Jan Smets: The impact of monetary policy on the macroeconomy and European banks

Speech by Mr Jan Smets, Governor of the National Bank of Belgium, at the EACB Regulatory Debate, Brussels, 20 March 2018.

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Accompanying slides of this speech.

Ladies and gentlemen,

I would like to thank you for inviting me to participate in this interesting event. My talk will somewhat deviate from the main topic of regulation that you are debating today. Instead, I will focus on the ECB's monetary policy and its impact on the banking sector and the macroeconomy.

A recovery with low inflation

I am well aware that the last years have been challenging for the banking sector. Banks have navigated the troubled waters of a financial and economic crisis. They have had to adapt to a new regulatory and supervisory setting. Believe me, also for central banks the last few years have not really been a walk in the park.

Over the past decade, the ECB, like other central banks, has taken unprecedented measures to limit the impact of the financial crisis on the economy of the euro area. Supported by these measures, economic conditions improved. Unemployment has gone down and confidence, up. Economic indicators are solid and the most oft-used measures of slack are closing; and yet – inflation has remained subdued.

Since 2014, euro area inflation has averaged 0.6% in annual terms. Currently, both headline and underlying inflation remain well below 2%. Looking ahead, we expect a slow recovery of inflation towards our inflation aim.

Why this disconnect between growth and inflation?

Despite stronger growth, slack might be larger than presumed

One important factor that may be weighing on inflation is the presence of idle resources in the economy. Indeed, we suspect that, despite the recovery, there remains slack on the labour market, although its exact magnitude is uncertain.

For instance, it is useful to look at the 'broad' unemployment rate, which includes discouraged work seekers, or employees working part-time but who would want to work full-time. During the crisis, the rise in this measure was considerably stronger than that of the 'normal' unemployment rate. The gap between the two remains wider than before the crisis. This shows that the untapped supply of labour remains more significant than suggested by the simple unemployment rate.

The latest estimates for the equilibrium rate of unemployment also make us suspect that slack is bigger than we thought. This measure is the unemployment rate which is consistent with stable wage inflation, the NAWRU (non-accelerating wage rate of unemployment): if unemployment is higher than this equilibrium rate, increases in wages will be slower; if lower, wages will go up faster. Since 2014, the NAWRU –here I present European Commission estimates— has been systematically revised downwards. This means that the economy could converge towards an even lower level of unemployment without creating undue inflationary pressures.

Structural factors (for instance labour market reforms) may be boosting the economy's potential. This is good news, for it means that we have more margin to grow. However, in the short term it implies a slower convergence of inflation towards our aim.

Furthermore, more flexible price and wage setting can imply that idle resources weigh more on inflation. Besides, a long period of low inflation could lead firms and unions to become more backward-looking when setting prices and wages, making inflation more persistent.

If low inflation stems from such factors, one can be confident that it will recover, albeit perhaps only slowly. To support it, as President Draghi stressed, monetary policy needs to remain patient, persistent and prudent.

The importance of getting inflation back towards 2%

Absent such support, the economy would be prevented from tapping its full potential. Furthermore, the too long period of low inflation would lead economic agents to reassess their long term inflation expectations. Were this to happen, the trend inflation rate could fall below pre-crisis levels and hence below our price stability definition. Inflation would thus settle permanently at a level below our inflation aim.

This lower trend inflation, through its impact on nominal incomes, would complicate the still necessary deleveraging efforts. There is yet another, and perhaps even more worrying and long-lasting, effect: because inflation is a determinant of nominal interest rates, low trend inflation implies low nominal interest rates in steady state. This means that, faced to negative shocks, the central bank would have a smaller margin to reduce rates, so recessions might last longer and inflation would recover more slowly.

Of course, faced with the lower bound, the central bank could use non-standard measures more often. Yet, such unconventional measures – asset purchases and negative interest rates, for instance – are typically seen to have more side effects, including on financial stability. In sum, I believe such "low inflation-low interest rate" environment would not be a friendly one for banks – either because it means less macroeconomic stabilisation or because it means more non-standard measures.

You may think it paradoxical that a member of the ECB Governing Council – the first big central bank to lower rates below zero – is warning you about the risks of low interest rates. And yet, this is precisely what I want to address today, with an important nuance: these adverse effects are larger the longer the period over which rates remain at such low levels. With our measures, we intend to provide strong enough a stimulus to get inflation up again, creating the conditions that allow us to again raise nominal interest rates. On the contrary, surrendering to the low inflation would cause lower inflation expectations and an even longer period of low nominal interest rates. The experience of the Fed, where the US macroeconomic situation has allowed it to raise rates, is encouraging in that respect.

At the same time, I acknowledge that our current measures may have a temporary negative impact on financial stability or bank profitability. This is particularly true of the negative rate policy, particularly when combined with a flatter yield curve.

Monetary policy makers are not directly concerned about bank profitability. However, banks are the main source of funding for the non-financial private sector in the euro area and, thus, the main channel of transmission of our measures. If the adverse impact of our measures on bank profitability becomes – or is expected to become – too large, banks' capacity to lend may decline, and we would not achieve the more favourable financial conditions we seek. Thus, a profitable and well-functioning banking sector is essential to ensure a good transmission of our monetary policy measures.

Negative rates affect bank profits in different ways

The potentially most adverse effect of negative rates on banks' profits works through the net interest income. This is the essential source of revenue for the traditional banking model, based on maturity transformation and financed by deposits. Thus, banks focused on retail business, among them many cooperative banks, could be especially hurt by the negative interest rate policy.

How so? The crux of the matter lies in the coincidence of two circumstances: the reluctance of households to pay to banks for depositing their money, and the importance of this type of funding for banks.

Retail customers are strongly averse to negative nominal rates, even if negative real rates are generally accepted. Because the cost of holding cash is relatively low when amounts are not too large, withdrawing part of their negative-yielding deposits could even be a rational reaction for many households.

In the euro area, household deposits account for one fifth of banks' liabilities on average. Thus, a large withdrawal of retail deposits could be very problematic for banks, as they could become underfunded and more dependent on less stable financing.

Hence, banks have a strong interest in keeping retail deposit rates positive, even when other funding costs drop: in practice there is a zero lower bound for retail rates, so when policy rates become negative, the cost of part of the bank's funding does not go down. However, after the drop in policy rates, interest revenues on assets do decrease: variable rate loans adjust to market rates, and the maturing portfolio will be replaced with assets yielding less. Thus, banks' net interest income starts to fall.

Of course, banks can try to limit the impact on profitability, by taking on more risk, or getting cheaper, but less stable, funding. However, this could make them more fragile.

To limit the fall in their interest income, banks could reduce lending rates to a lesser degree than with a "normal" interest rate reduction. Of course, this would hamper the monetary transmission to the real economy. That is the opposite of what we want.

Fortunately, this is not the whole story, as other channels can offset this adverse impact of negative rates.

When policy rates are lowered, fixed-rate marketable assets held by banks gain in value. This boosts banks' economic capital at the moment of the rate cut. Banks also benefit from the improvement in the economy that follows the rate cut: the quality of the lending book improves, borrower risk goes down, and the demand for loans increases. In addition, variable rate loans become more affordable after a rate cut. While this reduces banks' interest income, it also makes repayments cheaper and should lower default rates.

Banks' characteristics matter

Thus, the ultimate impact of negative rates on bank profits and credit supply is difficult to estimate.

Not all banks would be affected to the same extent by the negative rates. The impact of negative rates on banks' profits will depend on the composition of their balance sheets and, more generally, on their business model. The channels through which profitability is affected – the share of retail deposits, scope for valuation gains and maturity of the loan book– can provide an indication of the direction and the extent of the effect on each bank.

The lower bound in the remuneration of retail deposits is the core factor behind the specialness of negative policy rates for banks. Therefore, the share of retail deposits in a bank's funding is the first relevant variable to assess.

Indeed, some analyses show that, when rates are at zero or below, new rate cuts will weigh more on banks' stock prices[1] and on their lending volumes[2] if banks are more funded through retail deposits. To be clear: this does not mean that our negative rate has had a general tightening effect. Rather, we have all indication of the opposite: bank lending rates have decreased and lending has accelerated over the last three years. But it indicates that the rigidity of the cost of deposits can make cuts in negative territory less expansionary than when rates stay above zero.

On the asset side, interest risk exposure works in the opposite direction: the smaller or slower the adjustment of interest income to the new rate cut, the more positive the impact on bank profitability. A longer average maturity of marketable assets implies bigger capital gains for banks. Long-term fixed-rate loans allow the bank to benefit from higher net interest income until the full repayment, although loan renegotiations may limit the additional benefits. In contrast, more variable-rate or short-term loans entail a faster fall in interest income.

Thus, the net impact of negative rates on profitability will be different for different banks. Those most reliant on deposits, providing short-term lending and holding fewer marketable assets might be the most affected. Many cooperative banks may fit in this description. Yet, the final impact on aggregate credit supply will depend on still other characteristics: banks with higher initial capital or margin to lower costs will be able to weather the temporary compression on profits and to better transmit the easier financial conditions to the economy.

Other measures implemented by the ECB over the last few years may have also offset the potential hampering impact of negative rates. The Targeted LTROs, for instance, have contributed to lowering the cost of funding for banks. Our forward guidance on policy rates and our asset purchase programmes have increased the value of assets held by banks and to accelerate the recovery. In sum, they help to create the conditions which will allow us to normalise interest rates again.

[1] Ampudia and Van den Heuvel, 2017.

[2] Heider, Saidi and Schepens, 2017; de Sola Perea and Kasongo Kashama, 2017.

Final thoughts

I will briefly summarize. Low rates, and most particularly negative rates, can have an adverse impact on bank profitability and, in consequence, on financial stability. Such an impact will be stronger the longer the period of low or negative rates. However, today's very low – even negative – rates have been and are still absolutely necessary to avoid that inflation settles at too low levels, which would mean permanently low rates and even larger challenges for the economy, including the banking sector.

Let me share three final thoughts.

First, the experience of the past years highlights the importance of banks' resilience, so they can withstand a transitory period of very low rates. This underlines the necessity of prudential – including macroprudential– policies to strengthen the banking sector. There has been progress on this: the prudential framework has been revised and extended significantly since the crisis. While adapting to it has been a challenging task for banks, its completion should kick-start a period of regulatory stability.

Second, even when we deliver on our mandate and bring inflation back towards 2%, the real component in nominal interest rates might not recover to pre-crisis levels. Beyond cyclical factors, the low level of real rates is also due to structural drivers, such as demographic developments or slower potential growth. These factors are beyond the reach of monetary policy. That might mean that interest rates could settle at lower levels than before the crisis, and that episodes of very low rates – for instance during recessions – may become more frequent. That makes my previous recommendation even more important. In order to increase real returns again, other policymakers should do their job by pursuing structural reforms to boost economic growth.

Finally, while the current period of low rates can put pressure on banks' profits, other, more structural factors, may also play a role. Banks, especially in Europe, are still facing a number of considerable challenges going forward, which will remain after the 'normalisation' of monetary policy. These challenges include still elevated cost structures, the emergence and growing role of Fintech competitors, IT and cybersecurity risks, and evidence of overcapacity in the European banking sector, to name but a few examples. To continue playing their important role in our economy, banks must still continue to adapt to the new environment.

Thank you for your attention.