Addressing financial stability risks in the current monetary context

Mário Centeno - Governor, Banco de Portugal

Yannis Stournaras - Governor, Bank of Greece

Boris Vujčić - Governor, Croatian National Bank

Boris Vujčić (Chair)

Boris Vujčić (Chair) noted that the crisis has been handled quite well compared to expectations from the beginning of last year, in March and April. The current situation represents a satisfactory outcome in terms of the rapid recovery of the economy. In the spring of 2020, the shape of the recovery was discussed. The recovery at present is probably better than most expectations at that time, in terms of the speed of output recovery and number of corporate bankruptcies. The overall monetary/fiscal-policy mix was successful in that sense.

However, financial stability risks must be considered. This is what central bankers do. Both corporate and government debt are currently higher than they have ever been following the unprecedented fiscal expansion. Financial stability risks in the banking sector have also been exacerbated by easier, covenant-light credit, due to excess liquidity in the banking system. There may be differing opinions on asset valuations, but they are generally very high in comparison to measures of asset valuations in the past, with the new and quite complex credit products that have emerged as a consequence of very high liquidity and very low interest rates. Bank profitability has been affected by a long period of very low and even negative interest rates.

There are probably still a number of zombie firms in existence, given the unprecedented support for the corporate sector during the pandemic crisis. Inflation is rising after many years. Whether it is temporary or whether higher inflation will be present for a longer period of time will be discussed during the session.

Yannis Stournaras

Yannis Stournaras is optimistic about the future. The current coordination of fiscal, monetary and supervisory policies forms a mix quite different, more realistic and flexible, than the one 13 years ago. However, new and old financial risks are still present. In terms of new risks, despite the overall improvement in gross domestic product (GDP) growth, the path to recovery remains somewhat uncertain and uneven across countries and economic sectors. General government primary deficits are now of the order of 7% of GDP in Europe and have to go to zero in about two years' time, or to surpluses in a number of countries. The removal of state aid might lead to a number of corporate insolvencies. It is not expected to be a massive number, but there should be an awareness of the possibility. The pandemic has not yet been beaten and neither have non-performing loans (NPLs) and assets.

Because of the recession and the fiscal measures introduced in response to the pandemic, public debt to GDP ratios have, on average, increased by about 25 percentage points, as have deficits. Especially for very high debt countries, some vulnerabilities are expected to develop. These are not present currently due to the very low interest rates. It is uncertain whether this will continue in the future. A sovereign-bank nexus is also emerging. Mitigating policies include the European Central Bank (ECB) asset-purchase programmes and the forthcoming issuance of EU bonds in the context of the Recovery and Resilience Fund.

Yannis Stournaras also said that the pre-existing risks have not disappeared. First, the very low interest rate environment remains a major challenge for European banks, with clear implications for their profitability and internal capital generation capacity. Second, the non-bank financial sector is continuously increasing in size, generating heightened risks and potentially increasing the procyclicality of financial conditions. Third, climate-related risks, which seemed a distant possibility some years ago, are rapidly gaining importance on the risk heat map. There have been tragic events this summer in both central and southern Europe. Fourth, and perhaps most importantly, the banking system remains largely segmented in the EU, due to the lack of a European Deposit Insurance Scheme (EDIS), a common crisis management framework and a single rulebook.

Mário Centeno

Mário Centeno stated that the crisis that began 18 months ago is a crisis of unique dimensions and nature. There was no playbook to guide decisions. At the start of the crisis, Mário Centeno was finance minister and president of the Eurogroup. It was unprecedented to ask people to leave their jobs unattended. Brave and correct decisions were taken in Europe in response to the difficulties. For the first time, monetary, fiscal, supervisory and regulatory authorities worked in a coordinated way. This should be maintained in Europe.

Mário Centeno commented that the recovery is continuing, despite the Delta-variant and some supply constraints. However, even if there is a return to 2019 levels more quickly than expected, the pre crisis economic dynamics of the European and world economy had a setback. Financial stability was preserved. There should be caution around tail risks, which are latent risks that are not observed. Economic adjustment is typically staggered, meaning that it does not happen at any moment in time in all institutions or firms. As such, the present numbers should be read with cautious.

Mário Centeno stated that financial stability was preserved also because, in the pre-crisis period, there was a very significant reduction in risk in Europe in both public finance and the banking and financial sector. Low profitability in the financial sector and a technological challenge in mainstream institutions are important issues, but Europe is better prepared now. Europe has much better institutions currently compared with 2008, so the institutional risk is not such a concern as in the previous crisis. Institutions in the euro area were incomplete during the previous crisis. Hard lessons have been learned from this and the euro area was better prepared for this crisis.

Boris Vujčić

Boris Vujčić (Chair) asked panellists to comment on the risk of asset-price bubbles, for example real estate prices in their countries. This seems to be more of an issue in Portugal than Greece currently, but there has been a rapid rise in real estate prices all over Europe, including Croatia, where they are increasing very rapidly. Boris Vujčić (Chair) asked if this is a more serious issue from the perspective of financial stability, because much of it is not leveraged. There is an increase in the real estate prices but not so much in terms of leverage, so it should be less of a problem for the financial stability of banks. Another consideration is affordability of housing for young people. Boris Vujčić (Chair) asked panellists to comment on how they expected these risks to evolve.

Mário Centeno

Mário Centeno stated that developments in the valuation of assets, especially residential and commercial real estate, are carefully followed. We definitively cannot conclude that a bubble is developing. There are several mitigating factors, as mentioned by Boris Vujčić (Chair), which are also present in Portugal. In addition, Governor Mário Centeno noted that the current market in Portugal is international as well as domestic, which avoids a concentration of risks in the banking and financial sectors in Portugal. Leaving this crisis with a very substantial increase in debt requires time and economic agents to engage in resolving issues. From an institutional perspective, regulators and supervisors follow this situation very carefully

Yannis Stournaras

Yannis Stournaras noted that the position is similar in Greece. Due to the previous crisis, asset prices and real estate prices have fallen to a very low level. These prices are now rising, reflecting the better fundamentals of the country. The rise is a smooth and steady one, with a 3-4% increase every year in the prices of apartments and commercial and residential real estate.

Yannis Stournaras noted that a positive aspect of this, is that banks now have a lot of real estate, houses and other properties as collateral. As the value of collateral increases, banks balance sheets improve. Also, real estate prospects based on fundamental values attract foreign investors. Interest in the NPL market is, to a large extent, being driven by the increasing value of collateral. This is also good news for the State, since, for historical reasons, the Greek state owns a lot of land. In terms of GDP, the Greek state owns more land than any other country in the Organisation for Economic Co operation and Development (OECD). The trend reflects fundamentals and is not a concern.

Boris Vujčić

Boris Vujčić (Chair) asked what the reason for weak bank profitability is and how risks will evolve. Boris Vujčić (Chair) asked if there will be very low interest rates and compressed spreads, or if there is greater risk of tangibly higher interest rates leading to credit risk materialisation going forward. There are two types of risk for the banking sector at the moment. One is a relatively rapid increase in inflation, and one is that inflation does not return. One would probably mean higher interest rates relatively more quickly and the other would maybe keep rates very low for a prolonged period of time. Boris Vujčić (Chair) asked panellists to comment on these risks.

Yannis Stournaras

Yannis Stournaras commented that medium-term inflation prospects are assessed largely according to data and models. Most models indicate that the current inflation jump is temporary. Whether it becomes permanent will depend on many conditions, including wage contracts. In 2022, inflation in the eurozone is expected to tall below 2%, and even lower in 2023. Hence, these models suggest that inflation is not a medium-term problem. The accommodative monetary policy should continue. This creates a number of problems for banks and insurance companies. The interest-rate margin has fallen. Macro and microprudential measures have been taken to ease the situation, such as tiering.

Yannis Stournaras stated that banks face credit risks. Banks should be transparent and accept the reality that, in two years' time, with the lifting of state aid, there might be a number of corporate insolvencies and new non-performing assets might appear. This should be reflected now in provisions and, if necessary, new capital. However, the elephant in the room in Europe is the lack of an EDIS, which does not contribute to a more integrated banking sector in Europe. This generates, among others, and a number of risks in crisis periods.

Mário Centeno

Mário Centeno stated that very low net interest rates are a concern for banks. Fintech, technological challenges and debt are not specific to this period and are certainly also a challenge for banks. In terms of the way that the recovery is proceeding and considering the support that exists and must be adopted through the crisis, developments must be monitored. Maintaining existing policies could become disruptive because distortions and vulnerabilities may build up. Policies should be adapted to face the challenges from the banking sector.

Mário Centeno commented that, looking ahead, there are good signs and room for policy decisions in line with Yannis Stournaras's comments on inflation. No single sector can handle the recovery on its own. Neither the banking sector, nor the state, nor the non-financial sector, nor households can be exclusively relied upon to drive recovery from the crisis. All sectors must contribute to drive recovery from the crisis. The increase in savings is an important contribution from the non-financial private sector. The flipside of these savings in the private sector was that governments and states increased their debt quite substantially, which also needs attention. Progress should continue with close monitoring and, not by impulse, with further policy decisions and adaptation of existing ones through the crisis.

Boris Vujčić

Boris Vujčić (Chair) asked what would be a sign of sufficient progress in a recovery to enable the normalisation of monetary policy. Boris Vujčić (Chair) asked how the mix of monetary and fiscal policy should then evolve from the point of normalisation of monetary policy.

Yannis Stournaras

Yannis Stournaras explained that the European Central Bank (ECB) renewed forward guidance implies that there should be a steady and sustainable rise in underlying inflation before what is called monetary policy normalisation.This is not the case presently, with inflation expected to fall back to a level well below the medium-term target of 2 percent. The test of the ECB's new forward guidance fails as far as normalisation is concerned, so an accommodative monetary policy is still needed. An accommodative fiscal policy should continue until the pandemic has been eradicated. Europe is very successful regarding vaccination, but continued vigilance is necessary.

Yannis Stournaras added that there are important differences between the current situation and the difficult period between 2012 and 2014, when he served as finance minister of Greece. European institutions have learned not to insist on procyclical fiscal policies. There should be cooperation between fiscal and monetary policy when necessary. This is not anathema and is not against the independence of central banks. It is certainly not fiscal dominance but an effort to achieve favourable financing conditions, a smooth transmission of monetary policy and to prevent monetary and financial fragmentation in the euro area.. Policies should be flexible and realistic, as they are currently.

Mário Centeno

Mário Centeno emphasised the importance of flexibility. The use of different instruments must be balanced due to their characteristics and associated pros and cons. For example, different instruments have distinct impacts on the rate term structure, so care must be taken when moving them. There should be a move to the next stage, looking ahead to some normalisation and taking advantage of the flexibility in terms of monetary policy.

Q&A

Didier Cahen, Secretary General, Eurofi

Didier Cahen noted that public over-indebtedness and fiscal dominance have not been mentioned as potential financial risks. Didier Cahen asked if panellists perceive any vulnerabilities in this area or if they expect that low interest rates will stay forever, and money creation will address the structural problems that EU member states are facing.

Mário Centeno

Mário Centeno answered that interest rates will not remain low forever, but it is unavoidable. Public plus private debt in the euro area increased by 26 percentage points in 2020 alone. 50% of this was public and 50% was private. Two thirds of private debt was from non-financial corporations. There was no way around this. The actions taken at that point were appropriate. Sustainable growth is a precondition for sustainable debt that has to be properly accounted for as the right way to direct the economy. The Recovery and Resilience Facility (RRF) is a great instrument on the public sector side from the European project, which must be considered very carefully. Time should be taken to develop appropriate, well-crafted policies, not on impulse but with patience.

Yannis Stournaras

Yannis Stournaras added that it is important to ensure that the snowball effect (the difference between government borrowing rates and growth rates), remains negative, that is, the growth rate exceeds the interest rate. This is extremely important in order to avoid future public debt vulnerabilities. Despite the fact that public debt to GDP has increased significantly due to the pandemic fiscal measures, forecasts indicate that it is going to fall if, in the following years, realistic and flexible fiscal policies are followed, ensuring the snowball effect remains negative.

Yannis Stournaras recalled that, in Greece, despite three adjustment programmes, despite the primary budget adjustment being the largest in the history of the OECD, at the end of the third adjustment programme, the debt-to-GDP ratio was higher than at the beginning of the crisis. This was so, because the snowball effect cancelled the fiscal effort. This mistake should not be made again. Procyclical fiscal policies should be avoided. Yannis Stournaras reiterated his optimism that the lessons from the previous crisis have been learned.

Participant

A participant commented that the recovery in Europe appears to be proceeding well. Internationally, the Fed and other central banks are openly talking about tapering, but the ECB is not. At the moment, the ECB seems to be quite dovish. The ECB's current forward guidance is to buy assets and purchase government bonds almost until interest rates are about to be raised, closely marrying asset purchases and the rise in interest rates. Christian asked if this is the best approach for the future. If asset purchases and the rise in interest rates are separated, it is possible to ease concerns about fiscal dominance, where asset purchases could be stopped, even though there may be no desire to raise interest rates for a bit longer. Christian asked if the panellists believe that asset purchases and the rise in interest rates should stay closely linked.

Participant

A participant asked if the Phillips curve is alive or dead.

Mário Centeno

Mário Centeno stated that the instruments currently in use must be considered and balanced. Central bankers tend to use a great deal of data on their analysis and decision-making process. Communication is also key and we always send messages of reassurance to the markets and citizens. As such, a problem in terms of managing these two forces is not foreseen within the forward guidance.

Mário Centeno stated that the Phillips curve is alive, but the labour market is working in a very artificial setting presently, given the measures implemented after governments' decisions, for example asking people not to work. These decisions were counterintuitive to social models and had to be accommodated by unique forms of support. The current period demonstrates why the European labour market model is better than others. In Europe, there is less churning through the business cycle and adjustment is more in terms of hours than in terms of bodies. This has severe consequences for wage bargaining, for example. Mário Centeno is optimistic. The European model is proving to be right, which is why Europe is doing so well at this stage of the crisis. Uncertainty is still important also due to some latent variables, and policies should be adapted. The same policies cannot be retained forever. The European institutions and treaties can accommodate the huge responses that all European and national institutions in Europe had to make in 2020 and 2021, which is worthy of praise.

Yannis Stournaras

In respect of the first question, Yannis Stournaras agreed that this particular aspect of the ECB's forward guidance has not changed. It has been useful up to now, but it is certainly not written in stone and could change if circumstances change. He gave an example saying that, to his understanding, the Bank of England follows the opposite path and does not require net asset purchases to finish before it raises interest rates. The new ECB forward guidance has already had positive implications. It has moved expectations about interest rate rises into the future, so it was a successful move.

Yannis Stournaras said that the Phillips curve is not dead, but it needs to be adjusted. Dynamic, Stochastic General Equilibrium (DSGE) models perhaps need some improvement regarding wage and price equations. The international forces that have kept inflation low up till now must be understood better. The dynamics in the DSGE models do not say much about that, because they are constructed around a steady state, which is exogenous. According to pure Phillips curve models, inflation is even lower than ECB forecasts. The Phillips curve is not dead and is a very good instrument.

Boris Vujčić

Boris Vujčić (Chair) thanked the panellists and closed the session.