Yannis Stournaras: Monetary policy and bank supervision in Europe after the last financial and sovereign debt crisis and challenges for the future

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, in the governors' panel discussion at the Bank of Greece Economic History Conference "The birth of inter-war central banks: building a new monetary order", Athens, 2 November 2018.

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Since the onset of the global financial crisis in 2007, major central banks have resorted to unconventional monetary policy measures, such as ample liquidity provision to commercial banks and large-scale asset purchases, while short-term interest rates hit the zero lower bound. The purpose of these measures was to help alleviate tensions in financial markets and to lower long-term interest rates, thus supporting the real economy and avoiding a deflationary downward spiral. In addition, supervisory authorities have tightened regulatory standards in order to avoid a repeat of the crisis in the future. In my introductory remarks to this session, I will first focus on the monetary policy measures of the Eurosystem and then turn to the supervisory measures adopted in response to the financial and sovereign debt crisis. Domestic issues of particular interest will be touched upon at the end.

Non-standard monetary policy measures of the Eurosystem

The first episode of volatility in early August 2007 was associated with waves of downgrades of securities based on US subprime mortgages and concomitant acute difficulties faced by some financial institutions. The crisis intensified with the collapse of Lehman Brothers a year later. As a response, several policy actions were initiated by central banks around the globe. In this context, the Eurosystem started to provide liquidity without any quantitative limit and at a fixed interest rate, i.e. adopting the so-called fixed rate full allotment policy, and conducted additional refinancing operations with longer maturities. Key interest rates were cut in several steps and the list of eligible collateral was expanded.

In 2010 the focus of concern switched to the euro area, which was facing an escalating sovereign debt crisis that led to dysfunctions in the transmission mechanism of monetary policy. Therefore, the Eurosystem introduced the Securities Markets Programme (SMP) in May 2010, acquiring securities issued in the vulnerable Member States.

By the summer of 2012, the contagion had spread further. To counter the unwarranted worries relating to the eventuality of a redenomination back to national currencies, the Governing Council of the ECB intervened by unveiling, late in the summer of 2012, a new instrument, termed “Outright Monetary Transactions (OMTs)”. With the OMTs, the Eurosystem would undertake large-scale purchases of government debt under strict conditionality. Although in fact it never became necessary to activate this instrument, its mere announcement led to much calmer conditions in euro area financial markets and to receding fragmentation, demonstrating the commitment of the ECB to do “whatever it takes” – to use the famous phrase of President Draghi earlier that summer – to save the euro.

Subsequently, the euro area faced very low inflation rates, far below 2%. Again, the Eurosystem initiated a multidimensional policy reaction, aiming to counter the fragmentation of financial markets in the euro area, which was fed by the sovereign debt crisis, as well as to revive the lending activities of banks. The Eurosystem carried out targeted long-term refinancing operations (TLTROs), on favourable lending terms for those banks with the strongest credit expansion to the real economy, continued to cut key interest rates, and employed forward guidance. Additionally, a large-scale purchase programme of private and public sector securities (APP) was initiated in late 2014 and is unprecedented in scale at €2.5 trillion last month. Purchases

under the APP are expected to run until the end of the current year, after which time the Eurosystem will continue to reinvest the proceeds from securities maturing in its portfolio.

To a large extent, these measures have helped improve financial conditions and the inflation outlook, and boost the recovery in the euro area[1], while potential side-effects from the monetary policy easing, in the form, say, of excessive asset valuations or excessive risk-taking by market participants do not seem to have materialised. Given that inflation pressures continue to be moderate in the euro area, substantial monetary policy stimulus shall continue to be provided in several ways, until the Governing Council assesses that developments regarding inflation are compatible with the Eurosystem's mandate.

Challenges for the future

Looking ahead, one main challenge relates to the formulation of monetary policy strategies by central banks in the aftermath of the crisis.

Will the strategies eventually converge to the pre-crisis status quo or will the "new normal" reflect some of the lessons learnt over the previous years?

• According to the first approach, central banks may gradually wind down the non-standard policy measures and return to the pre-crisis consensus of an as lean balance sheet as possible.

• The second approach includes the incorporation of unconventional policies into the standard central bank toolkit in normal times, thus leading to a 'permanently' larger balance sheet.

Other aspects of monetary policy strategies also feature in this debate, including, inter alia, calls for revisions of central bank mandates to encompass, for instance, financial stability objectives. Moreover, there have been voices pointing to the need to adopt a higher inflation target so as to reduce the likelihood of hitting the zero lower bound, even after large adverse shocks. However, the difficulty of managing the transition to the new target without losing credibility should not be underestimated.

Furthermore, recent academic research[2] has suggested that policy makers should target the price level and not inflation, but only when the zero lower bound is binding, i.e. any low-inflation episode would be compensated by a period of relatively high inflation. However, the practical difficulties of implementing this policy could prevent markets and the public from fully understanding it, and could render it ineffective[3].

Another future challenge relates to the evolution of the equilibrium real interest rate, the "natural rate". There are reasons to believe that the natural rate has declined substantially over the past few decades due to productivity slowdown, population aging and other structural forces affecting the global economy. The Global Financial Crisis seems to have accelerated the downward trend of the natural rate due to deleveraging of the private sector, higher risk aversion and the lack of supply of risk-free assets. The policy rate set by the central bank would have to keep track of the evolution of the equilibrium real rate, otherwise monetary policy would be too tight, dampening both economic activity and inflation[4]. The natural interest rate is, however, unobservable in the real world and is merely measured using various models which provide different results. Thus, it is challenging to use estimates when formulating monetary policy.

Overall, as far as the setting of the new monetary policy framework is concerned, the prevailing pre-crisis orthodoxy has served well in achieving price stability, while also contributing to favourable growth and financial stability outcomes. At the same time, the positive experience so far with unconventional measures − from longer-term refinancing operations to large-scale asset purchases − speaks in favour of including some of these measures to a certain extent in the standard toolkit. Further developments in this regard are still subject to debate, and policy makers look forward to relevant research that will help inform future decisions.

The response of supervisory authorities to the crisis

The response of the Eurosystem to the global and European financial crisis has been effective, despite the initial lack of crisis mechanisms and the challenging external environment. As outlined above, the initial response came in the form of a significant easing of the monetary policy stance. However, deeper institutional reforms had to be established.

In response to the strong negative feedback loops between banks and sovereigns, as well as contagion among national financial markets, European leaders, in 2012, initiated the creation of a Banking Union. Its three pillars consist of the Single Supervisory Mechanism, the Single Resolution Mechanism and the still-to-be-completed European Deposit Insurance Scheme (EDIS). Apart from the elements of the Banking Union, a number of other important regulatory initiatives have been taken, covering almost all aspects of the financial sector and activities (the Bank Recovery and Resolution Directive, an updated Capital Requirements Regulation and Directive for the banking sector, Solvency II for Insurance, the European Market Infrastructure Regulation for financial markets and infrastructure, to name a few). The establishment of the European Systemic Risk Board (ESRB), coupled with the creation of appropriate macroprudential instruments, allowed policy makers to place greater emphasis on identifying and addressing system-wide risks and to prevent the incipient build-up of financial imbalances.

The Banking Union, however, must be completed, by creating a common European Deposit Insurance Scheme and by setting up a credible common fiscal backstop to the Single Resolution Fund that underlies the Single Resolution Mechanism. Such steps are necessary to improve confidence in the banking system and break the bank-sovereign feedback loop.

Moreover, a genuine Capital Markets Union (CMU) can be promoted through legislation changes that impose harmonisation towards best practices on securitisation, accounting, insolvency and company law, property rights, etc. Such changes will allow for deeper integration of bond and equity markets and will ensure that companies (in particular SMEs) can gain access to capital markets on top of bank funding. The Capital Markets Union will enhance cross-border investment and consequently strengthen private sector risk-sharing across countries as returns on assets and access to credit become less correlated with domestic economic conditions in each Member State.

Moreover, in view of the creation of the CMU and in order to preserve financial stability, particular emphasis in the future should be placed on the risks and vulnerabilities of the rapidly expanding non-bank financial sector[5]. In addition, further steps to enhance data quality and availability are necessary, including by harmonising data definitions and promoting greater standardisation at global level (e.g. financial and real estate transactions data).

Issues related to Greece

Let me now turn to a few key domestic issues. Throughout the crisis, the Bank of Greece has been the guardian of financial stability, fully protecting all deposits and supporting the economy and serving the public interest. The Bank focused on two major fronts: ensuring adequate provision of liquidity, and managing and assisting recapitalisation, resolution and restructuring of the banking sector.

With respect to liquidity provision, the Bank has been critical in ensuring continuous liquidity provision to banks in its role as the lender of last resort. On various occasions, the Bank of Greece has provided ELA to the banking system. This has helped preserve financial stability and contributed to the avoidance of a banking crisis.

With respect to managing and assisting recapitalisation, resolution and restructuring, the Bank, in the context of the adjustment programmes, aimed to strengthen viable institutions and resolve non-viable ones, whilst safeguarding financial stability. To this end, viability assessments and

capital needs assessments were undertaken.

Those banks deemed non-viable were resolved and absorbed by systemic banks. With 14 such resolutions having successfully taken place since 2011, this process has also facilitated the considerable consolidation of the banking sector.

Following three rounds of recapitalisation, Greek banks now have among the highest capital ratios of banks in the euro area and maintain buffers sufficient to absorb additional credit losses, as the recently completed pan-European stress test indicated. They have also markedly improved their liquidity position, reducing their reliance on central bank funding, regaining access to the interbank market and issuing covered bonds. Concurrently, customer deposits have been gradually increasing.

However, the ratio of Non-Performing Exposures (NPEs) to total exposures remains quite elevated and constitutes the most significant challenge for the Greek banking sector. Banks have set operational targets to significantly reduce the stock of NPEs by end-2019. At the same time, significant reforms have been implemented, aimed at removing administrative, legal and judicial impediments to NPE resolution, as well as establishing a secondary market for NPL servicing and sales. These efforts have started to bear fruit: according to end-June 2018 data, the stock of NPEs reached €88.6 billion (47.6% of total exposures), i.e. it decreased by 17.3% or €18.6 billion from its March 2016 peak. The key driver of NPE reduction so far has been write-offs. Going forward, NPL sales and securitisation will play a more important role, coupled with collections, collateral liquidation and curing of loans. The pace of NPE reduction is anticipated to accelerate based on the more ambitious revised banks' NPE targets covering the period up to 2021.

Efficient NPE management will also underpin the operating profitability and internal capital generation capacity of banks, contributing to the restoration of their credit intermediation function and the establishment of a sustainable business model. This, in turn, is of utmost importance for the financing of innovative and export-oriented investment projects and companies in the context of the rebalancing of the Greek economy.

Conclusion

The recent financial crisis has been the most severe in seventy-five years. A key question not only for all of us in this room but also for those who study it or act as policy makers is "Will it happen again?"

My answer is − if and when it does happen − next time will be different.

First, a long absorbed lesson is that, while things may work well if left to the invisible hand, during periods of stress that hand seems to lose its grip, in the words of Ahamed Liaquat in his Pulitzer-winning "Lords of Finance". Policy makers around the world have learned their lessons from the Great Depression: a financial system in distress requires active central bank intervention. Central banks thus acted quickly and forcefully. They equipped their toolkit with a combination of more flexible, effective and innovative measures and enormous firepower. Given the success of these policies, some of these instruments may be permanently included in the new standard-framework, and thus equip policy makers with the tools to engage in proper and timely action.

Second, we as central bankers have gained a much better understanding of how the financial system operates and how risks to the stability of the financial system may develop. A lot has been done to make the system much safer than it was 10 years ago and as resilient as possible. Such work has progressed in various directions, including not only better regulation but also higher capital and liquidity buffers for banks, early warning systems and the development of macroprudential tools to increase resilience to shocks when they occur.

Third, we have also taken bold steps to strengthen Europe. At the national level, euro area

countries have stepped up structural reform efforts in the labour and product markets to boost productivity and in the fiscal sector to make public finances more effective. The Banking Union (with a single supervisor, a Single Resolution Mechanism and – a yet-to-be-established but of utmost importance – shared European Deposit Insurance Scheme) has helped create a better integrated, more efficient and well capitalised European banking sector. Coupled with the completion of the capital market union, it can support the single market and fund investment and growth.

At the same time, many challenges remain and a lot still needs to be done. The financial system continuously innovates and the work of regulators comes with a lag. In fact, certain large financial institutions that conduct activities similar to banks but have no banking license – what we call non-banks – remain insufficiently monitored and under-regulated. Challenges also remain outside the financial system, with for instance geopolitical risks remaining elevated, trade disputes or cyber-risks. As central banks, we have to be prepared for all contingencies.

For someone like me, with deep interest in economic history, it is clear that "those who can't remember the past are condemned to repeat it". We need not only the ability to learn from the mistakes of the past, but also the vision to avert repeat mistakes. At the same time, it is our duty to strengthen our safety net and be better prepared for all contingencies and, as I just discussed in my remarks today, a lot has been done on that front

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1 Since the announcement of policy measures in June 2014, lending rates for non-financial corporations and households have dropped by around 130 basis points and 110 basis points, respectively. Rates on very small loans (a proxy for loans to SMEs) have declined by more than 210 basis points. Heterogeneity of lending rates across countries has fallen sharply. See Mersh, Y. (2018), "Monetary policy in the euro area – a brief assessment". MNI Connect Roundtable, Singapore, 10 October 2018. (www.ecb.europa.eu/press/key/date/2018/html/ecb.sp181010.en.html)

2 Bernanke, B. (2017), "Monetary Policy in a New Era", conference on Rethinking Macroeconomic Policy, Peterson Institute for International Economics, 12–13 October 2017.

3 See, for example, Constancio, V. (2018), "Past and future of ECB monetary policy", speech at the Conference on "Central Banks in Historical Perspective: What Changed After the Financial Crisis?", organised by the Central Bank of Malta, Valletta, 4 May 2018 (www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180504.en.html).

4 Setting short-term interest rates above the natural rate puts downward pressure on activity and inflation. Setting them below the natural rate has the opposite effect. See, for example, Cœuré, B. (2016), "Assessing the implication of negative interest rates", Yale School of Management, New Haven, 28 July. (www.ecb.europa.eu/press/key/date/2016/html/sp160728.en.html). Cœuré, B. (2017), "Outlook for monetary policy in the euro area", Association d' Économie Financière, Paris, 2 February (www.ecb.europa.eu/press/key/date/2017/html/sp170202_2.en.html)

5 The shadow banking sector accounts for around 40% of the EU financial system. See Draghi, M. 2018, Welcome remarks at the 3rd annual conference of the ESRB, Frankfurt, 27 October. (www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180927.en.html)