Financial stability risks in Europe with high inflation and indebtedness

1. A stark risk environment

1.1 Financial stability has become increasingly vulnerable

A Central Bank official explained that the EU post pandemic recovery has been disrupted by Russia's aggression in Ukraine. Together with the sanctions against Russia, this has caused serious economic problems and energy price increases. The record inflation in the euro area has led to a substantial rate hike by the European Central Bank (ECB). This is happening in the context of weakening growth outlook.

Another Central Bank official remarked that the year began with an improvement in the Covid crisis. The consequences of this Covid crisis for economies are not yet understood both in terms of the financial side and the longer-term behaviour of citizens. Russia's war in Ukraine has now tremendous consequences for the energy market, the food market and the financial market as a whole and for the growth prospects for the coming years. The Covid related supply side disruptions and the Russian invasion of Ukraine exposed the fragilities in the EU's food and energy systems and its high dependence on the foreign supply of raw materials and technologies, including those which are very important for the green and digital transition. The reaction of many firms was an increase in inventories, which caused prices to rise further.

A Central Bank official queried whether the present situation is a Minsky moment. The accretion of risks has made a financial stability event more likely. Along with the continuing aftereffects of the Covid pandemic and the 'low for long' scenario, there are enhanced credit market and operational risks. There is a generalised economic slowdown, further geopolitical fragmentation, supply chain disruption and persistent inflation, which could lead to disorderly risk price resetting and/or the renewal of sovereign bank feedback loops and commodity market disruptions.

1.2 A challenging macro environment with near term and long-term issues

An industry speaker emphasised that a positive yield curve is more beneficial for banks than a negative one. However, if the rise is too fast, banks will carry the negative result of replicated savings. Higher rates are good, but the pace is important. The world is currently fixated on the growth reducing implications of inflation, higher rates and wartime issues such as energy squeeze. There are more near-term issues, but there are also longer-term problems like demographics, resources and climate.

The macro-economic environment is becoming challenging and is raising various risks. In the near term, the well-known problems around food, energy and fertiliser will create price pressure, which will hopefully force households to choose between eating or heating. Secondly, while China has carried the majority of global growth for the last 30 years, it is now facing a shortage in the supply of workers and significant real estate issues. Thirdly, there is fiscal tightening taking place as governments wean their economies from the Covid stimulus. In the longer term, there will be a shortage of workers in the developed world. Resources is another key topic. Many metals are in short supply. The world currently has between 5% and 20% of the materials required to reach net zero by 2050. There is also climate risk. In history, there have never been great droughts, dangerously high temperatures and fires on all continents at the same time. The policy response will have to be broader than the central bank response; a much broader and more coordinated effort will be required from all stakeholders.

1.3 High energy prices in Europe and rising downside risks to growth in the euro area

A Central Bank official described how the year started very positively. The first quarter was very good, and the second quarter was even better. The figures for the euro area were revised upwards. However, the situation in the second half of 2022 and 2023 will probably be rather different. In the baseline scenario, growth will slow significantly in the third quarter and then decrease further in the last quarter and the beginning of 2023. The ECB has downgraded prospects for the period ahead.

An official agreed that there are unprecedented shocks. The pandemic was a huge shock with a huge monetary and fiscal policy response, the impact of which is still being felt. As the EU exited the pandemic, inflation was higher than expected. It became more persistent and supply chain disruptions took longer to resolve than expected. Financial stability was not an issue, however. The decisive shock was the war in Ukraine. This was an enormous trade shock. Inflation became persistent and high. It is reducing the purchasing power of households and putting pressure on corporate profit margins. The cost of servicing debt will increase further with the inevitable tightening of monetary policy that accompanies persistently high inflation.

To complicate matters, the Ukraine shock is also adding a massive terms of trade shock with a reduction in incomes, which again impacts the recovery side. On one hand this might dampen aggregate demand pressures, but it is also dampening aggregate demand. Recessions in euro area countries should be expected in 2023. Policymakers need to have consistent and coherent policy settings on the monetary side, on the fiscal side and on the macroprudential side, including structural reforms. These policy settings will be extremely important in terms of limiting the financial stability risks as the EU exits the crisis.

A regulator stated 2022 was meant to be a great year for the financial sector and Europe's economies, but that optimism has drained away. There is now a very pessimistic business outlook. From BaFin's perspective, there might be unforeseen risks in the future, but the financial system has started this difficult phase in robust shape compared to its position before many crises.

1.4 Frailties in the non bank financial sector and real estate markets and are a source of concern; credit risks are also increasing

A Central Bank official stated that the non-bank financial sector is an important subject. March/April 2020 demonstrated the frailties in the non-bank sector that can emerge during periods of stress. There were frailties in the less liquid open ended fund (OEF) segment and in volume market funds, which have not been addressed. That is a real question around addressing further stability dynamics, because they could play a significant role here. In the current environment, it is also important to consider technological innovation and the rapidly changing dynamics around crypto and distributed finance. It is not known how effectively they are integrating into the financial sector.

A second Central Bank official observed that one of the most important financial stability developments is the shift from the banking sector to the non bank financial sector. In this regard, much was learned from the previous financial crisis. The institutional system related to the banking sector was strengthened, but the non bank sector is outside of this domain.

A regulator suggested that there are several issues that affect the robustness of the system. The first key concern is the state of the real estate markets, which in many parts of Europe have been heating up for a long time. As they cool off, which should be expected, the question is whether there will be a soft or hard landing and for which parts of the market. The commercial real estate market is very diverse, with many sectors and regions, but there are areas where valuations have reached an unsustainable level. There are the classic risks of importing problems from the real estate market into bank balance sheets and stretched borrowers having issues with their household budgets. In addition, rising mortgage rates and worsening debt-servicing capacity will exert downward pressure on house prices and lead to a cyclical downturn.

A Central Bank official confirmed that the housing market in many countries around the world is a financial stability issue. The situation is improving, but this is one of the most significant risks. There is a deterioration across the board, but the main assumption for the next two years is that positive growth momentum will be maintained. The figure for the year will be positive; the following year a significantly lower but still positive figure for overall growth is expected.

A regulator agreed that real estate markets and corporate credit are significant concerns in an environment that will be challenging for many sectors. It is difficult to predict what will happen, however. There is unprecedented state intervention in the credit markets. State intervention during the pandemic neutralised credit risk, but the selective approach being taken at present makes it difficult to determine where credit risk is greatest. Energy intensive sectors without the pricing power to pass on inflation to customers are going to struggle. The banks are built to absorb credit losses, but there is no visibility on where the concentrations could be. Supervisors will try to determine this, but it is difficult. Almost no one has lived through a period of entrenched inflation in the advanced economies. This dynamic is very new. While the current position is nowhere near a financial stability crisis, the distance to one has narrowed.

1.5 The Minsky moment has not been reached

A Central Bank official noted that one of the legacies of the past crisis and the prolonged period of low interest rates is the high level of sovereign and corporate indebtedness. This is not a uniquely European problem, but the institutional framework in a currency union poses its own challenges.

An industry representative agreed that the risks are mounting and are plentiful, but the tipping point or Minsky moment has not yet been reached. The ratings outlook for large sovereigns in the eurozone is currently stable. A Minsky moment requires a dramatic change in the environment, the economy and the financing world. A high debt load alone is not predictive of an imminent Minsky moment. A change in the environment and a trigger is needed. The Covid pandemic could have triggered a Minsky moment, but the policy response helped to avoid that. The current energy price shock and the shock on the terms of trade is historic and could be such a trigger. So far, the European economy has been resilient to the strong headwinds. For now, real interest rates and returns are deeply negative. That will probably not remain the case in two years' time. Consumer price inflation should recede after this wave of soaring commodity prices has passed. In real terms, yields may be much higher than they are now, which would make the question of debt sustainability entirely different.

A Central Bank official doubted that there would be a Minsky moment similar to the reversal of fundamental underpinning assumptions in 2007/08 or the rude awakening from the Reinhart Rogoff 'this time is different' thinking. Assumptions are changing and have had to change, but this is not the same as the sudden and shocking reversal of assumptions seen in 2008. For example, the geopolitical shocks have been significant and there is the fragmentation, but in some sense that geopolitical fragmentation has been accreting over a period of time. In relation to risk-price resetting, it has been reasonably well understood that the recent period has been rather unusual, and that normalisation would come sooner or later.

In any case, however, there are heightened stability risks. They need to be understood differently, though, which is always a challenge with financial stability. A piece of perceived wisdom in the world of boxing is that the punch to fear is the one the boxer does not see coming. The fact the tipping point was concealed was very powerful during the last financial crisis. At present there is the somewhat concealed erosion of resilience due to the impacts of the recent supervening crises. Not only are there increased frailties and vulnerabilities, but there are also frailties and strains resulting from massive public interventions.

Secondly, and somewhat ironically, there is a danger of excessive complacency. With expectations of public intervention comes the real danger that risk pricing becomes skewed.

1.6 Two positive recent developments: The exit from negative interest rates and an already achieved asset price correction with little contagion in other parts of other financial system

A regulator emphasised that the exit from negative interest rate policies is extremely positive for certain business models like banking and life insurance. This considerable tailwind is already flowing through bank results in the first half year. There may be some casualties among institutions that misjudged the risk of a rapid upward interest rate movement, but it is unlikely to be systemic. Additionally, it is also positive to see the substantial corrections and volatility in some markets, such as the meltdown in the crypto market, happen with extremely little contagion to the banks.

A Central Bank official agreed that for some business models the changing interest rate environment is favourable. For large financial institutions there are positives and negatives. A bank's business model might benefit as rates rise, but there is a risk of possible credit losses and other challenges.

2. EU policies for addressing the main risks

2.1 Global coordination is needed

An official highlighted the importance of having a consistent and coordinated policy response. Europe also does not live in isolation. There are many external risks which require international coordination, especially on the climate side. It is not enough for Europe to succeed on climate if China is not on board. International policy coordination is extremely important.

2.2 Europe has been successful in dealing and mitigating the risk of a Russian gas shutdown

An official explained that there has been success in mitigating the risk of a Russian gas shutdown. In July, it was predicted that a Russian gas shutdown would require a number of central European countries, including Germany and Italy, to ration gas. Rationing has a huge GDP cost. The estimated negative GDP impact was between 2.5% and 4%. There has been a massive policy response in terms of acquiring alternative resources, saving energy and spending on infrastructure, pipelines etc. Europe is currently balanced on a knife edge. If Russian gas is shut off, there will not be rationing in the winter if the winter is not unusually cold and there are no other shocks.

2.3 Monetary policy has to ensure that inflation expectations remain anchored

An official stated that the setting of monetary policy is right. Monetary policy should focus on limiting the risk of unwarranted second round effects, i.e. ending up in a wage price spiral or a de anchoring of inflation expectations. As inflation pressures persist, in most scenarios monetary normalisation will need to continue expeditiously. Any weakening of demand or softening of the medium term price outlook would be a reason to slow down the normalisation, however.

2.4 Fiscal measures need to be targeted to the most vulnerable and temporary

An official noted the importance of the fiscal response. The fiscal scorecard is not quite as good as on the energy side, however. The IMF advocates targeted support to address the cost-of-living crisis. Europe could protect the most vulnerable by fully compensating them for the cost of living increases caused by energy and food price rises. The cost for the lowest 20% households would be 0.4% of GDP; the cost for the lowest 40% of households would be 0.9% of GDP. In reality, broad based measures were pursued which blunted the price signal on the energy side and therefore blunted the demand response while being hugely costly. For many countries, the fiscal cost is above 1.5%; in some cases, it is above 2%.

A Central Bank official explained that there is a common monetary policy at the European level, but fiscal policy is still largely diversified among the Member States. This has an additional impact in the decisions about the speed of the normalisation of monetary policy. That is the main reason why the transmission protection instrument (TPI) was introduced: to protect the integrity of monetary policy throughout the jurisdictions.

2.5 Structural reforms, banking union and Capital Markets Union (CMU) will make Europe more resilient to market shocks

An industry representative largely agreed with the IMF's policy recommendations. Fiscal and monetary policies cannot perpetually play a firefighting role. A German would say Ordnungspolitik also matters. One growing risk is financial fragmentation in the eurozone. In this respect, structural policies have a role to play perhaps more so than fiscal and monetary policies. There is a very large pool of savings across Europe. If this circulates as easily as citizens do across borders, there will be greater resilience than there is currently. That is why completing Banking Union and moving forward with CMU are important. Small and medium-sized enterprises (SMEs) are the backbone of the European economy. Great work was done on banking regulation and monetary policy to ensure there was no financing gap for SMEs, but these measures did not make SMEs in Europe more dynamic in terms of innovation, turnover and employment. The CMU and a genuine Banking Union would develop private and venture capital to support productivity growth via SMEs in Europe.

A Central Bank official agreed on the importance of completing Banking Union. Having an integrated banking market would serve the economy. There are huge benefits to be gained. Being halfway through this process has active negative effects because it results in duplication, and there are worries about a mismatch between centralised supervision and nationalised failure. One important aspect of CMU is the securitisation markets, where Europe suffers. Europe will need them in the times

ahead. It needs to do what it can to revive them. Time should be granted to work on the difficult issues around, for example, the most efficient and effective regulation for securitisation. Europe may do itself a disservice by trying to move too fast and then not actually solving the problem.

An official suggested that the macroprudential settings are right. They should be tight, but if there is softening there could be an argument for some loosening. For the IMF, structural reform is extremely important for increasing productivity, supporting long term growth and helping the countries most impacted by the pandemic. The combination of reform requirements and the provision of money for investment is working, but there should be further structural reforms across EU countries.

2.6 Strong capital and liquidity buffers will prevent financial institutions becoming part of the crisis

A regulator emphasised the importance of preventing financial institutions from becoming part of the crisis. When making policy choices, there should be caution about not drawing financial institutions deeper into the risk zone. There are still ideas floating around about passing the risk in the energy markets elsewhere. Governmental and state interventions to cover current risks are not going to be able to cover everything everywhere forever. There is a need to follow the old recipe of a cautious approach, with first-class risk management and strong capital and liquidity buffers. It is liquidity that is hit fastest if there is a sudden loss of confidence.

2.7 Implementing the FSB recommendations on money market funds and open-ended funds

A Central Bank official praised the terrific work done internationally and regionally on money market funds by the Financial Stability Board (FSB) and the European Systemic Risk Board (ESRB) and on Open Ended Funds (OEFs) by the FSB and the International Organization of Securities Commissions (IOSCO). The recommendations made by these organisations should be implemented. These recommendations should not remain international 'nice-to-haves'. These are very important regulations which seek to fix a risk that has emerged from the successful diversification of funding markets post-crisis.

2.8 The EU must show its political unity upfront

An industry speaker sympathised with governors of central banks, as the last 15 years have been a very difficult time to do their jobs. As a systemically important financial institution (SIFI), ING has experienced many more impediments to integrating the systems of its business units since 2008. There is a huge amount of goodwill in EU institutions but addressing the challenges ahead will require a continuous monetary response, continuous centralised supervision and the management of failures at a European level. Now more than ever, it is time for this to be addressed by Europe's political representatives.