BANCO DE ESPAÑA
Eurosistema

24.05.2017

The interaction between monetary policy and financial stability in the euro area

First Conference on Financial Stability/Banco de España-CEMFI

Mario Draghi,
President of the ECB

Introduction

Price stability and financial stability are inherently interlinked. They tend to be mutually reinforcing, and in the long run each is a necessary, albeit insufficient, condition for the other. As the crisis showed, periods of heightened financial turbulence can impair the transmission mechanism of monetary policy. Similarly, the failure of price stability – periods of deflation or hyperinflation – has also been accompanied in the past by periods of financial instability.

These interactions have been visible in the euro area during the crisis. The combined effects of the financial and sovereign debt crises resulted in a protracted period of low growth and low inflation. The severity of the recession in turn contributed to episodes of financial turbulence. By 2014, it had left its mark in the form of a very challenging situation both for price stability and financial stability in the euro area. Accordingly, the policy response has involved decisive action aimed at both policy domains.

The ECB has taken a series of unconventional measures to enhance the transmission of monetary policy and secure its mandate. Important changes have also been made to the policy framework for financial stability in the euro area. Together, these actions have been instrumental in stimulating and sustaining the economic recovery while limiting the possible side-effects of unconventional policies. They have enabled a longer period of low interest rates unmarked by any significant negative side-effects on financial stability.

Policy responses to the crisis

The crisis in the euro area has been characterised to a large extent by feedback loops between the financial and real sides of the economy. In the early phases of the crisis, we witnessed a severe disruption in the transmission of monetary policy in parts of the euro area as the interbank market fragmented along national lines. Later, as the economy deteriorated, a number of national banking sectors saw a sharp increase in non-performing loans and, in some, the macroeconomic situation created a strong incentive to deleverage by reducing lending.

The ECB took a number of measures to respond to financial fragmentation within the euro area. But by the start of 2014, the provision of bank credit to the real economy had dried up, shrinking at an annual pace of 1.7% in the first quarter. The euro area found itself in a vicious circle: as credit tightened, the economy worsened and risk perceptions rose, causing credit to tighten still more. The economic outlook at the time was marked by the risk of a further recession and potentially even deflation – a combination that would likely have resulted in worse outcomes for financial stability.

So in 2014 and thereafter, the ECB took further decisive action to counteract these forces and comply with its price stability mandate. We introduced a number of unconventional measures including negative deposit facility rates, targeted longer-term refinancing operations (TLTROs) and an expanded asset purchase programme. These measures – known as our “credit easing” package – were aimed at combating the impairment of the transmission mechanism caused by bank deleveraging, and thereby ensuring the even transmission of our policy decisions across all euro area countries and along the yield curve.

But at the same time as these measures were being deployed, two important regulatory changes took place which had profound implications for financial stability. The more resilient financial system in turn bolsters the ability of monetary policy to achieve its price stability objective.

First, in 2014 the Single Supervisory Mechanism (SSM) Regulation came into force, under which the ECB became responsible for the direct supervision of significant credit institutions in the euro area. This has helped produce a more resilient financial system than in 2014, with higher capital ratios and lower leverage. Indeed, one of the first steps of European banking supervision was to perform a "health check", namely a Comprehensive Assessment of bank balance sheets. The announcement alone of the Comprehensive Assessment encouraged banks to frontload their deleveraging and strengthen their balance sheets, by over €200 billion in advance of the outcome.

The second important regulatory change was the SSM Regulation conferring macroprudential powers and responsibilities upon the ECB. Macroprudential measures are now a shared responsibility between national authorities – which have the power to implement them – and the ECB, which has the power to tighten the measures set out in the EU legal texts (i.e. in the Capital Requirements Directive IV and the Capital Requirements Regulation).
The ECB can therefore counter any inaction bias if national authorities do not take adequate and prompt actions to implement macroprudential measures. It can lead analysis of cross-border effects, helping to avoid cross-border arbitrage and spillovers via large and interconnected banks. And it can promote a common basis for analysis, the sharing of information and the adoption of best practices, contributing to the consistency and coordination of macroprudential policies across the SSM area.[1]
This new policy framework supports both the implementation of our monetary policy and helps build resilience in the financial system. Financial and business cycles can potentially be de-synchronised, meaning financial imbalances can grow in an environment characterised by relatively muted inflation. And in such an environment, the use of monetary policy to counteract financial imbalances may not be optimal, since it may result in substantial deviations of aggregate output and inflation from their desirable levels. In this situation, macroprudential policy, addressing financial imbalances, can complement the long-run objective of monetary policy.[2]

The unconventional monetary policy measures and the improvements to the regulatory architecture have put the euro area banking system in a stronger position to transmit the ECB's credit impulse to firms and households across the monetary union and to ensure sufficient financing to sustain the recovery – which is exactly what we have seen. In the first quarter of 2017, annual loan growth to euro area households stood at 2.6% and non-financial corporations at 1.6%, up from respective troughs of -0.6% in the second quarter of 2014 and -3.6% in the third quarter of 2013. Bank lending rates for both firms and households have dropped by around 110 basis points over the past three years and are now at historical lows.

As a result, the euro area is now witnessing an increasingly solid recovery driven largely by a virtuous circle of employment and consumption, although underlying inflation pressures remain subdued. The convergence of credit conditions across countries has also contributed to the upswing becoming more broad-based across sectors and countries. Euro area GDP growth is currently 1.7%, and surveys point to continued resilience in the coming quarters. [3]

Challenges for financial stability in the current environment

With the resilient recovery underway, the tone of the debate in Europe surrounding financial stability has shifted. Some have expressed concerns that monetary policy measures are having unwanted side effects on financial stability. This is not a new subject for academics or central bankers: monetary policy *always* has side effects. But the use of unconventional measures by central banks has generated greater awareness of the issue.

Of course, the monetary policy measures taken in recent years can have *positive* side effects on financial stability. Lower interest rates across the curve reduce the debt-servicing costs of households and businesses. Furthermore, by sustaining the recovery and the consequent lower unemployment, monetary policy bolsters the earnings of households and businesses, reducing the likelihood of default, which in turn supports bank profitability.[4] Banks also benefit from capital gains on assets held, and from a short-term reduction in overall funding costs. Finally, banks accessing the Eurosystem funding via the TLTRO-II can borrow at rates as low as the deposit facility rate, provided that they exhibit strong performance in loan origination.

Yet the current environment also suggests that close monitoring is necessary in the following three areas: the effect on **risk-taking** in bank lending, the impact on bank **profitability** and the impact on **institutional investors**.

The so-called risk-taking channel of monetary policy transmission is where changes in interest rates may also affect banks' incentives to bear risks.[5] In particular, low interest rates may lead to a search for higher yields, encouraging banks to soften their credit standards, thereby increasing both the volume and average riskiness of supplied loans.[6] If credit growth and additional risk-taking became excessive, this could lead to a build-up of imbalances and endanger the stability of the financial system.

Of particular concern is the development of so-called credit-fuelled bubbles, which previous experience has shown to be particularly detrimental to financial stability.[7]Such bubbles, which typically plague real estate markets, are characterised by an adverse spiral between asset price and credit growth. Positive growth in the market value of real estate supports credit growth, which at the same time contributes to inflating the value of real estate. When the resulting bubble bursts, the collateral underlying the credit loses value, impairing the lending and borrowing ability of lenders and borrowers, respectively.

The second challenge arising from the current environment is that a reduction in the spread between short and long-term rates may compress banks' net interest margins and thus exert pressure on their profitability. Since banks carry out maturity transformation by borrowing short and lending long-term, both the slope of the yield curve and its level matter for profitability. This, in turn, could reduce their accumulation of capital via retained earnings and make them more fragile.

Finally, the protracted low interest rate environment also puts pressure on the profitability of financial institutions that provide long-term return guarantees, such as life insurance or pension funds. To meet their challenging return targets, such institutions could be prone to engage in search-for-yield behaviour and take on excessive risks.

Monitoring financial stability developments

Our current assessment is that there is no widespread emergence of imbalances, but there remain some localised areas that require continued close monitoring and vigilance.

In keeping with our institutional framework, macroprudential policy has been appropriately active in mitigating the build-up of risk in these localised areas. In terms of the banking sector, authorities have taken decisions to identify global and domestic systemically important financial institutions, requiring them to hold additional capital buffers. Moreover, authorities have taken decisions to calibrate the systemic risk and countercyclical capital buffers, as well as sectoral capital requirements for real estate and housing.
In terms of risk-taking by banks, we see no evidence of a widespread development of credit-fuelled bubbles. In the last quarter of 2016, euro area bank lending for house purchases increased by around 2.7% a year – well below the growth rates of up to 12% a year recorded in the run-up to the crisis. In the same quarter, nominal residential real estate prices in the euro area grew by 3.8% a year. Although residential real estate price dynamics are gaining momentum, valuation estimates suggest that, in the euro area as a whole, there are no signs of imbalances in such markets.[8]
Nevertheless, there is considerable heterogeneity across the euro area, and we closely monitor countries with more robust developments in real estate. We also closely monitor developments in the commercial real estate markets, especially where prices in the prime segment have departed from their long-term averages.[9] It is also worth noting that this is an area where national macroprudential authorities are already quite active, with many countries in the euro area having introduced prudential measures, such as caps on loan-to-value ratios, to counteract emerging risks.[10]
Moreover, there are few signs of banks in aggregate taking on excessive risk in their lending. According to the ECB's euro area bank lending survey, banks have certainly decreased on average their lending rates and softened their credit standards in the wake of our monetary policy measures. The availability of loans to small and medium-sized enterprises has improved since October 2014. [11] But a closer inspection of the drivers of changes in credit standards is informative. Heightened "risk perceptions" and low "risk tolerance" contributed to a sharp tightening of credit standards in the years that followed the crisis. Yet while banks' "risk perceptions" have gone down since 2014 in line with general economic conditions and the overall pick-up in the flow of bank credit, "risk tolerance" remains restrained, and has even tightened somewhat since 2015.
This suggests that banks remain prudent when deciding to extend credit. Indeed, euro area banks are less likely overall to grant loans than they have been on average since 2003.[12] This evidence is reinforced when looking at the composition of banks' balance sheets, where we observe a broad-based decline in probability of defaults by exposure class and a shift towards less risky credit exposures in the past few years.[13]

There is an important role here for microprudential supervision. Under the SSM Regulation, the ECB became responsible in 2014 for the supervision of significant credit institutions in the euro area, permitting a more harmonised approach to supervision. Microprudential supervision can mitigate excessive risk taking by applying institution-specific measures to the banks that invest the most in risky assets. Risks at individual institutions are regularly assessed as part of the Supervisory Review and Evaluation Process (SREP). Based on the outcome of this comprehensive analysis, supervisors can implement additional capital and liquidity requirements or other measures targeted at banks' specific weaknesses.

What about overall banking sector profitability? Certainly return on equity (RoE) – a frequently used measure of profitability – is lower now than it was pre-crisis. In 2016, aggregate RoE stood at 5%, compared with close to 20% in 2006. Yet such a comparison may be misleading for two reasons. First, bank capital ratios, particularly core equity, are higher and overall leverage is lower than pre-crisis. Higher leverage can flatter measured profitability, but as we saw in the crisis it comes with a greater risk of financial instability. The balance sheet repair that banks undertook after the crisis pushed their leverage down. The resulting decline in banks' RoE relative to the pre-crisis years needs to be put into perspective and forms part of a transition towards a more sustainable "new normal".
Second, the correct comparison is the counterfactual of what profitability would be like in the absence of our measures. As I noted earlier, the prospect in 2014 of renewed recession and the risk of deflation was one that brought its own risks to financial stability. Research by the ECB that takes into account the effect of the improvement in macroeconomic conditions and asset prices resulting from our monetary policy measures shows that the overall impact of our measures on bank profitability was positive.[14]
Let me also underline that there remains ample room for a large part of the financial sector to improve profitability by increasing efforts to improve operational efficiency via organic cost-cutting: euro area banks' cost efficiency has not improved since 2010 and, by standard metrics, compare unfavourably with many of their international peers.[15]
Finally, what about the effects on institutional investors? Our latest Financial Stability Review, which was published today, states that over the past few years some institutional investors, including insurance corporations, pension funds and investment funds, have shifted their asset allocation from higher to lower-rated debt securities.[16] Such developments need to be closely monitored. To mitigate their risks, these institutions may have to adapt their business models, for instance by continuing to reduce their reliance on guaranteed-return schemes.[17]

Conclusion

Let me conclude.

The macroeconomic environment is improving. The monetary policy measures put in place in recent years have proven to be effective at sustaining a resilient recovery that is increasingly broad-based across countries and sectors. This recovery in turn contributes to greater financial sector resilience.

The breadth of our monetary policy measures and the length of the time they are in place are necessary for achieving our objective of price stability. These policy settings have been made possible because the financial system is more resilient than in the past. Today we have a suitable – and active – macroprudential framework to address potential negative side effects. This, together with stronger banks and stronger supervision, has enabled us a longer period of low interest rates unmarked by a build-up of financial stability risks. Nonetheless, we remain vigilant.

When we introduced unconventional policy instruments in order to secure a return of inflation towards our objective, we were aware that those new instruments could result in somewhat more pronounced side effects than conventional instruments. These side effects have remained contained, but we take them into account in the formulation of our policy, in the sense that we try to minimise them, without prejudice to our ability to achieve our objective.

And this is reflected also in the logic underpinning our forward guidance about the sequencing of the withdrawal of monetary stimulus. Indeed, as I said in my speech at the ECB Watchers' conference,[18] in a multi-country monetary union such as the euro area, made up of segmented national financial markets, asset purchases are inevitably more difficult to calibrate, more complex to implement, and more likely to produce side-effects than other instruments, including moderately negative rates. Negative rates may also have unwarranted side-effects, but those have so far remained limited. Our current assessment of the side effects suggest therefore that there is no reason to deviate from the indications we have been consistently providing in the introductory statement to our press conferences.

More generally, our monetary policy actions in pursuing our mandate will benefit from the completion of the banking union, through the creation of a European deposit insurance scheme, the third pillar of the banking union, as well as a common backstop for the Single Resolution Fund.

Moreover as we move towards capital markets union, which is likely to further increase the importance of market-based finance in the euro area, the relevant EU and national authorities should be endowed with tools to address risks arising from non-bank financial intermediation. [19]

[1] See, e.g., European Central Bank (2016), Macroprudential Bulletin, Issue 1 / 2016, Chapter 1 – Topical issue: The ECB's macroprudential policy framework.

[2] See, e.g., Hanson, S., A. Kashyap, and J. Stein, (2011), "A Macroprudential Approach to Financial Regulation", Journal of Economic Perspectives, 25(1): 3-28.

[3] See Draghi, M. (2017), "Monetary policy and the economic recovery in the euro area," speech delivered at The ECB and Its Watchers XVIII Conference, Frankfurt am Main, 6 April.

[4] See, e.g., Cœuré, B. (2016), "Assessing the implications of negative interest rates," speech delivered at the Yale Financial Crisis Forum, Yale School of Management, New Haven, 28 July.

[5] See Borio, C. and H. Zhu, (2012), "Capital regulation, risk-taking and monetary policy: A missing link in the transmission mechanism?", *Journal of Financial Stability*, 8(4): 236-251.

[6] For empirical evidence, see e.g. Jiménez, G., Ongena, S., Peydró, J.-L., and Saurina, J., (2014), "Hazardous Times for Monetary Policy: What do Twenty-Three Million Bank Loans Say about the Effects of Monetary Policy on Credit Risk-Taking?", *Econometrica*, 82(2), 463-505; Maddaloni, A., and Peydró, J.-L., (2011), "Bank Risk-Taking, Securitisation, Supervision and Low Interest Rates: Evidence from the Euro-area and the U.S. Lending Standards", *The Review of Financial Studies*, 24(6), 2121-2165.

[7] See, e.g., Reinhart, C., and Rogoff, K., (2009), "This Time Is Different", Princeton University Press, or Schularick, M. and A. Taylor (2012), "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles, and Financial Crises, 1870-2008", *American Economic Review*, 102(2): 1029-61.

[8] See European Central Bank, (2017), "Financial Stability Review", May 2017.

[9] See European Central Bank, (2017), “Financial Stability Review”, May 2017.

[10] See for instance Constâncio, V. (2017), “Macroprudential policy in a changing financial system,” speech delivered at the second ECB Macroprudential Policy and Research Conference, Frankfurt am Main, 11 May.

[11] See European Central Bank (2016), Survey on the Access to Finance of Enterprises in the euro area – April to September 2016, November.

[12] See European Central Bank, (2017), “The euro area bank lending survey – first quarter of 2017”, April.

[13] See European Central Bank, (2017), “Financial Stability Review”, May 2017.

[14] See Rostagno, M., Bindseil, U., Kamps, A., Lemke, W., Sugo, T. and T. Vlassopoulos, (2016), “Breaking through the zero line: The ECB’s negative interest rate policy”, Brookings Institution, Washington DC, 6 June. Presentation available on the Brookings Institution website.

[15] European Central Bank (2017), Financial Stability Review, May 2017, chapter 3.

[16] European Central Bank (2017), Financial Stability Review, May 2017, chapter 3.

[17] See final report of the joint Task Force of the ESRB Advisory Technical Committee, the ESRB Advisory Scientific Committee and the ESCB Financial Stability Committee on “Macroprudential policy issues arising from low interest rates and structural changes in the EU financial system”, November 2016.

[18] Draghi (2017), *op.cit.*

[19] See European Central Bank (2016), “ECB contribution to the European Commission’s consultation on the review of the EU macroprudential policy framework”, published on 12 December.