

Denis Beau: Navigating a changing weather

Speech by Mr Denis Beau, First Deputy Governor of the Bank of France, at a Meeting with Observatory Group, New York City, 10 June 2019.

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Accompanying [slides](#) of the speech.

I would like to discuss with you today a few issues that come to mind when watching over global financial developments.

I do not know whether a storm is coming but the weather has certainly changed over the past quarters and we need to make sure that we are ready to withstand harder times.

Indeed, the two points I would like to make in my initial remarks are 1/ risk to financial stability are on the rise 2/ against that backdrop, it would be prudent to strengthen further the resilience of the global financial system. Macroprudential policy has a critical role to play in this respect, alongside a strong focus on filling knowledge and policy gaps while maintaining a steady (regulatory and supervisory) hand at the helm.

(1) Risk to financial stability are on the rise

[Slide 1]

The macroeconomic outlook remains uncertain: the global slowdown, which was initially exacerbated last year by idiosyncratic factors, is deeper and more persistent than initially foreseen.

Since last summer, the IMF has revised its assessment of the global economic outlook downwards.

The cyclical upswing it expected back in the spring of 2018 became a less even expansion with increased downside risks over the summer. Last autumn and late last year, the IMF insisted on the weakening of the expansion. The latest forecast took note of the global slowdown and foresaw a precarious recovery.

Overall, at global level, it looks like we are facing a slowdown at the end of a long expansion rather than an outright downturn.

However, uncertainty is rising markedly: trade tensions, geopolitical risks across the globe, political risks in Europe, etc. This makes the current juncture harder to navigate.

In the US, the macroeconomic outlook has led the Fed to, somehow, pause in its normalization process.

In emerging markets, potential problems could be brewing as geopolitical issues (from trade tensions to Middle East developments) are compounded with financial fragilities.

Europe also has its fair share of uncertainties, with a few risks still unresolved.

The macroeconomic outlook remains uncertain: last year slowdown was mostly driven by idiosyncratic developments but their consequences over the next quarters and, more broadly, the influence of the global slowdown are still unclear.

According to the latest projections of the Eurosystem, GDP growth in the euro area would decelerate significantly in 2019 at 1.2% (after 1.8% in 2018) before gradually increasing to 1.4%

in 2020 and in 2021. This deceleration is mainly driven by Germany and by Italy.

The Brexit situation is unsettled. A combination of “not so bad” growth figures earlier this year in the UK (with short term hoarding somewhat covering the longer-term impact of Brexit on investment) and the decision last April to delay the Brexit deadline until 31st October may have allowed this issue to slip down in the preoccupations of economic and financial actors.

However, a “hard Brexit” would be a very unfortunate development but it remains a realistic outcome. In such circumstances, I cannot but advise anyone not to be complacent and carry on implementing contingent plans to have them in place if such a possibility were to unfold.

The situation in some other members states [Italy] can also cause concerns and lead to episodic unrest in markets.

Against that background, central banks have responded by pausing or delaying the normalisation of the monetary policy stance. At its recent meeting in Vilnius, the Governing Council of the ECB extended its forward guidance so that interest rates are now expected to remain at present levels at least through the first half of 2020. The Governing Council also released details of a new series of quarterly targeted longer-term refinancing operations (TLTRO III) intended as a backstop measure against possible future funding pressures. These actions will support the macroeconomic outlook and the financial system.

[Slide 2]

The resulting prospect of a low interest rate environment for a longer period of time is nurturing two related developments. These are unintended consequences or, more precisely, side effects that are not completely unrelated with the medicine but should be monitored closely by central banks in their financial stability capacity and, more generally, by macroprudential authorities.

The first one is an incentive given to corporates and households to take on more debt.

The second one is a sustained slip toward greater risk taking in the markets that may not be recognized because “things look fine” or because “we should dance while the music is playing”.

In this respect, I am not disputing the relevance of “alternative asset classes” (which the hotly debated CLO market is an emblematic yet tiny part) and the rising exposure of institutional investors toward “real assets”. Such developments are indeed useful and welcome.

However, the large shift in allocations toward these assets classes and the more general increased risk appetite driven by the current macrofinancial environment are not without risks:

- ♦ On the equity market, valuations can be stretched and mainly responding to financial developments rather than macro or fundamental factors as we have seen over the past few months when the late 2018 correction “corrected” quickly in 2019;
- ♦ Similarly, after a (modest in a longer-term perspective) increase in late 2018, risk premia in the bond and credit market are compressed back to their historically low levels.

Losing sight of fundamentals while your risk tolerance is at its highest and you have grown accustomed to suppressed volatility can foster difficulties ahead when adjustments would have to be made.

These two trends, non financial actors leveraging up and greater risk taking by financial institutions, are indeed global trends. Within the euro area, credit distribution (bonds and loans) to the private sector has remained the most dynamic in France, resulting in a gradual but persistent increase in debt ratios.

More recently, credit has been getting some traction in other economies so that French developments may be informative of forthcoming developments elsewhere.

In all cases, the concern is less about an immediate risk that one regarding the sustainability of the current developments. These are indeed medium-term trends deserving serious attention alongside other medium-term developments such as digitalization or climate change.

The former (digitalization) hold very promising prospects in terms of efficiency, inclusiveness and quality of consumer services, etc. It is also a formidable challenge for the incumbents, threatening established positions and questioning business models.

Depending on the reactivity of the various stakeholders, (traditional financial institutions, new players, established players in other sectors making a foray into financial services, regulators, etc.), this challenge can be satisfactorily overcome or leave the whole financial system in a rather precarious situation.

The latter (climate change) is a tremendous challenge that will contribute to reshaping the global economy and, more broadly society. This challenge is so significant that it is bound to have consequences for the financial system both as a risk concern and as a business issue.

(2) Strengthening the resilience of the global financial system

Faced with such developments, it would be prudent to strengthen further the resilience of the global financial system.

[Slide 3]

I would argue that macroprudential policy has a key role to play to address the immediate concerns and is one critical element in strengthening resilience further.

Macroprudential authorities can seek to prevent an acceleration of the financial cycle. Or, with more reasonable ambitions, to contribute to limit the formation of “lumps of risks”.

The most ordinary macroprudential intervention relies on communication. By reminding time and again of the possible pitfalls of leveraging up and becoming complacent about risk taking, we seek to prompt second thoughts and ensure that risks are effectively understood, adequately priced and sensibly managed.

If it starts with communication, macroprudential policy in this respect can also go further.

Indeed, this preventive reasoning led the HCSF, the French macroprudential board, to limit the main French banks' exposure to large “highly indebted firms”: by making it more difficult to an already heavily indebted corporate to take on even more debt, the aim is to restrain the development of a segment of overstretched large firms.

But the main objective of macroprudential authorities and an easier one to achieve should be to strengthen the resiliency of the financial sector when things are going well to allow it to withstand the shocks that will eventually hit.

This is the rationale behind the CcyB. We do not intend to curb the overall credit growth. Rather, as JFK once said, “the time to repair the roof is when the sun is shining”. By setting the CCyB rate above zero now, we lock in existing excess capital at a time it is relatively cheap (in good times, retain earnings is the main driver of capital increase and the impact of a higher capital requirement on credit and the economy at large is limited by the current circumstances) to be able to absorb future losses and loosen the regulatory requirement at a time capital is scarcer and the macroeconomic impact of a gap would be significant.

A number of European countries have taken similar steps to increase their room for manoeuvre ahead of a possible future storm.

In that context, macroprudential policy is often described as a complement to monetary policy: a policy necessary to remedy the financial stability consequences of very accommodative monetary policy.

I would have a more encompassing perspective: macroprudential policy is a complement to monetary policy both today and in the future:

- ♦ by contributing addressing financial buoyancy, it enables monetary policy to be relatively more accommodative today – but the preventive reach of macroprudential policy should not be overestimated, especially while macroprudential authorities are still relatively young and the policy toolkit less sophisticated than that of other policies;
- ♦ more significantly, by building up (macro)prudential room for manoeuvre ahead of the next storm, it also helps restoring monetary room for manoeuvre to address adverse developments.

To conclude, I hope I convey the obviousness and urgency of the case for macroprudential policy in the current circumstances. But as I said, it is one part of the answer to address the clouds looming on the horizon.

Over the past ten years, we have ensured that the financial system has a stronger capacity to withstand shocks. But we need to develop it further:

- ♦ through achieving the implementation of post crisis regulations and deploy international standards as agreed. This also includes evaluating the effectiveness of these new regulations and possibly adjusting some of them. But evaluating is not a catch word for deregulating;
- ♦ through maintaining a supervisory steady hand. In Europe, this would include delivering on the NPL action plan, overseeing the implementation of robust lending standards, etc.;
- ♦ through developing macroprudential policies; and
- ♦ through relentlessly filling the knowledge gap, to seize, understand and address the risks from market developments (e.g. leverage finance), cyber-risks, new systemic players (e.g. big tech as systemic solution providers or alternative suppliers of or hub to financial services).