interbank markets impossible. A vital channel in the redistribution of liquidity among banks was thus blocked.

The central banks of the main developed economies had to adopt extraordinary measures to combat the clogging-up of this channel. The ECB was a pioneer in its response to these dysfunctions and many of its initiatives were later followed by other monetary authorities. Its measures initially took the form of massive liquidity injections, fully meeting as from October 2008 the demand for funds by banks in its regular operations, extending the term of loans over progressively longer horizons (they were extended up to one year in summer 2009) and providing readier access to Eurosystem loans through the easing of collateral eligibility requirements.

As a result, central banks ultimately met not the net liquidity needs of the system as a whole, as they do in normal circumstances, but rather – largely – the gross funding requirements of each individual bank.

As the crisis progressed, the drastic contraction in global demand brought about by the financial turbulence, the freezing of financing flows and the emergence of the first signs of deflationary risks made it necessary for the monetary authorities to undertake further measures.

As regards conventional monetary policy, the main central banks opted for official interest rate cuts, taking them to historical lows. In the case of the euro area, interest rates fell by over 300 basis points to 1% in scarcely seven months from October 2008 to May 2009.

But as official interest rates drew closer to zero, central banks had to resort to other less conventional types of tools to provide the monetary boost that the seriousness of the situation required.

Central banks thus resorted to large-scale asset purchase programmes, which were successively amplified until the economic recovery showed signs of firming. Such quantitative easing, as it is known, seeks – once the scope for reducing short-term interest rates has been exhausted – to influence more directly the yield on government and private instruments in the medium and long term, these being relevant for agents' spending decisions.

The non-standard measures also extended to the communications area. Pursuing a policy dubbed "forward guidance", central banks began, on a regular basis, to emit explicit indications about the future course of official interest rates or about other non-standard measures. The aim of such guidance is to entrench agents' expectations and enhance the pass-through of the measures adopted to the interest rates prevailing on other markets.

In the specific case of the ECB, its asset purchase programmes had, until mid-2014, been more restrictive in nature than those of other central banks, regarding both scale and the classes of assets acquired. Indeed, its purchases were chiefly aimed at private securities, often issued by banks themselves or by bank asset securitisation vehicles.

In the second half of 2014, however, weakening demand and a series of negative surprises concerning the evolution of prices in the area began to pass through to medium-term inflation expectations, which showed growing risks of disanchoring. In this scenario, one clearly diverging from that in the United States or the United Kingdom, the ECB had to deepen its expansionary monetary policy stance which, in this way, differed from that pursued by the US and UK central banks.

In this connection, the ECB once again cut its official interest rates, lowering its MRO rate to its effective lower bound and actually taking that on the deposit facility into negative territory. Further, in June 2014, it introduced a new longer-term refinancing operation (up to 4 years) tied to the granting of loans to the private sector, and it stepped up its forward guidance strategy, announcing in November that same year its intention to expand the size of its balance sheet to the maximum levels attained in March 2012.

To achieve this, the ECB's extended its asset purchase programmes to include acquisitions of securities issued by the public sector, a measure that was announced on 22 January this year. Since March, the ECB has been acquiring public- and private-sector assets for a value of around €60 billion per month. The Governing Council intends to prolong these purchases at least until September 2016 and, in any event, until inflation has resumed a path consistent with the medium-term inflation objectives.

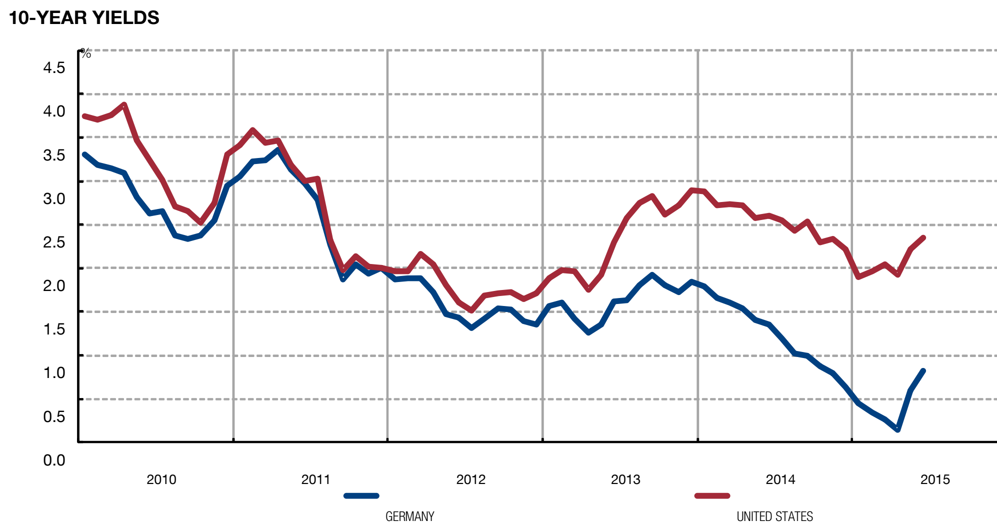
2 The macroeconomic effects of the ECB's non-standard measures

The effects of the measures adopted by the ECB operate through different channels. Although the latest measures have not yet had time to deploy their full potential, the evidence available suggests that several of these effects may already be beginning to arise.

Firstly, the asset purchase programmes are exerting a direct effect on the prices of the securities acquired. One of the first signs of the ECB's quantitative easing programme was the reduction in long-term government bond yields, and this despite the fact that, unlike in other areas, the application of quantitative easing in the euro area came about when these yields were already very low in some of the Member States.

German government bond yields, for instance, turned down with an intensity that few had anticipated, posting negative figures for all terms shorter than 6 years. In fact, 10-year Bund yields reached levels below 0.10%. In recent weeks, long-term interest rates have risen to higher levels, which is more in keeping with the foreseeable course of growth and inflation in the euro area (see Chart 1).

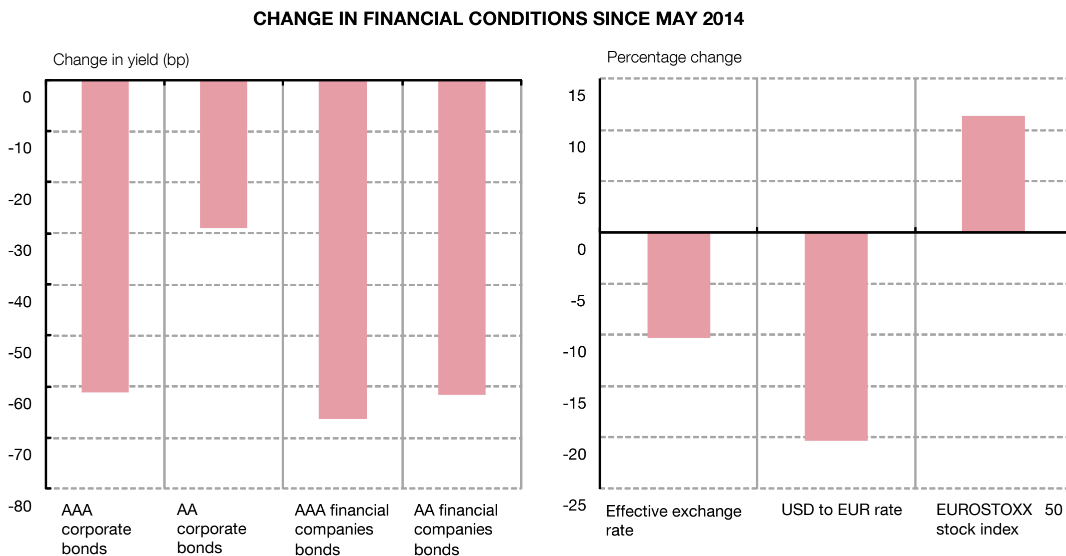
Chart 1: Sovereign debt yields



Source: ECB and Banco de España

In addition to the direct effect on long-term government bond yields, the large-scale asset purchase programmes trigger a private-sector portfolio reallocation, whereby the cuts in rates favour an appreciation of other instruments, such as corporate bonds and listed shares, and the depreciation of the exchange rate. These effects are also already visible in the euro area (see Chart 2).

Chart 2: Portfolio reallocation (prices of other financial assets)

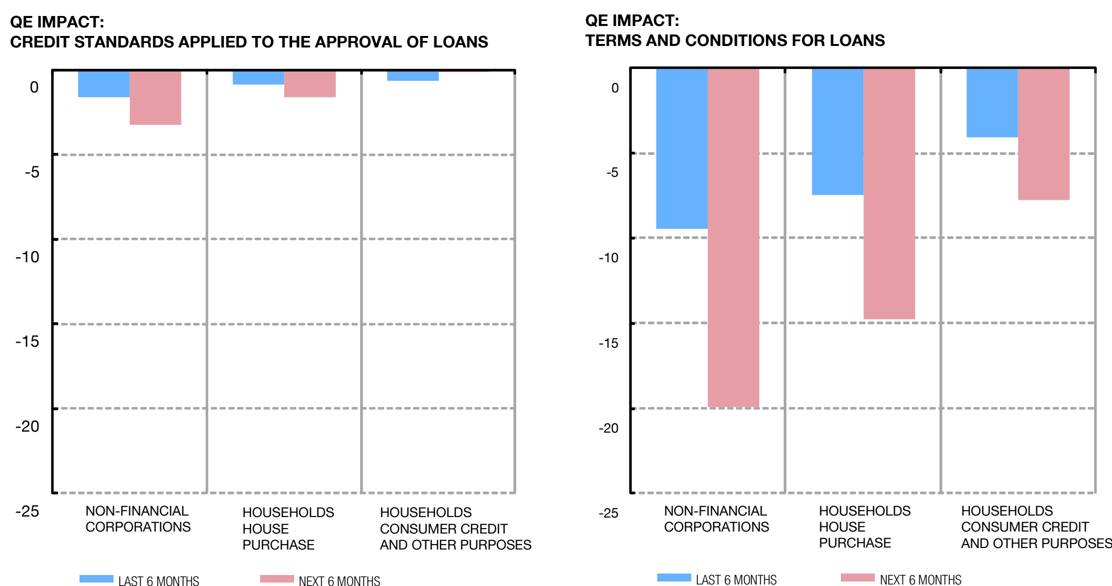


Sources: ECB, Datastream and Banco de España

Change from May 2014 to June 2015

When the rate cuts become extensive to bank financing conditions, they activate a credit channel which, in short, makes for less burdensome financing conditions for households and firms. The latest wave of the Bank Lending Survey regularly conducted by the Eurosystem central banks to monitor credit supply and demand conditions in the area shows that, both in terms of prices and amounts, these conditions are already responding positively to the ECB's asset purchase programme (see Chart 3).

Chart 3: Loan approval standards and conditions



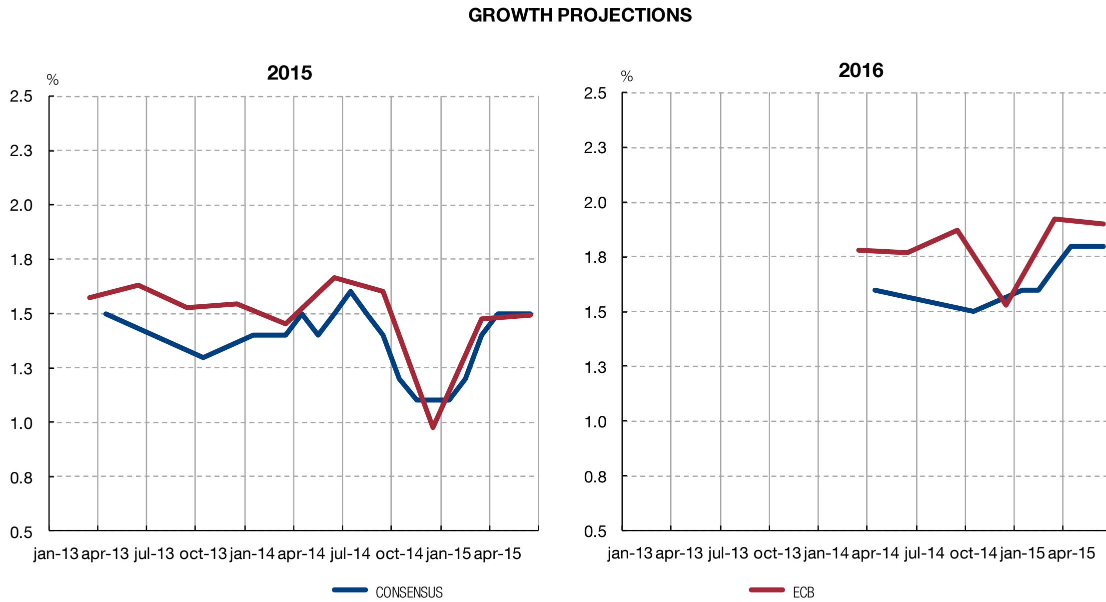
Source: ECB, April 2015 Bank Lending Survey.

Negative values denote an easing in standards and conditions in the period indicated.

All these effects on the prices of financial assets and agents' financing conditions stimulate economic activity and inflation expectations, although the degree of uncertainty associated with the calibration of these stimuli is considerable according to the empirical literature available.

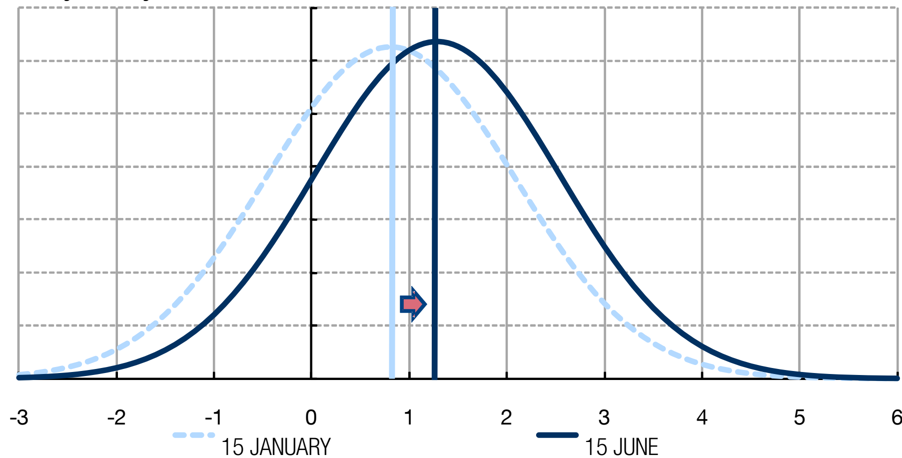
Since the programme was announced in the euro area, most international agencies and private analysts have significantly revised their growth forecasts upwards (see Chart 4) and the declining trend of medium-term inflation expectations has been checked; indeed, they have begun to turn upwards (see Chart 5). Though still some distance off the 2% reference, this change in trend is essential for moderating long-term real interest rates and, thereby, contributing to a greater expansion in private spending.

Chart 4: Euro area growth forecasts



Sources: Consensus Forecast and ECB

Chart 5: Medium-term inflation expectations



Sources: Reuters and own calculations

Probability density function for two-year inflation expectations within two years estimated on the basis of inflation options and swaps

3 Implications for financial stability

Like any other economic policy action, monetary policy actions also have effects on variables other than those that policymakers wish to influence.

Recent papers have analysed, for example, the potential effects of the asset purchase programmes on the distribution of income. They warn that by favouring the appreciation of such assets, these programmes tend to improve the financial situation of agents who have larger holdings of these instruments, who generally are those with higher incomes.

However, I think it is difficult to draw conclusions on such a complex question without adopting a sufficiently broad perspective. The direct effects on individuals' portfolios cannot be assessed without also considering the eventual effects of the programmes on growth and inflation and their different consequences for each group of households and companies. By way of example, higher inflation will tend to benefit more indebted agents to a greater extent. In the case of Spanish households, it has been precisely the lower-income ones that have been affected to a large extent by problems of over-indebtedness.

Here, however, I wish to focus on the possible effects of central banks' expansionary measures on financial stability. First, it should be noted that economic stability and financial stability are, in the medium term, inseparable objectives, and it is not possible to have one without the other. Indeed, price-stability-oriented central bank policies are conducive to the sustained growth that is essential to ensure the stability of the financial system.

The undesired effects that may arise in the short term are another matter. These are associated with the instruments deployed to pursue the fundamental monetary policy objective, such as interest rate changes.

In fact, there is evidence in the literature that extremely low interest rates, like those currently prevailing, tend to encourage investors and financial intermediaries to search for yield, which, in this context, may lead to excessive risk assumption and an inefficient allocation of resources.

It has also been argued that low interest rates tend to delay the deleveraging and clean-up of the balance sheets of over-indebted businesses, households and financial institutions.

A prolonged period of very loose monetary and financial conditions may, on the other hand, generate asset price bubbles, affecting both financial and real assets and, in particular, real estate.

Continuing down the list, a low interest rate environment also poses challenges for certain specific financial sectors, such as life assurance companies and pension funds. For example, as the stress tests recently conducted by the European Insurance and Occupational Pensions Authority (EIOPA) have illustrated, low interest rates may generate imbalances between the yield of the assets, which depends on the level of interest rates, and the cost of the liabilities, when the latter is determined by pre-defined benefits.

Finally, when interest rates are no longer merely low, but actually in negative territory, new challenges emerge as a result of changes in agents' payment customs and in the very nature of banking business. In the limit, cash, which offers a zero nominal yield (without taking into account mobilisation and storage costs) would eventually dominate other alternative financial instruments, if the latter persistently offer yields significantly below zero.

All these potential risks to financial stability require attention. At the moment, however, there is no evidence that they could be reaching significant levels in the euro area. That is the conclusion to be drawn, for example, from a review of the early warning indicators regularly compiled by the Bank for International Settlements (BIS) and the IMF. Property prices, credit growth and, even less so, investment show no signs of imbalance. Nor do

the cyclically adjusted price-earnings ratios in stock markets show any significant deviation from their historical averages.

The risk warning is especially low in the case of Spain. The long recession and the adjustments in real-estate prices, in private indebtedness and in banking solvency have very significantly reduced the risk of macro-financial imbalances that could disturb financial stability in the short term.

4 The actions required

All told, the expectations that interest rates will stay low for some time make it advisable not only to remain vigilant to the evolution of these risks, but, as a precautionary measure, to reflect on the actions needed to mitigate them and minimise their impact if they do arise.

From this perspective, it is important to remember, first, that we cannot immediately deduce from the fact that low interest rates stem from monetary policy that the response to the emergence of any of these risks to financial stability must necessarily be an immediate change in the central bank's policy. The ECB has a mandate, which is to achieve and maintain price stability, and this mandate is not conditional.

In an environment like the present one in the euro area, the low level of inflation expectations and the limited buoyancy of aggregate demand justify the maintenance, over the foreseeable horizon, of an expansionary monetary policy.

Accordingly, the prevention of risks arising from the looseness of financial conditions requires the use of other economic policy instruments, such as those in the macro-prudential area. These policies aim to affect the decisions of agents (households, firms and financial intermediaries) in order to prevent the emergence or growth of macroeconomic imbalances that may damage the stability of the financial system as a whole.

The availability of macro-prudential policy tools at the national level is especially important in currency areas, like the euro area, in which monetary policy measures aiming to achieve price stability in the area as a whole may generate macro-financial imbalances in particular jurisdictions.

However, the task is not an easy one. Macro-prudential policy has a broad and less clearly defined objective than that of other economic policy areas. Thus, while micro-prudential policy clearly seeks to ensure the solvency of financial institutions, the aim of macro-prudential policy is twofold: first, it seeks to strengthen banks' capacity to withstand specific macro-financial imbalances, such as the generation of asset price bubbles; further, it aims precisely to mitigate the build-up of these imbalances. Identifying the end-objective is essential when it comes to determining the instruments to be used and correctly evaluating their effectiveness. Also, as they are of recent standing, work has still to be done to fully understand the interactions between macro-prudential policy and the other economic policies, whether monetary, fiscal or micro-prudential.

The prudential regulations in force encompass a significant range of instruments that may be used with a macro-prudential approach by both the national and European authorities. I refer here to the countercyclical capital buffer or to that established to withstand systemic risks. The European Regulation also offers the possibility of making the risk weightings of specific exposures more stringent for reasons of financial stability, along with the introduction of specific quantitative limits to avoid excessive risk concentrations.

In Spain, the competent authority for activating the available macro-prudential policy instruments in the banking area is, under the pertinent regulations, the Banco de España. Following the experience of other central banks, it is currently designing an analytical framework for the regular assessment of potential risks to financial stability that might give rise to the activation of one or more of the instruments mentioned.

In any event, the creation of a Macro-Prudential Board – in line with the recommendations of the European Systemic Risk Board (ESRB) – has yet to be finalised. This Board, on which the ministries and supervisory agencies involved would sit, along with the central bank, would assess, from a broader perspective, the outlook for the maintaining of financial stability and would formulate the appropriate recommendations to those responsible for activating the measures deemed suitable.

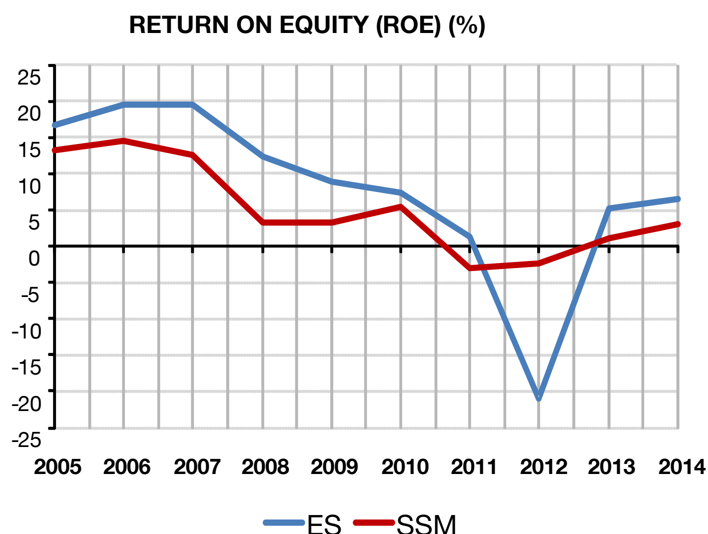
5 A challenge for the short term: banking industry profitability

That said, one of the key challenges arising in the short term from continued low interest rates is the direct effect these have on profitability in the banking industry and, therefore, on banks' ability to pursue their business of intermediation of financial flows in the economy in an appropriate manner.

In view of the asymmetry existing in the ability to pass lower market interest rates through to banks' loans or deposits, banks' financial margins tend to narrow considerably when market rates fall as sharply as they have in recent years. This effect exacerbates the adverse effect of weak credit demand on banking sector profits, in a setting characterised by the relative sluggishness of the main economies, despite the recent improvement observed, and by the necessary process of deleveraging by households and firms.

In effect, the average return on equity in the banking sector in the euro area, which was negative in 2011 and 2012, barely rose above zero in 2013. As a result of the moderate recovery in net interest income and lower impairment losses arising from the cyclical upturn, in 2014 the average ROE rose slightly, although not enough to end above 3%. This is still well short of the pre-crisis rates, which were generally in double digits, when profits were more than double their current figures and capital was 30% lower. Given that the cost of capital could reach around 10% it is clear that profitability must improve, to allow banks to attract the funds that the growth in lending and the new regulatory requirements demand.

Chart 6: Return on equity (%)



Source: Banco de España and SNL.

The Spanish banking industry's results were admittedly somewhat better than average in 2014, with return on equity at around 6.5%. This is partly a consequence of the improved efficiency indicators associated with the consolidation and restructuring efforts made in the sector in recent years. But there is no room for complacency at Spanish banks. Indeed, a large part of the industry's profits in 2014 came from non-regular financial operations.

Naturally, as indicated, the low rates of return are largely owing to cyclical factors which are, by their very nature, temporary. Moreover, although low interest rates have a direct adverse impact on profitability, this effect is offset by their expansionary influence on the real economy, the demand for funding and credit quality. However, in addition to cyclical factors, there appear to be a number of more permanent factors that could result in net interest income remaining low for some time.

For example, interest rate levels could be affected by secular trends such as population ageing, the slowdown in productivity and the necessary correction of high indebtedness that tends to encourage saving and depress investment, exerting downward pressure on the expected path of real interest rates in the medium and long term.

Further factors are the tightening of prudential regulations and the effects of the introduction of new legislation aiming to ensure high loss-absorbing capacity for banks in the event of resolution. All this will doubtless make institutions safer and will clearly reduce the likelihood of systemic crises and their associated costs. It is also evident that it will tend to penalise activities that entail higher risk, which are often more profitable, and to increase wholesale funding costs for banks, insofar as it reduces the implicit public subsidy traditionally associated with banks' liabilities at systemically important institutions.

Accordingly, restoring sustainable profit levels that will ensure the viability of the business in the medium term may require, depending on each case, significant strategic

adjustments at some banks. In this respect, the following three areas at least should be reviewed.

First, a reflection is in order as to whether the commercial banking sector can continue to base the bulk of its income generation on the loan-deposit gap. In the present setting, it seems reasonable to expect greater value generation from the provision of transactional or management services that can be directly remunerated through the relevant fees and commissions.

Second, the cost-cutting efforts must continue. In particular, despite the cutbacks in recent years, office density in the Spanish banking sector is still much higher than the European average, as the result of a business model that traditionally placed great emphasis on proximity to the customer. The introduction of new technologies should permit efficiency gains by further cutbacks in the number of points of sale, without substantially altering the existing proximity model.

Lastly, and in view of the current competitive environment, it seems logical that banks' corporate strategies envisage the possibility of operations being undertaken that will allow them to take more advantage of the economies of scale that can be seen at the national or European level. In this respect, the introduction of a common European banking framework, with the start-up of the single supervisory mechanism and the gradual disappearance of barriers to banking integration at the European level, entail a new operational framework for banks to consider when defining their strategies.

At the same time, although the degree of consolidation in the industry has increased significantly in recent years, there could still be some margin in Spain for mergers and acquisitions that would generate value for the shareholders of the banks concerned and enhance the efficiency of the banking sector in general.

6 Conclusions

To conclude, I believe the recent ECB measures have been effective in containing the risks of the euro area becoming mired in a situation of prolonged and potentially deflationary economic slackness.

Undoubtedly, monetary policy, in acting to help preserve economic stability, has also contributed to maintaining financial stability, as the former is essential for ensuring that household, business and banking finances remain sound.

Admittedly, extremely low interest rates over a long period of time may give rise to certain adverse effects. Although these effects are still far from being a cause for concern for our economy, we should make sure we have the appropriate economic policy tools – such as macro-prudential policy – at the ready should they prove necessary. Likewise, the agents most directly affected by low interest rates, such as financial institutions, should duly adjust their business strategies to adapt to the new economic environment.