François Villeroy de Galhau: Monitoring financial stability, with active monetary policies

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at a conference at the London Business School, London, 23 November 2017.

* * *

Accompanying slides

Ladies and Gentlemen,

Price stability and the prevention of financial imbalances are often two sides of the same coin. Indeed, price stability and financial stability are supposed to be complementary and mutually beneficial. During the recent crisis in the euro area, the transmission mechanism of monetary policy was hampered by a fragmented interbank market, as borrowing conditions deteriorated in stressed countries. The resulting deterioration in the economy in turn contributed to a further worsening of the financial stress, in what we call a real-financial feedback loop.

To cope with this difficult situation, the policy response in the euro area was twofold. First, we adopted an active monetary policy and launched unconventional measures that included the credit easing package. Second, we set up a Banking Union and assigned new macroprudential powers and tasks both at the European level (the ECB, the ESRB) as well as at the national level. In France, the *Haut Conseil de stabilité financière* (HCSF or High Council for Financial Stability) was created in July 2013 as the French authority with the legal ability to impose binding macroprudential measures.

The economy is now recovering, so the medicine seems to have worked. However, our attention is now turning to the potential side effects of our treatment. Monetary policy in the euro area is maintaining short-term nominal interest rates at very low levels, and through our forward guidance, rates are also very low up to medium-term maturities. But, as the economy is recovering and we are progressing towards our inflation target, the Governing Council clearly decided on 26 October to pursue the gradual normalisation of our monetary policy. We will continue along this road, but financial stability concerns could be increasing. It has recently been argued that this could result in unwanted side effects in terms of asset price misalignments or spur a search for yield that would entail excessive risk taking.

The issue of the side-effects of monetary policy is not entirely new. Monetary policy is never neutral since it works its way through to the real economy via its effects on financial conditions, that is to say the current and expected cost of borrowing liquidity, and in turn on asset prices and risk premia, even in normal circumstances. Let me first say some words on bank profitability – which is not the only element of financial stability (1). I will then discuss the price of assets and the financial cycle (2), before turning to the relation for policy makers between monetary policy and macroprudential policy (3). Lastly, I will say a few words on how we should complete financial regulations (4).

* * *

1. – Let me start with bank profitability

It is true that low interest rates may affect the interest margins of banks since the latter cannot generally pass negative rates on to depositors. Also, because these institutions engage in maturity transformation, both the slope and level of the yield curve matter for their profitability.

But let me comment on what I see as the predominant effects of interest rate cuts since 2014. Our monetary policy is driving up real asset prices and lowering debt-servicing costs. Indebted corporations, households and governments can improve their balance sheets and yet maintain a steady spending trajectory with improved growth prospects. As a matter of fact, the ongoing recovery in the euro area has been synonymous with lower unemployment (7 million jobs have been created since 2013), resulting in higher disposable income [SLIDE 2]. In turn, this has significantly lowered the risk of default borne by the banking sector. Banks have also benefited from very low interest rates through cheaper funding and significant capital gains on their long-term assets.

So far, these effects seem to have compensated for the reduction in the bank interest margins. In a recent ECB working paper by Altavilla, Boucinha and Peydró,[1] the authors even argue that there is no causal relationship between low interest rates and reduced bank margins. The latter effect is due more to the past deterioration in macroeconomic conditions than to active monetary policy.

A comprehensive assessment of our current policy package should not only look at the intended consequences and side effects that can be observed, but also weigh them up against what would have happened in the absence of our exceptional policy [SLIDE 3]. How profitable would our banking system now be had we not eliminated the 2014–15 deflation risk? The landscape for our banking system would have been somewhat dire. In a deflationary environment – and we have avoided this lethal danger thanks to our monetary policy –, the debt-servicing cost for borrowers is heavier in real terms. Defaults are more frequent, and less sustainable debts result in higher credit spreads. The risk of a debt deflation spiral then increases further. But this has been avoided in the euro area and if the price of this is a temporary reduction in bank interest margins, then it is worth incurring such a secondary side effect.

2. – Let me turn now to the price of assets and the financial cycle

At the level of the euro area, we consider the financial stability situation to be overall under control. The solvency ratios of significant euro area institutions have improved continuously since 2014, reaching 15% on average in Q2 2017. Overall private debt in the euro zone diminished as a share of GDP: 128% in 2011, 122% today. Non-performing loan ratios have also declined, especially for small and medium sized enterprises. I support the recent SSM initiative for provision rules for new flows of NPL, despite all the criticisms. Moreover, after some years of subdued financial cycles, most cycles in euro area countries have normalised and in some countries they have even accelerated [SLIDE 4]. This is the case for France, and should it be a concern?

In France, asset prices are currently rising in a context of low market volatility. Since low volatility and abundant liquidity may encourage risk-taking behaviour alongside search-for-yield behaviour, we must be vigilant against the risk of a widespread mispricing of financial assets that could hinder the economic recovery. To give you some numbers: residential real-estate prices are back in positive territory, with year-on-year growth of 2% in real terms, and the commercial real-estate sector is still buoyant. Our main alert is on non-financial corporation debt, which is now 74.4% of GDP against 61.8% in 2010 [SLIDE 5]. Overall, private debt in France now amounts to 130.5% of GDP.[2]

I do not want to bombard you with numbers but the main difficulty now is for policymakers to disentangle from these positive figures what is a desirable consequence of our monetary policy stance and what clearly signals a potential financial risk that we must address.

3. – Policy makers: can monetary policy and macroprudential policy be best [better?] combined?

As said, overall private debt in the euro zone has diminished as a share of GDP. But in some countries, the financial cycle is picking up, while at the same time inflation has been slowly increasing, but remains below our target.

Already before the 2008 crisis, central bankers firmly believed that price stability is a necessary – and for some even a sufficient – condition to ensure financial stability. This view is referred to as the 'Jackson Hole consensus'. Following the financial crisis, financial imbalances were seen as a huge source of disruption which decision-makers needed to remedy, questioning the relationship between monetary and financial policy tools and objectives. Let me give two polar views on that.

A first approach, in line with the 'Jackson Hole consensus', is to clearly separate monetary stability from financial stability. In line with the Tinbergen rule and the Mundell efficiency principle respectively, one policy should fulfil one objective and each policy tool should be assigned to the objective it can fulfil the best. In this regard, monetary policy would not be efficient at mitigating financial imbalances but would not generate them either.

On the other side, an extreme approach is to consider that both policies are strongly intertwined and that their respective objectives could be merged: in this case, monetary policy could reduce risk taking and target asset price bubbles.

I consider that full adherence to the separation principle and the combining of objectives are both approaches that are too radical to conduct monetary and financial stability policies. The implementation of unconventional policies has blurred the frontier between the two objectives. Let me quote here my colleague Vice-President Vítor Constâncio: "Macroprudential policy and monetary policy rely on separate tools and aim to achieve different objectives. Yet, they need to be co-ordinated, which is a non-trivial task."[3] It is a wise view. Keeping monetary policy aligned with its primary objective of price stability but not blindly sticking to the separation principle may help us to manage our two main objectives and strengthen our credibility.

As you may know, the Banque de France, like many other central banks, has had the dual mandate of maintaining price stability and preserving financial stability since 2013. The financial stability mandate is demonstrated by the fact that the governor of the Banque de France has the sole right and responsibility to make proposals for implementing macroprudential instruments to the High Council for Financial Stability, the French macroprudential authority. I consider this specific role assigned to the governor of the Banque de France as an opportunity to make price and financial stability objectives more consistent.

First, macroprudential policy complements the monetary policy framework decided at the euro area level, by adjusting it to national specificities and addressing idiosyncratic financial stability risks while maintaining the harmonious transmission of monetary policy across the euro area.

Second, macroprudential policy may help to fine tune the overall impact of monetary policy by ensuring that the risk-taking channel is not disproportionate in some specific sectors/countries, in order to prevent systemic risk. Let me give you two examples of what we monitor very closely in France: the increase in commercial real estate prices in Paris, and the rise in corporate debt.

Having said this, I do not mean that there is no hierarchy between the two objectives. I call for strong complementarity, not for a merging of objectives. To be more explicit, I consider that a monetary policy strategy that targeted asset prices would be a mistake. As central bankers, we need to avoid confusing economic agents; our role is to anchor expectations and ensure business continuity.

4. – There are still challenges to be addressed to provide authorities with the necessary policy toolbox for financial stability

For it to be more effective, we still face a number of challenges in order to achieve an optimal macroprudential regulatory framework. First, we have to complete the regulatory framework for banks, by finalising the Basel III reform: I strongly wish and hope that we can reach a fair and reasonable agreement soon. A revision of the European Macroprudential Framework is currently underway at the European Commission level. Moreover, decisive progress should be made to better provide macroprudential authorities with policy tools properly designed to address financial risks beyond banking. Market financing, shadow banking, Fintechs, pension funds, financial innovations are all part of the scope of macroprudential policy, insofar as they have the potential to pose a financial risk to our economies. Our next issue is less the solvency of banks than the liquidity of non-banks.

It is also our duty to complete the European regulatory framework with the finalisation of the resolution mechanism to make the functioning of the banking sector smoother – in line with the spirit of the Banking Union, also enabling the Capital Market Union (CMU) to bloom, within the holistic approach of the “Financing Union for Investment and Innovation” I have suggested.

Finally, we must ensure that the new regulatory framework is consistently implemented everywhere, and avoid any backtracking outside Europe. Financial stability is a global common good, and as such, regulatory arbitrage must not become an option.

* * *

Let me conclude. Credibility for central bankers now rests on admitting that monetary policy and macroprudential policy are somewhat porous, especially in a situation where we could have an upward financial cycle associated with weak inflation. This calls for a consistent action by central banks that covers both areas: price and financial stability. Moving away from an overly strict separation principle, let us try to be complete and consistent central bankers playing an active role in monetary policy as well as in macroprudential policies.

---

1 Altavilla C., Boucinha M., Peydro JL, 2017, Monetary Policy and Bank Profitability in a Low Interest Rate Environment, ECB Working paper series #2105, October 2017.

2 Ratio of non-financial agents’ debt to GDP, first quarter 2017. Source: Eurostat, Federal Reserve, Banque de France calculations.

3 “The future of finance and the outlook for regulation”, Remarks by Vitor Constâncio, Vice-President of the ECB, at the Financial Regulatory Outlook Conference organised by the Centre for International Governance Innovation and Oliver Wyman, Rome, 9 November 2017.