

Luis de Guindos: International spillovers of monetary policy and financial stability concerns

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the conference “The ECB and its watchers XX”, Frankfurt am Main, 27 March 2019.

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Introduction

It is a great pleasure for me to speak at this year’s ECB Watchers Conference. Given the topic of this session, I will start by referring to our recent findings on international spillovers of monetary policy and the related financial stability concerns for the euro area. I will then focus on our financial stability assessment at the present juncture. In doing so, I will briefly refer to an analytical tool we have employed to monitor and assess the banking system’s resilience.

Globalisation has not only caused inflation and output to become increasingly synchronised across countries. Equity prices and financing conditions have become more synchronised, too. Most of this synchronisation stems from (common) global shocks, but the effects of international spillovers of monetary policy are less obvious.

In my talk today, I will touch upon issues surrounding these international spillovers, and whether they are of concern for the financial stability of the euro area.

In a globalised and financially integrated world, spillovers from the monetary policy of one country to other economies are unavoidable.

We can identify at least three international transmission channels:

1. The “aggregate demand” channel, through which monetary policy affects domestic demand and, thus, the demand for foreign goods.
2. The “exchange rate competitiveness” channel, through which monetary policy affects the exchange rate, meaning it changes the price of domestic goods relative to foreign goods.
3. The “financial channel”, through which monetary policy affects domestic financial conditions. When there are strong financial connections between countries, these conditions may change abroad as well.

From these transmission channels, let me focus on the “financial channel” for the remainder of my talk.

Financial spillovers from US monetary policy to the euro area

Measuring international spillovers is not easy, because global shocks lead to economies moving in a synchronised manner for reasons unrelated to monetary policy.¹

In line with previous evidence², recent ECB research identifies large financial spillovers from US monetary policy to global financial conditions, including euro area financial conditions.³

More specifically, over the course of one month, monetary policy tightening by the Federal Reserve System drives up euro area corporate bond spreads⁴ just as much as US corporate bond spreads. It also triggers declines in euro area stock markets of a similar magnitude to the declines in US stock markets.⁵

However, the financial spillovers from ECB monetary policy to US bond spreads, or to foreign equity markets, are found to be less impactful. This asymmetry in the international impact of US

monetary policy and euro area monetary policy is rooted in the dominant role of the US dollar in global financial markets.

Furthermore, our analysis⁶ shows that there are only limited spillovers from the monetary policy of the Federal Reserve to euro area inflation and output. This suggests that ECB monetary policy actions are, by and large, able to shield the euro area economy from spillovers from US monetary policy.

But undoubtedly, there is evidence that US monetary policy is a driver of a “global financial cycle”.⁷

In step with such a financial cycle the risks to euro area financial stability can change as well.

Current financial stability concerns in the euro area

As you know, our characterisation of the main risks to euro area financial stability has remained broadly unchanged over the recent years. We see four main risks: The most prominent risk stems from the possibility of a disorderly increase of global risk premia. The second risk is related to renewed debt sustainability concerns, for sovereign debt in particular. The third risk is that banks’ intermediation capacity may be hampered by their continued low profitability. Finally, we are of the opinion that possible liquidity strains in the investment fund sector constitute a growing risk. All four risks are intertwined and would have, if they were to materialise, the potential to be mutually reinforcing.

In 2018, a growing economy and improved banking sector resilience were important positive factors supporting financial stability. Now, however, the assessment is affected by a weakening economic growth outlook for the euro area. In the latest ECB staff macroeconomic projections, expected real GDP growth was revised downwards, and the outlook continues to be viewed as tilted to the downside on account of persistent uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets.

In my view, the deterioration in the growth outlook increases the risk of financial instability particularly via two main channels. First, low economic growth raises concerns about sovereign debt sustainability. And second, it further dampens profitability prospects for the banking sector.

A weaker growth trajectory will challenge euro area sovereigns’ ongoing deleveraging. Low growth and elevated public sector debt also leave a number of euro area countries vulnerable to higher funding costs. Furthermore, threats stemming from rising protectionism around the globe, and high political uncertainty within Europe, may amplify potential corrections of sovereign bond risk premia. These risks notwithstanding, market-based indicators of stress in the euro area sovereign bond markets have remained relatively contained in 2019, and debt sustainability concerns have remained country-specific. Looking ahead, as growth prospects moderate it is imperative that fiscal buffers are rebuilt in countries where government debt still is too high.

A prolonged period of low economic growth also poses challenges for euro area banks. Over the past ten years following the great financial crisis, funding strains and subsequently hampered bank intermediation capacity related to low bank profitability have figured prominently in our risk assessments. The low growth and inflation environment will probably exert downward pressure on the risk-free rate component of bonds across maturities. As a result, profitability stemming from the maturity transformation business may come under renewed pressure – not least as retail household deposits tend to be bound at zero. Furthermore, should downside risks to the economic outlook materialise, higher loan loss provisions may further compress bank profitability.

Accommodative monetary policy has greatly supported bank profitability in past years. In fact, conventional and unconventional measures have improved the quality of credit overall, thereby

reducing provisioning needs. Our measures have also increased the demand for loans, which has more than offset the negative effect of compressed margins. Furthermore, structural factors are also weighing heavily on euro area banks' profitability.

In an environment where cyclical factors may exert further downward pressure on bank profitability, banks would need to step up their efforts to overcome structural challenges. Such measures may include cost reductions – including lower staffing costs and streamlining of branch networks, enhanced digitalisation – implying initial, one-off large-scale investments, revenue diversification and the reduction of the stock of non-performing loans in the six countries where levels are still high.

A number of regulatory and policy measures could help to improve the institutional setting in which the banking sector operates and facilitate banks' efforts to adjust their business models. Such measures should include completing the banking union (in particular the establishment of a European deposit insurance scheme), the subsequent removal of the remaining non-harmonised national options and discretions, and making progress with the capital markets union. This could foster further consolidation, including across borders, and address the problem of overcapacity in the euro area banking system.

Assessing the financial stability of the euro area

Beyond regular monitoring activities, financial stability analysis entails assessing the impact on the financial system of risks materialising, including risks related to international spillovers. Such assessments can also help inform the calibration of possible appropriate macroprudential policy responses.

The stress-testing framework is an important analytical tool to quantitatively assess financial system vulnerabilities and risks. Stress testing exercises of the banking sector assess the sector's resilience and how it performs under adverse circumstances, thus providing a measure of the severity of these risks. Individual bank results provide further information about banks' potential capital needs. Stress tests can therefore show how the financial system will react when risks, such as those relating to spillovers, materialise.

In order to enhance its stress-testing capacity, the ECB has invested in an analytical framework that not only tracks the resilience of the banking sector but also accounts for how it interacts with and feeds back in to the economy as a whole.⁸

This framework complements the EU-wide stress tests conducted under the aegis of the European Banking Authority (EBA), which are predominantly microprudential in nature.

Our so-called macroprudential stress testing loosens the assumption that banks' balance sheets are constant. As banks are hit by, say, negative (spillover) effects from the global environment, they may react by deleveraging their loan books. This type of stress testing also accounts for what implications banks' reactions would have for the real economy. In other words, macroprudential stress tests consider the adverse credit supply shock that may lead to an amplification of the macroeconomic effects of the global shock, which, in turn, could further damage banks' balance sheets. By modelling the negative feedback loop between the banking sector and the real economy beyond the first round of shocks, we believe the exercise becomes more realistic.

A macroprudential stress test of banks directly supervised by the ECB, using the baseline and adverse scenarios of the recent EBA stress test, confirmed the general resilience of the euro area banking system. Results, however, point to an additional fall in GDP of 1.6% across the euro area, on top of the GDP shocks of the adverse scenario over the three-year horizon.

This stress-testing framework can also inform the calibration of macroprudential policies with the

aim of limiting unintended spillovers to other parts of the financial system or the real economy.

In the spirit of pre-emptive macroprudential policy, these exercises can emphasise the need for the timely build-up of capital buffers, which can then be used to absorb losses when risks materialise, before they affect growth and employment.

Finally, the stress-testing framework can be used to analyse the spillover effects of the macroprudential policies themselves.⁹

For instance, another finding of the framework is that capital-constrained banks are more likely to reduce their foreign exposures than their domestic ones. We are particularly concerned about spillover effects of macroprudential policies within the euro area, because the build-up of a capital buffer in one country should, to the extent possible, not impair the functioning of financial intermediation in other euro area countries.

Conclusion

Let me conclude by emphasising that, in a globalised and financially integrated world, the euro area is not immune to spillovers from other regions, in particular to shocks emanating from the United States.

But we are convinced that we have the appropriate policy tools to largely shield the euro area economy and financial system from such spillovers. Monetary policy and macroprudential policy have different objectives and, therefore, different sets of policy tools.

Cyclical factors, such as compressed interest margins, pose challenges to banks' operating environment, but the gains have so far greatly offset the losses. In turn, euro area banks need to address their structural fragilities, which partially explain the very low price-to-book ratios of euro area banks when compared with their international peers.

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¹ Likewise, the response of financial variables within one day of a policy announcement might not be a good measure of persistent spillover effects. In fact, a sufficiently long horizon is crucial to capture the spillovers that are economically relevant. Results over shorter horizons typically differ. For example, Ehrmann and Fratzscher (2005) estimate that, over one day, about one-third of US Treasury bill rate changes feed through to euro area interbank rates, but that beyond this US monetary policy has no significant impact on the euro area. Neely (2015) finds spillovers of a similar magnitude. Curcuro et al. (2018), in contrast, find that during a one-day period, ECB announcement surprises spill over to US Treasury yields in a similar manner as Federal Open Market Committee announcement surprises spill over to German Bund yields.

² See, for example, Kim (2001), Georgiadis (2016), Chen et al. (2017) and Iacoviello and Navarro (2018). The

results for conventional and unconventional monetary policy are similar. Rogers et al. (2014) and Chen et al. (2016) provide evidence on large spillovers from the Federal Reserve's unconventional monetary policy to the euro area.

- ³ Ca' Zorzi et al. (2019) and Jarociński and Karadi (2018) draw a distinction between monetary policy surprises (the so-called shocks) and other surprises, such as news effects.
- ⁴ Spreads relative to speculative bonds (below BBB rating), averaged over all maturities.
- ⁵ Corporate bond spreads increase by about 10 basis points and stock markets decline by about 50 basis points in response to a monetary policy shock that increases one-year government bond yields by 2 basis points.
- ⁶ See Ca' Zorzi et al. (2019).
- ⁷ See Miranda-Agrippino and Rey (2018).
- ⁸ See ECB (2019), "A bird's-eye view of the resilience of the European banking system: results from the new macroprudential stress test framework", *Macroprudential Bulletin*, March 2019, forthcoming.
- ⁹ Forbes et al. (2017) describe how macroprudential policies can create spillovers on their own.