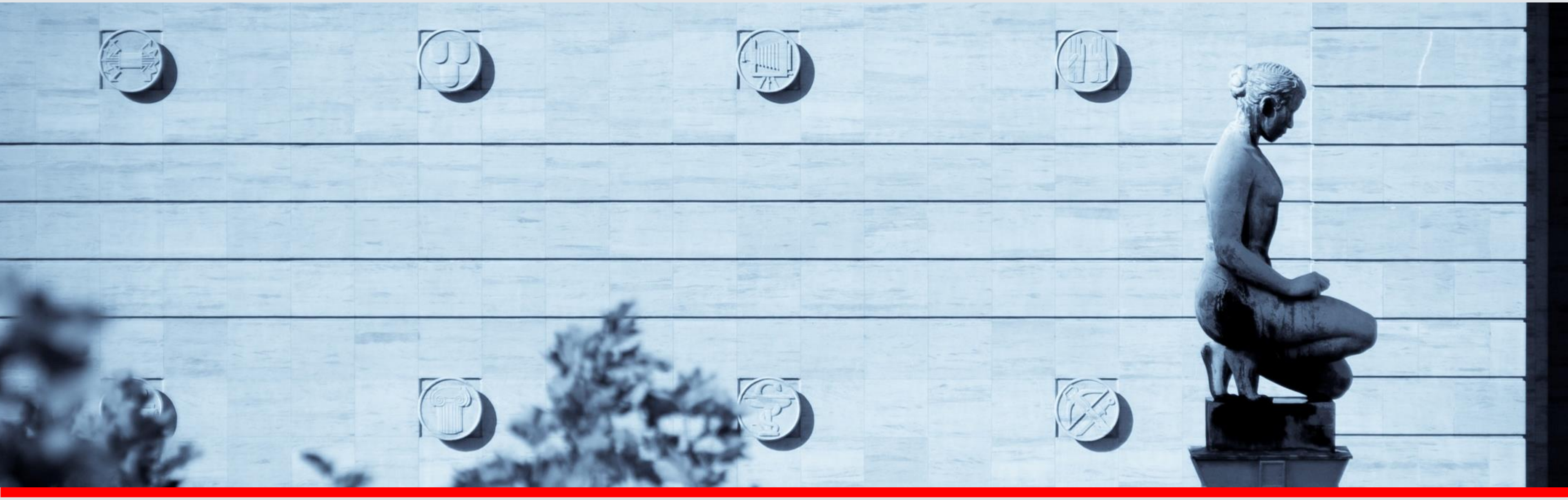
Trade-offs between financial stability and monetary policy

The 12th Edition of the Seminar on Financial Stability Issues
10 Years after the Global Financial Crisis: Macroprudential Measures

Sinaia, 14-17 November 2018



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BanqueNationaleBank
DE BELGIQUE VAN BELGIË
Eurosystem

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Introduction

- Focus on monetary policy and macroprudential policy interactions at the current juncture in the euro area

- Current juncture: monetary policy accommodation and consequent low interest rate environment
  - Motivated by monetary policy’s price stability mandate
  - Bearing the risk of negative side effects for financial stability

- Euro area: double level for macro-prudential policy
  - Area wide level
  - The national dimension of the 19 participating member states

Outline of the presentation

- A macro context still in need of significant monetary policy accommodation
  - Confidence in inflation picking up justifies normalisation – but a gradual one

- Monetary policy accommodation has both positive and negative spillovers for financial stability
  - While being vigilant as regards the negative spillovers …
  - … let's not forget about the positive spillovers

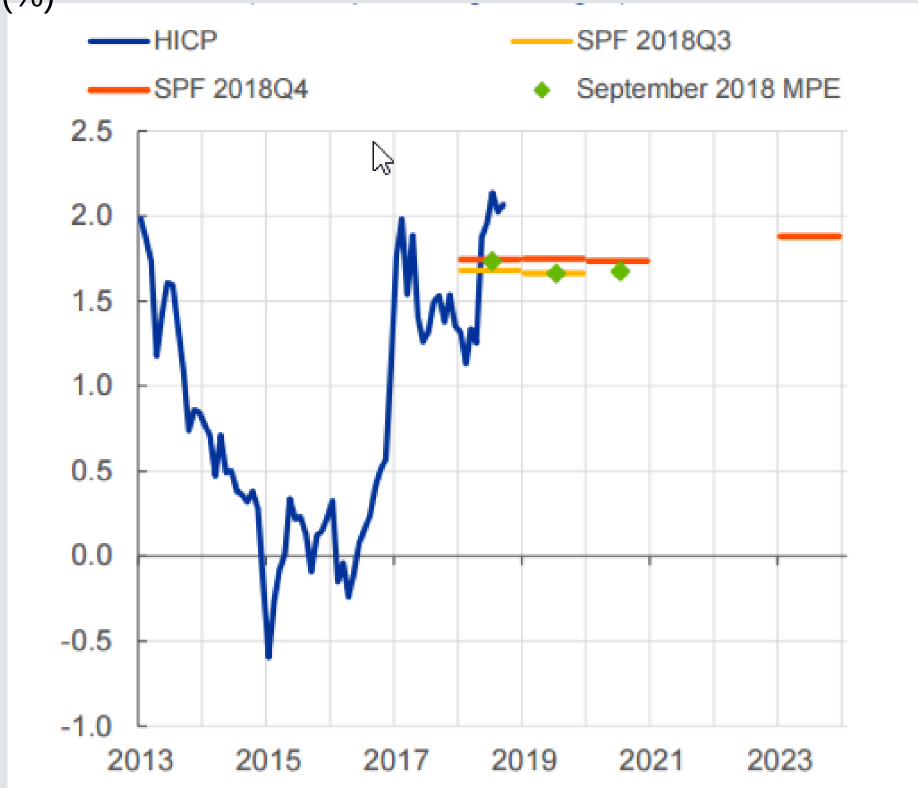
  → Strong role for macro-prudential policy at the current juncture

- Macro-prudential policy in the euro area
  - With an important national component
  - But area wide developments and common monetary policy have to be internalised when setting macro-prudential policy at national level

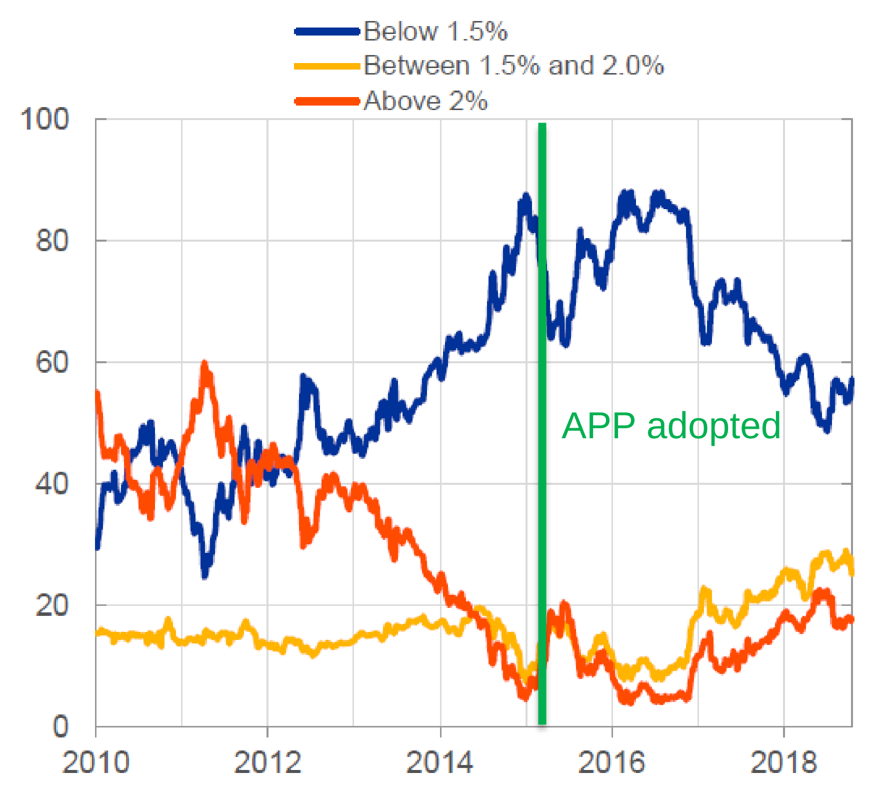
- Conclusion

Euro area inflation outlook warrants very gradual normalisation

Inflation path in the Survey of Professional Forecasters (SPF) and ECB staff forecast ("MPE") (%)



Option-implied risk-neutral probabilities of average inflation over the next 5 years (%)



Source: ECB.

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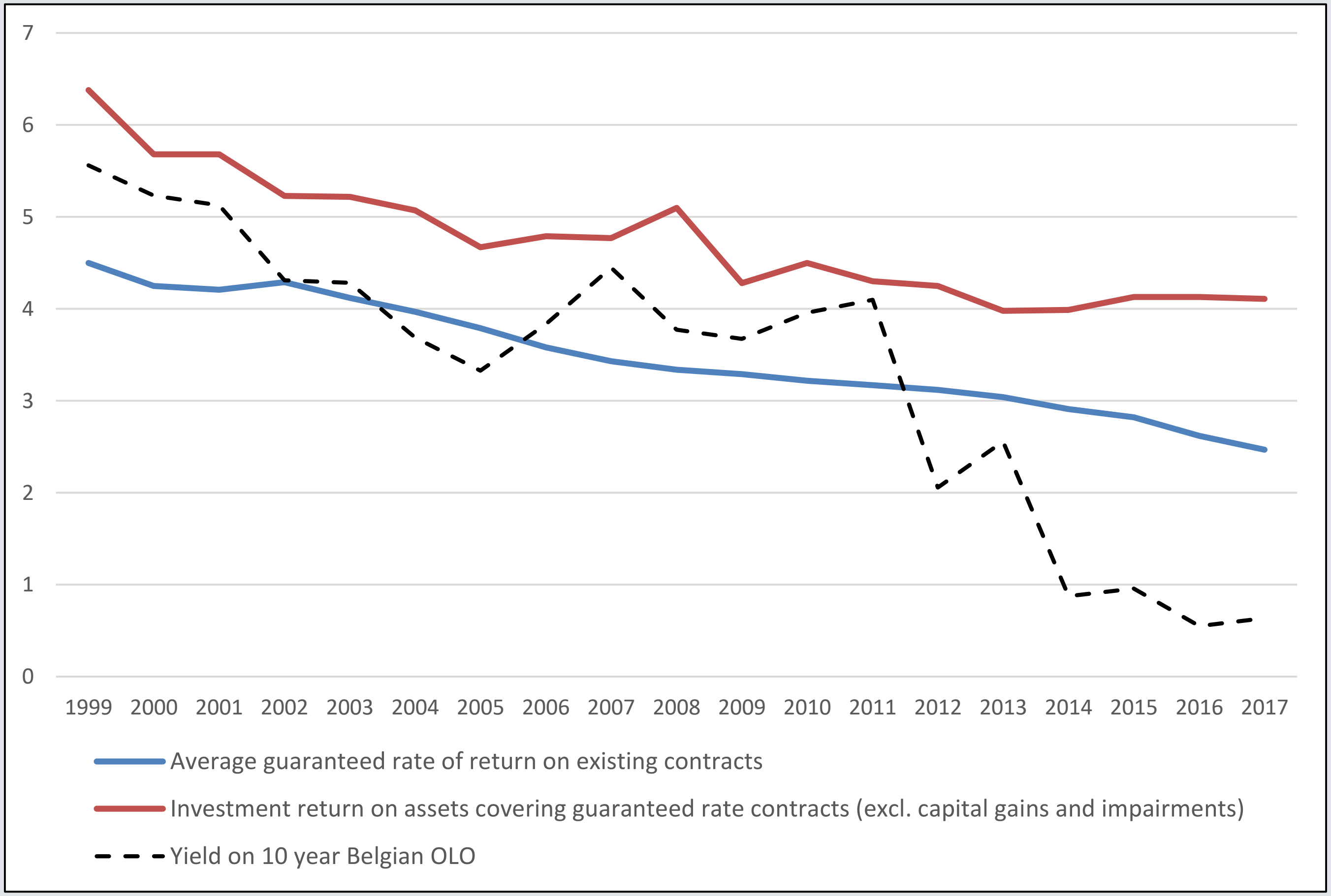
Negative side effects of monetary policy accommodation: strong role for macro-prudential policies addressing sectoral vulnerabilities

- **Possible negative side effects** of monetary policy accommodation
  - Overvaluation of asset prices
  - Excessive financial risk taking and search for yield (low profitability of financial institutions as a result of low interest rate environment)
  - Acceleration of the financial cycle
  - Leverage and liquidity positions in the in shadow-banking sector
  - Perverse incentives for resource allocation
- So far limited signs of broad-based stretched valuations in the euro area
  - With pockets of vulnerabilities, though: prime commercial property, housing markets, shadow-banking pressure on profitability of banks and insurers, …
- But increasing signs of an accelerating financial cycle and risk-taking in the euro against the background of more fragile economic outlook
- Macro-prudential policy is more targeted than monetary policy in addressing such sectoral vulnerabilities
  - While monetary policy accommodation also generates important, but not always very visible, positive spillovers for financial stability

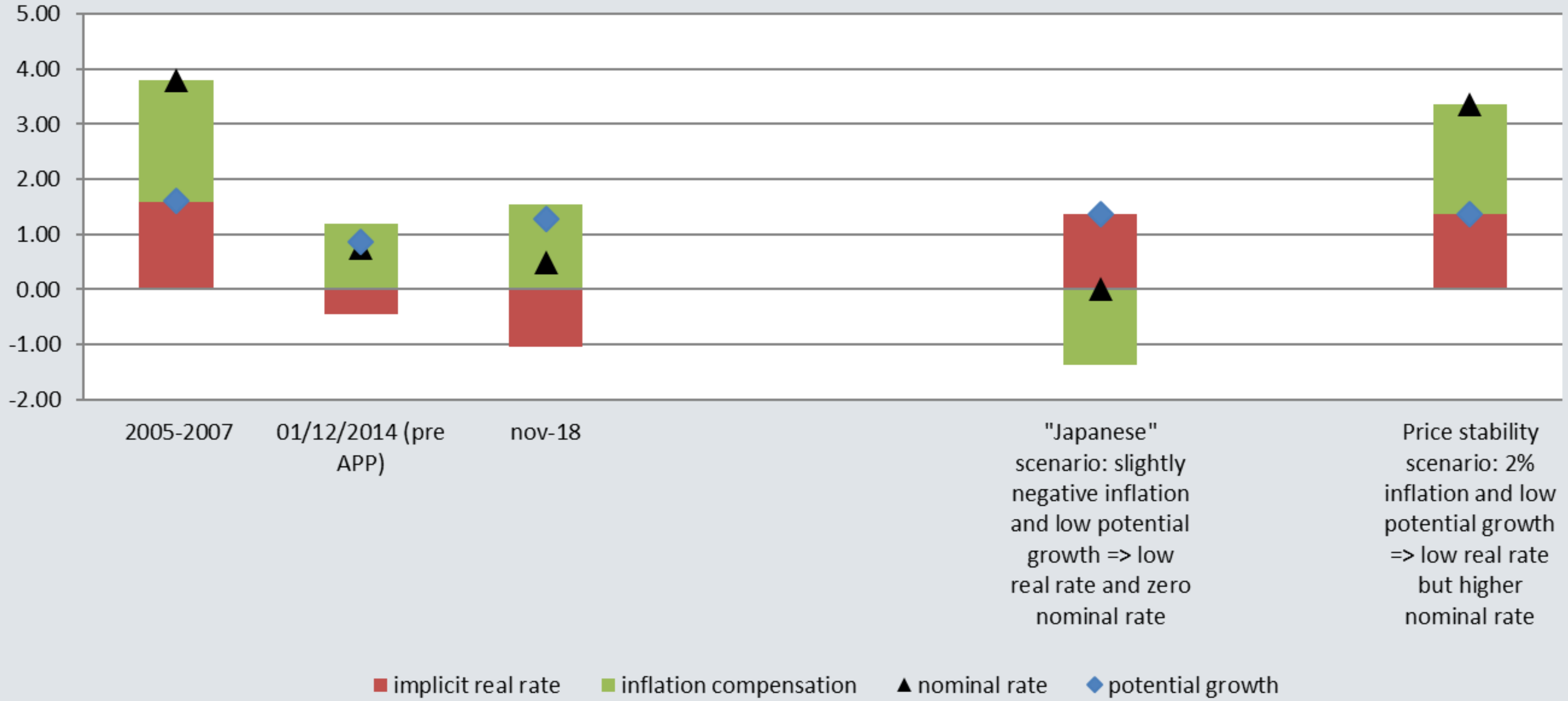
Low interest rate environment and life insurers

Relevant rates for insurers



Sources: NBB and Thomson Reuters Datastream.

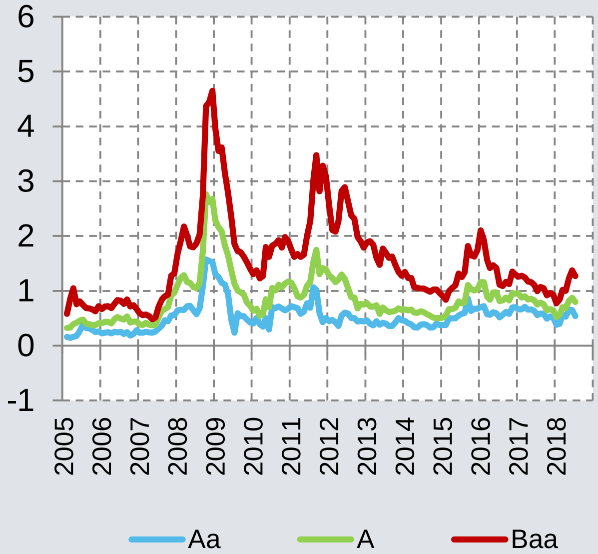
Two alternative scenarios for ten-year nominal bonds
(percentages)



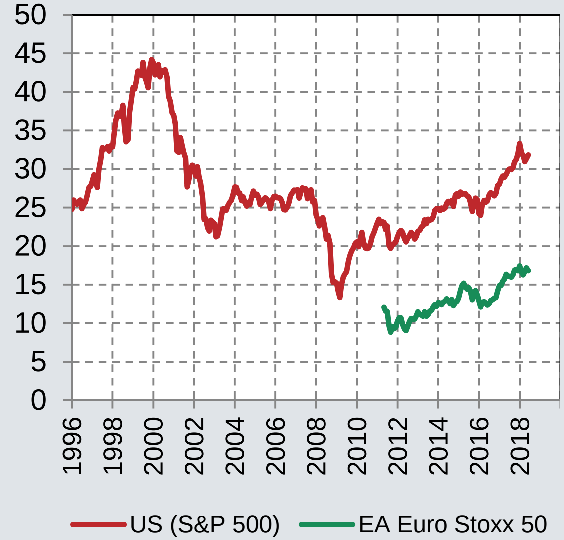
Sources: Bloomberg, OECD, ECB.
Interest rates are 10y AAA bond yields, inflation compensation is derived from inflation swaps and potential growth refers to OECD estimates and forecast.

Negative side effects of monetary policy accommodation: strong role for macro-prudential policies addressing sectoral vulnerabilities

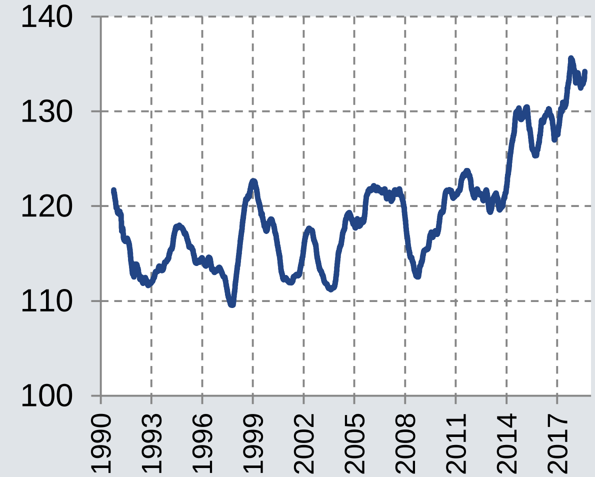
Euro area corporate spreads



CAPE US and EA

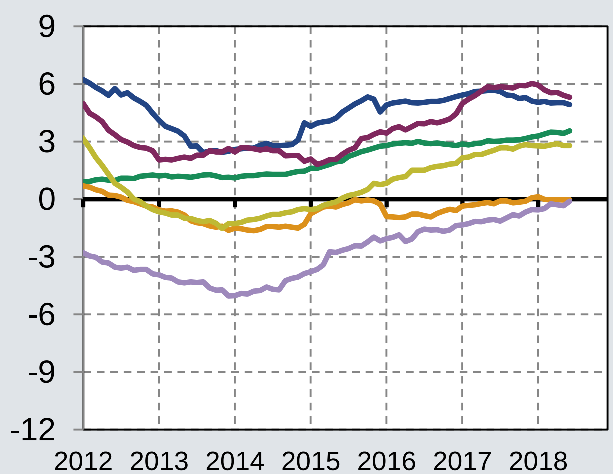


CBOE SKEW index (smoothed)



Credit to NFCs

Credit to households



RRE price growth

BE DE FR NL ES

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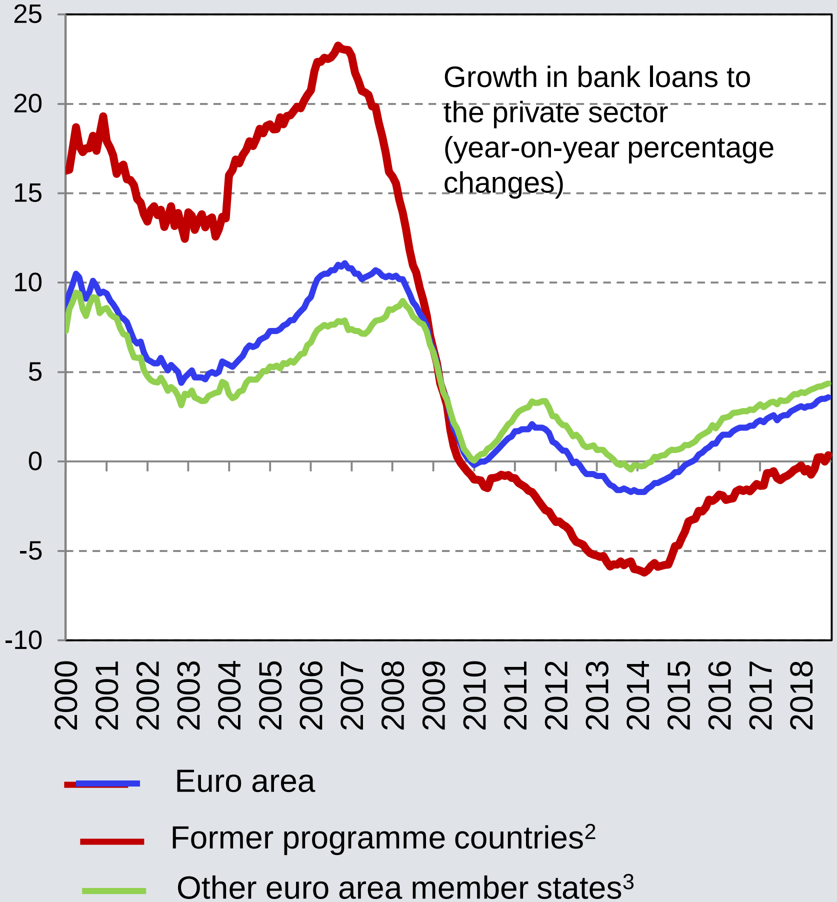
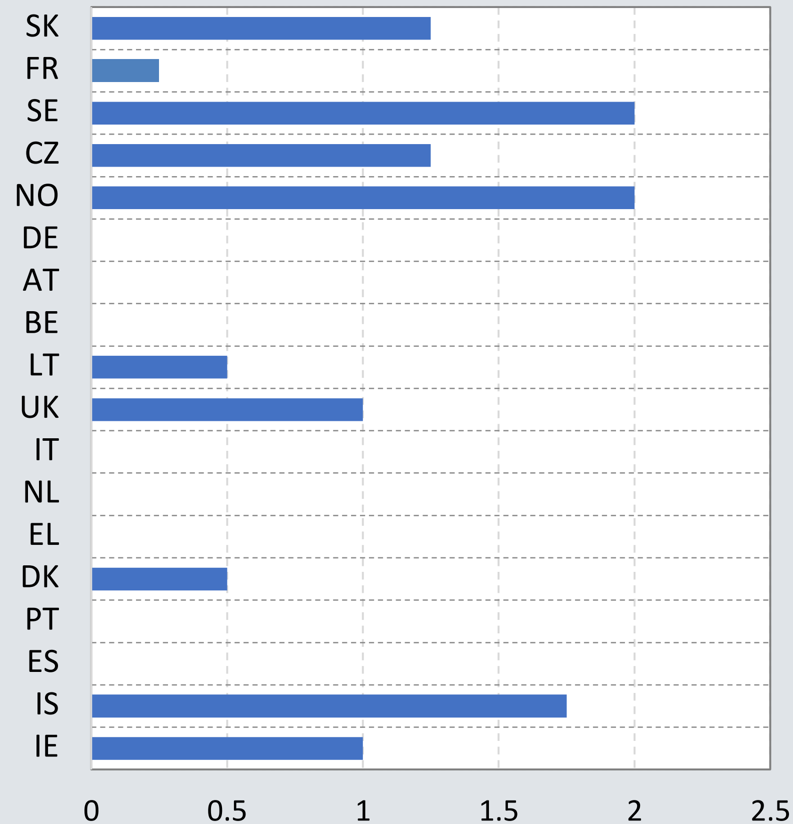
Heterogeneity in the euro area: a crucial role for macro-prudential policies at national level

Credit developments in euro area: credit to private non-financial sector



Announced CCyB rates 2018Q3

(% risk-weighted assets)



Source: ECB, ESRB.

[1] Total for households and non-financial corporations, corrected for sales and securitisation (data prior to January 2004 concern lending to the non-bank private sector and are not corrected for sales and securitisation).

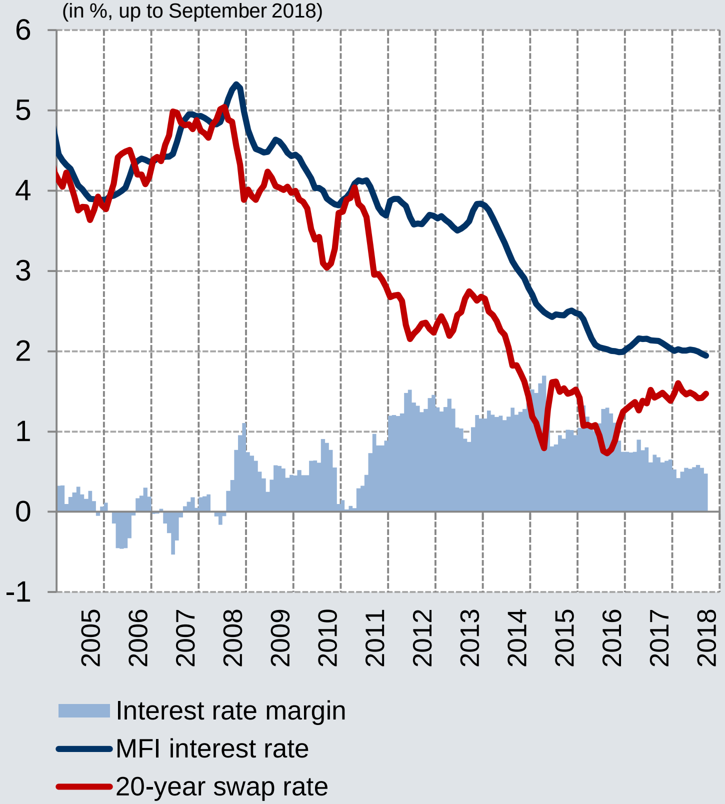
[2] Greece, Ireland, Portugal and Spain, GDP-weighted average (excluding Cyprus, for which data are not available for the entire period).

[3] Excluding Estonia, Latvia, Lithuania, Malta, Slovenia and Slovakia, for which data are not available for the entire period. GDP-weighted average (GDP weights refer to the period 2010-2018Q2).

An example: Belgian macroprudential policy addressing risks in housing and mortgage markets

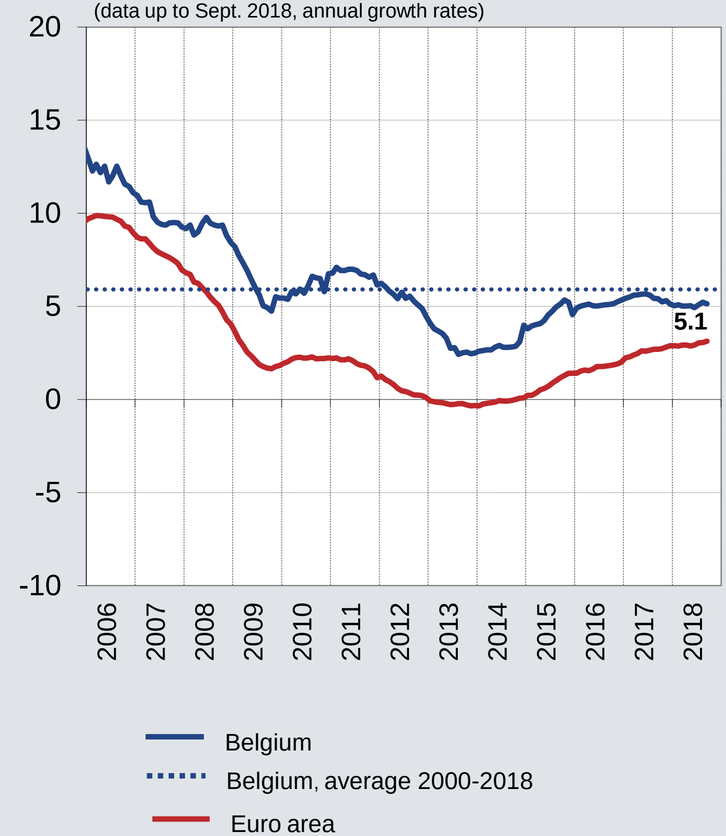
Interest rate margin on new loans to households[2]

(in %, up to September 2018)



Bank loans to Belgian households

(data up to Sept. 2018, annual growth rates)

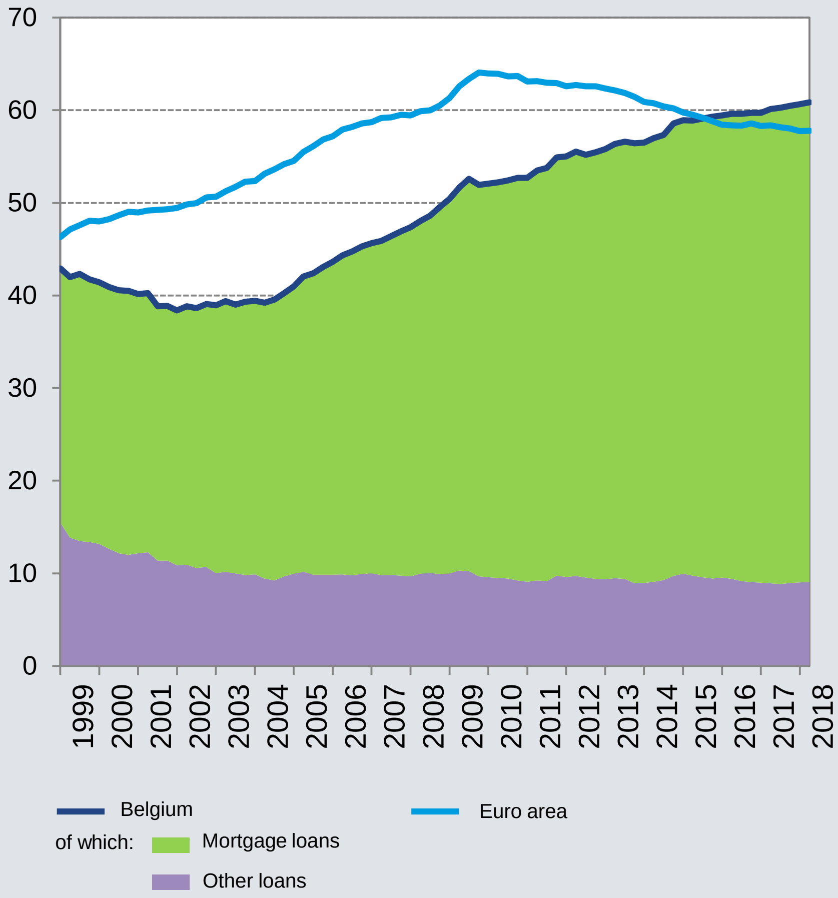


An example: Belgian macroprudential policy addressing risks in housing and mortgage markets

Increasing (active) leverage by Belgian household, in contrast to euro area where deleveraging is observed

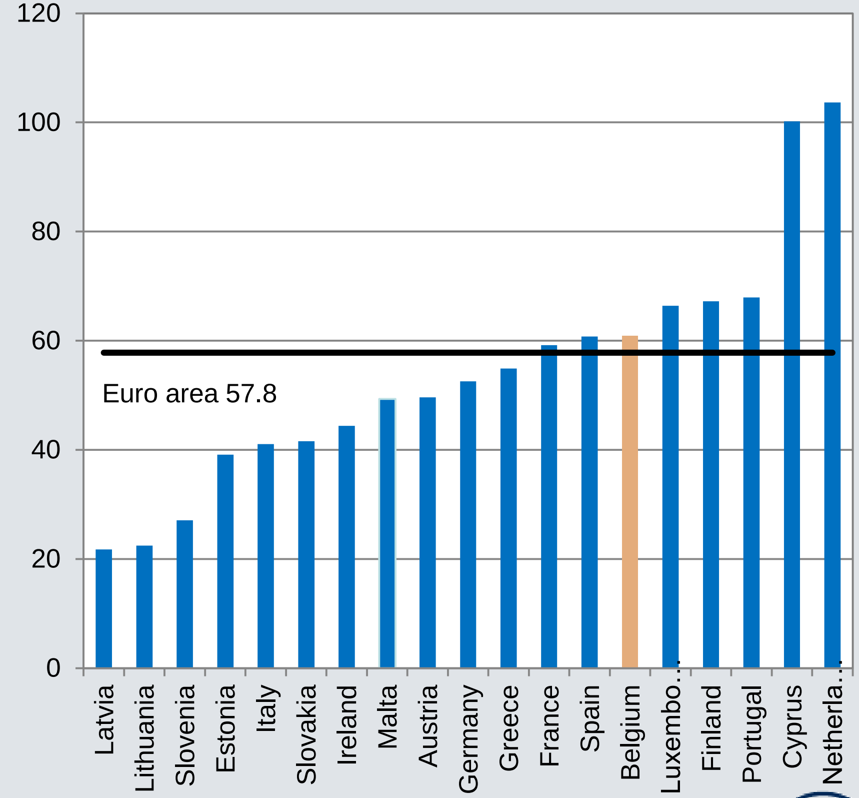
Debt-to-GDP ratio: development

(in %, 1999Q1-2018Q2)



Debt-to-GDP ratio: euro area countries

(in %, 2018Q2)

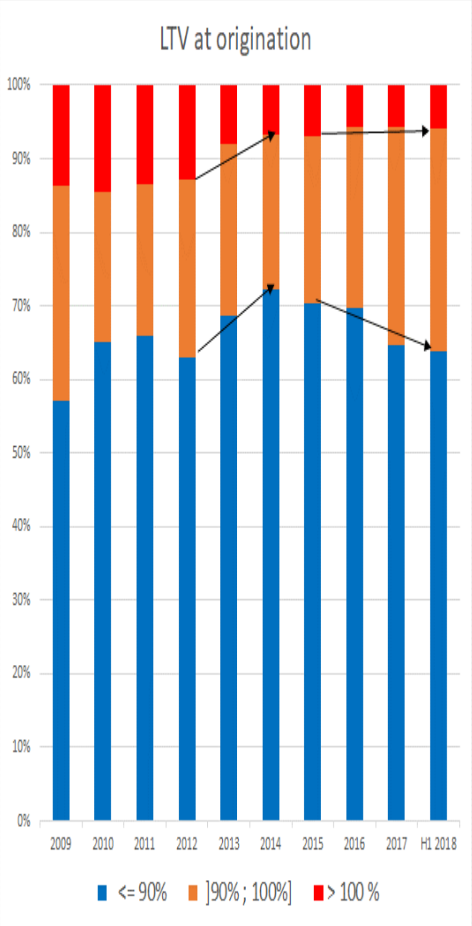


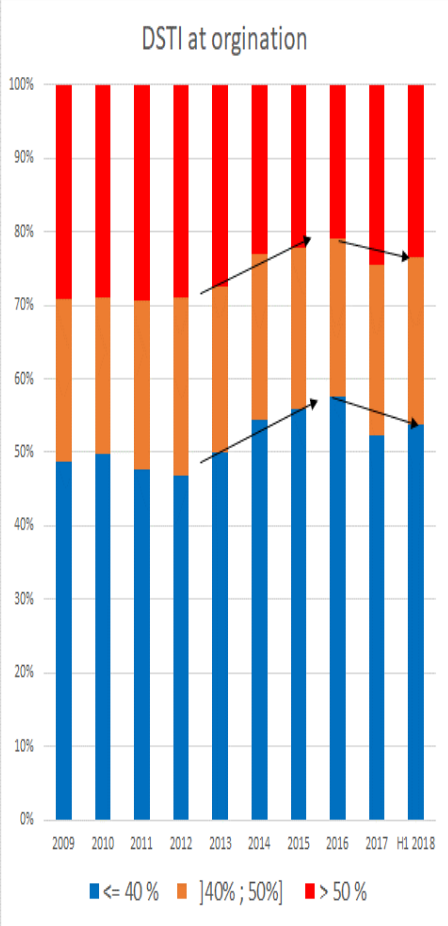
Sources: ECB, NBB.

* 2018Q1 data for Luxembourg.

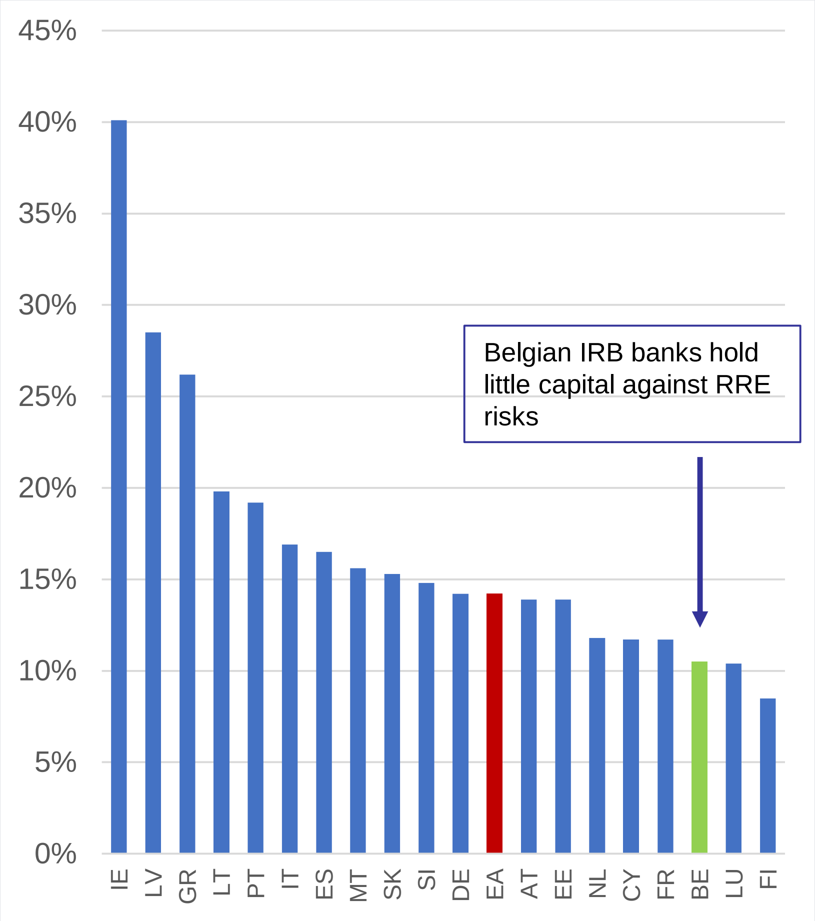
An example: Belgian macroprudential policy addressing risks in housing and mortgage markets

Deteriorating credit standards create a build-up of risk in RRE portfolios





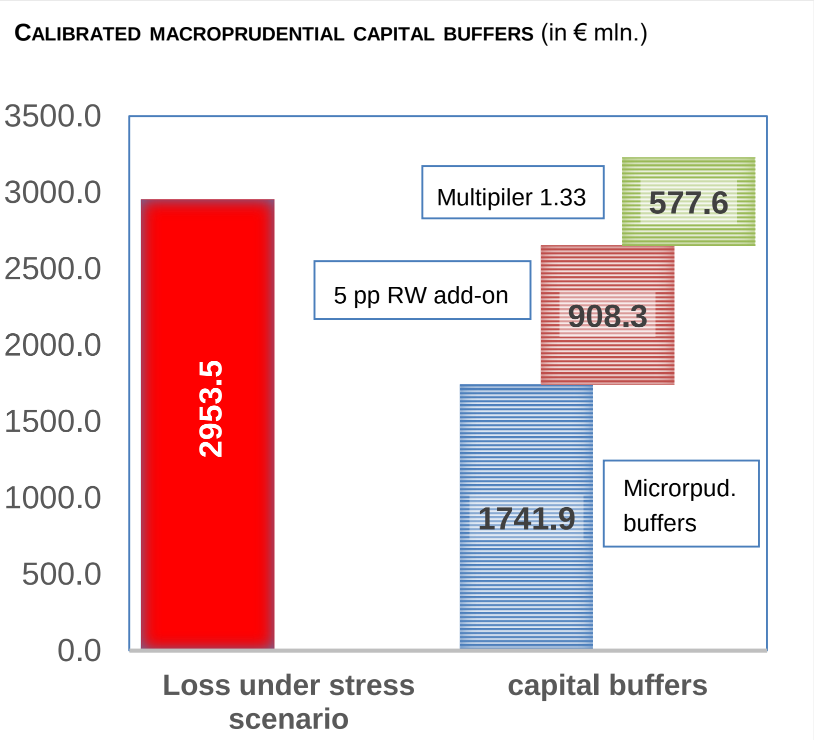
Micro-prudential RRE risk weights of Belgian IRB banks



An example: Belgian macroprudential policy addressing risks in housing and mortgage markets

Analysis points to significant losses on RRE portfolio, not fully covered by microprudential capital

Macroprudential measure builds up additional buffers to accommodate credit loss under severe RRE crisis scenario



Capital-based measure Art 458 CRR for Belgian mortgages at IRB banks (2013 - ...)

2013 – April 2018 : IRB risk-weight add-on of 5 percentage points.

Average microprudential IRB risk weight = 10 % (15 % incl. macroprud. add-on)

May 2018 – ... : measure broadened with targeted second component:

- IRB risk-weight add-on of 5 percentage points + Risk-weight multiplier of 1.33
- Average microprudential IRB risk weight = 10 % (18 % incl. macroprud. add-on)
- Increases buffers by € 1,7 bn

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  - → Strong role for macro-prudential policy at the current juncture
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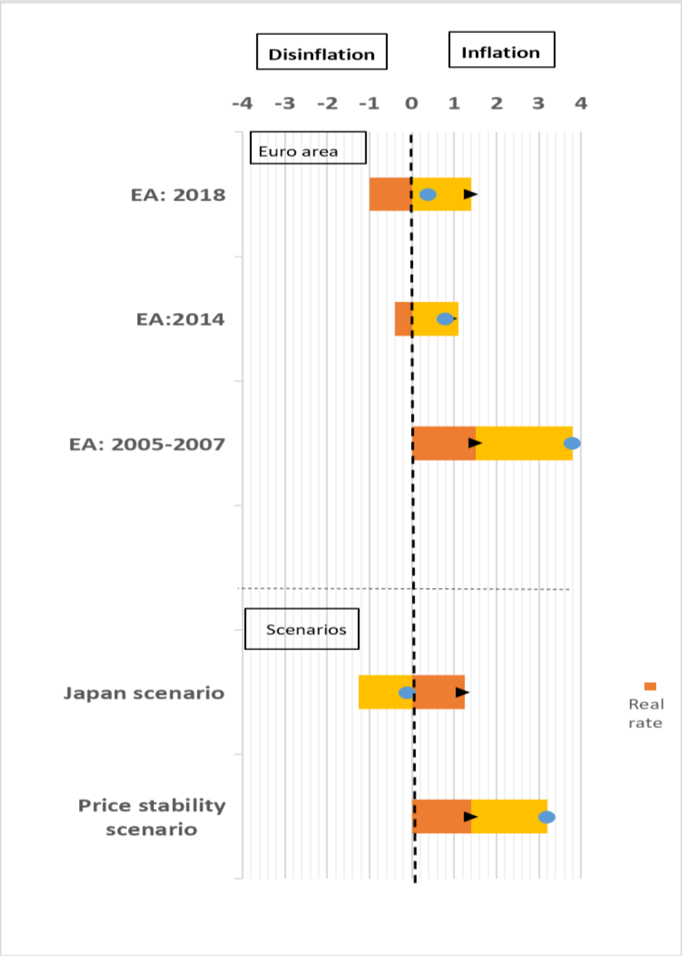
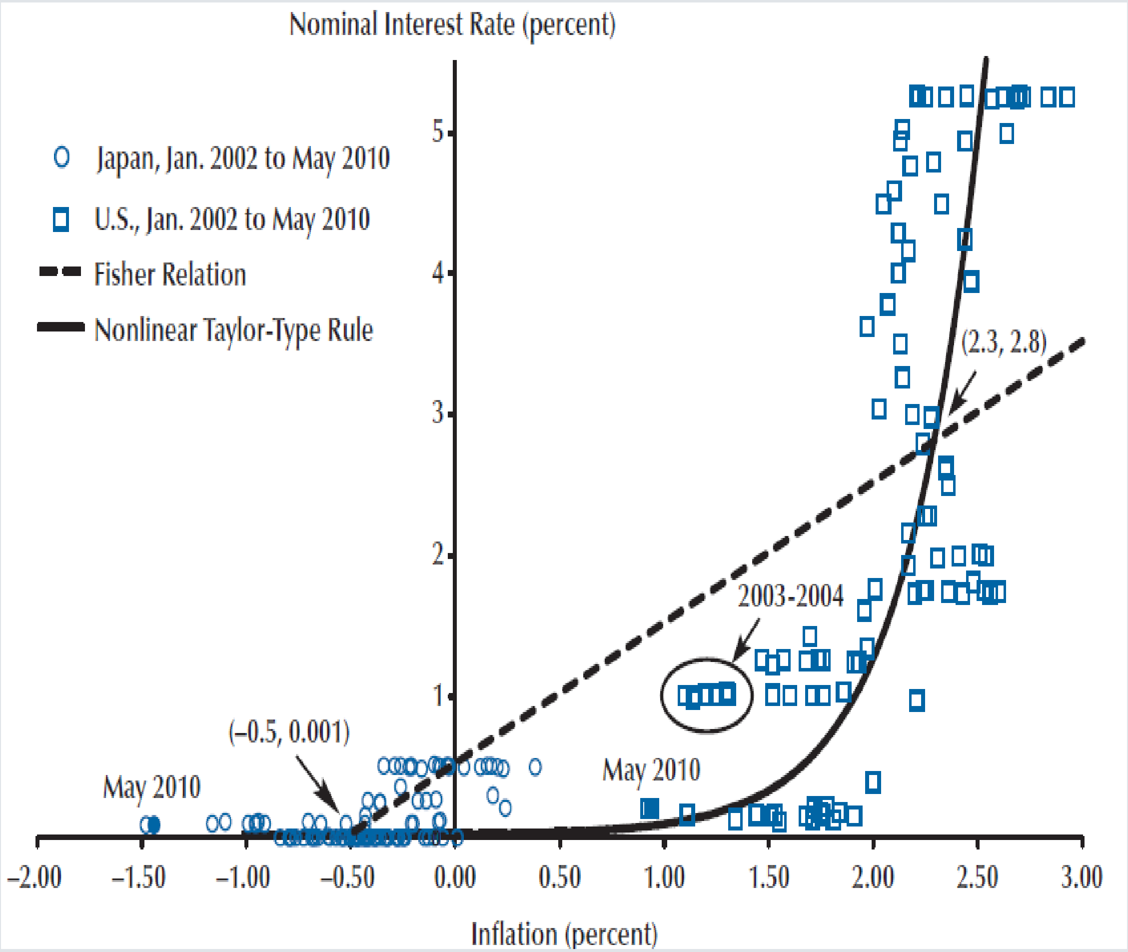
Conclusion

- Monetary policy has to focus on its primary objective in the euro area
- Macro-prudential policy is better placed to address negative side-effects of monetary policy accommodation as long as they are not broad-based
- This argument is even stronger in the euro area: imbalances and vulnerabilities can show up at the national level
- Optimally designed combinations of monetary and macro-prudential policy can significantly improve macroeconomic outcomes, but have their own limits
- Need to combine them with appropriate policies in other domains, e.g. structural reform and EMU completion
- If not: suboptimal outcomes and risk of overburdening monetary as well as macro-prudential policy

Background slides

Background slides



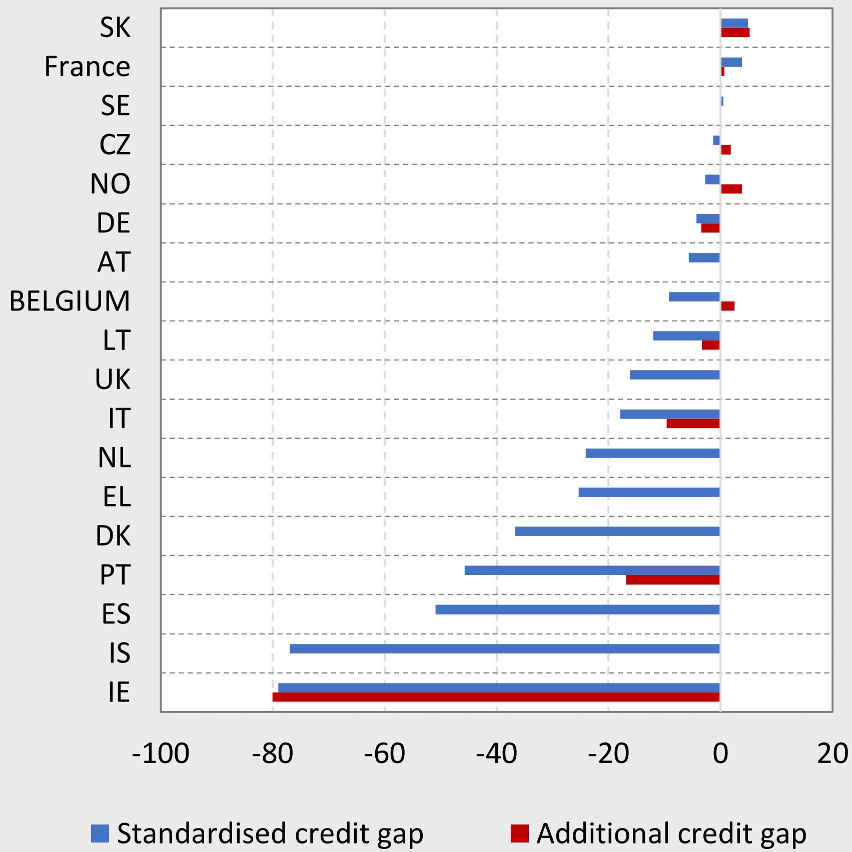


Sources: Bloomberg, OECD, ECB.
Interest rates are 10y AAA bond yields, inflation compensation is derived from inflation swaps and potential growth refers to OECD estimates and forecast.

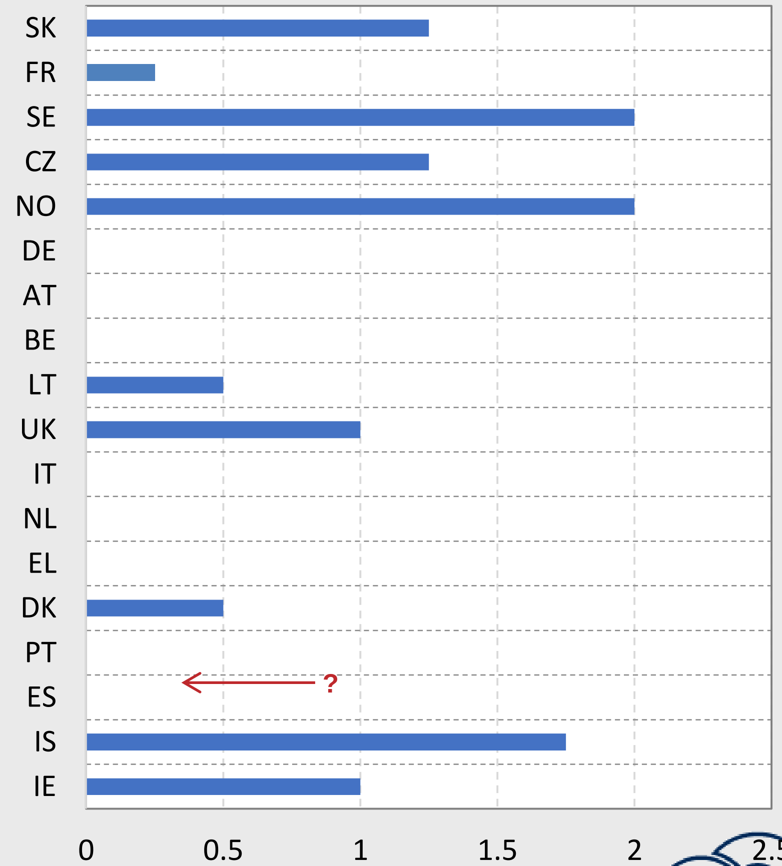
Background slides

Overview of CCyB decisions in Europe

Standardised and additional credit gaps[1]
(% GDP)



Announced CCyB rates[1]
(% risk-weighted assets)

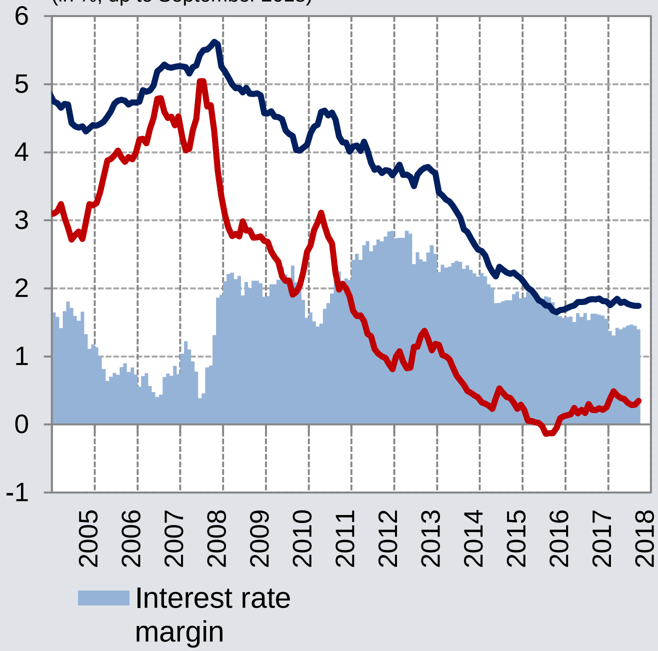


Sources: ESRB, ECB early interaction files.
[1] Credit gaps and CCyB rates were downloaded from the ESRB website on 4 July 2018. See underlying Excel file for reference dates.

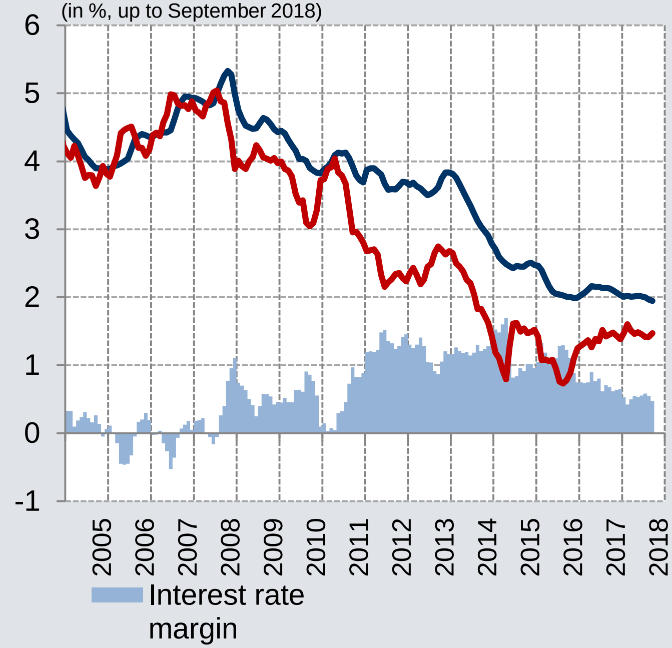
Background slides

Accommodative monetary policy leads to historically low lending rates

Interest rate margin on new loans to non-financial corporations[1]
(in %, up to September 2018)



Interest rate margin on new loans to households[2]
(in %, up to September 2018)

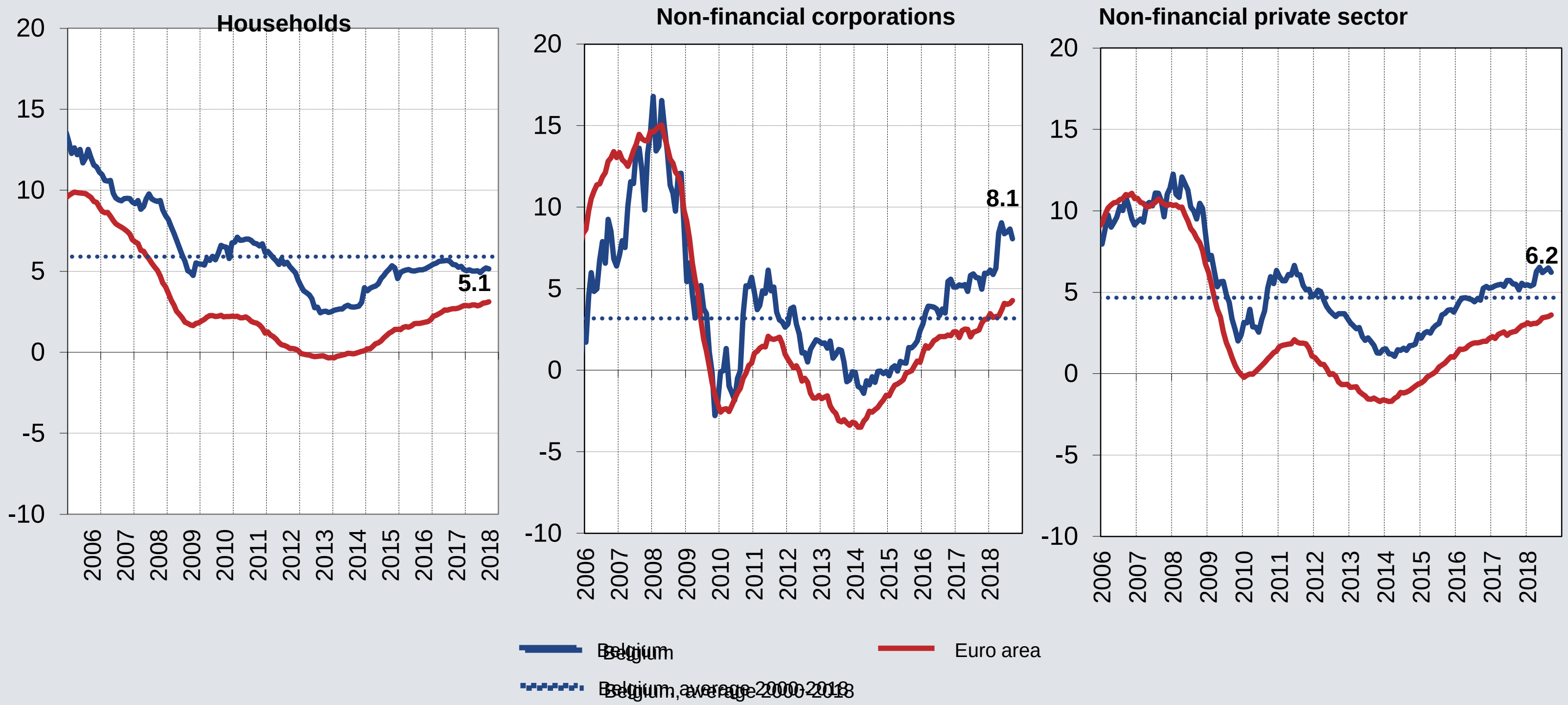


Sources: Thomson Reuters, NBB.
[1] Difference between the MFI interest rates on loans to non-financial corporations, up to an amount of € 1 million, over 5 years initial rate fixation and the 5-year swap rate for the 6-month Euribor.
[2] Difference between the MFI interest rates on loans to households, for house purchase, over 10 years initial rate fixation and the 20-year swap rate for the 6-month Euribor.

Background slides

Protracted and high growth to the non-financial private sector

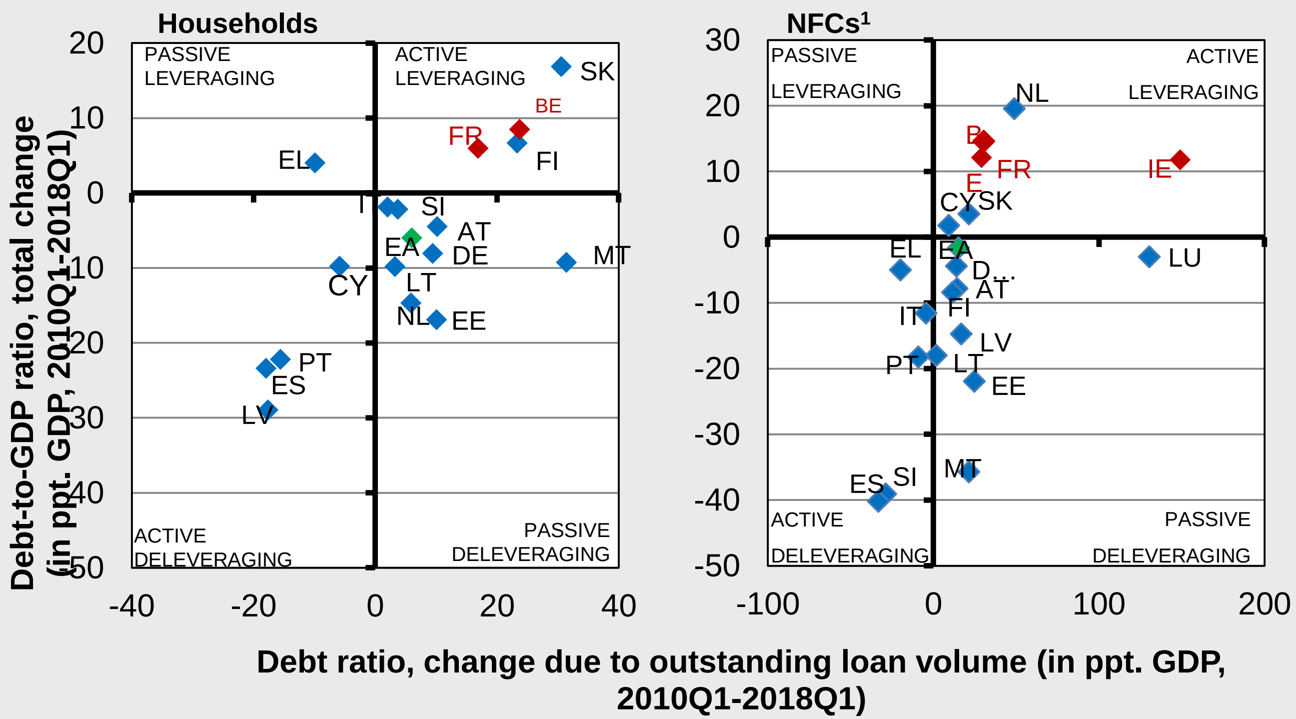
Bank loans to households and non-financial corporations[1]
(data up to Sept. 2018, annual growth rates)



Sources: ECB, NBB.
[1] Loans granted by resident MFIs to residents, including securitised loans and loans otherwise transferred.

Background slides

Active leveraging by Belgian households and NFCs

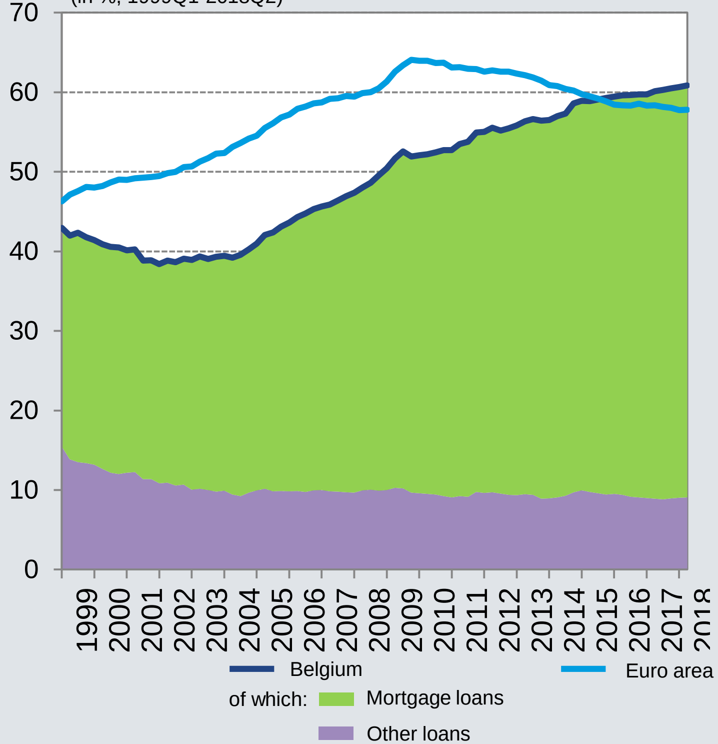


Sources: ECB, NBB.
[1] For Belgium: consolidated debt, excluding (domestic and foreign) intragroup loans.

Background slides

Increasing (active) leverage by Belgian household, in contrast to euro area where deleveraging is observed

Debt-to-GDP ratio: development
(in %, 1999Q1-2018Q2)



Debt-to-GDP ratio: euro area countries
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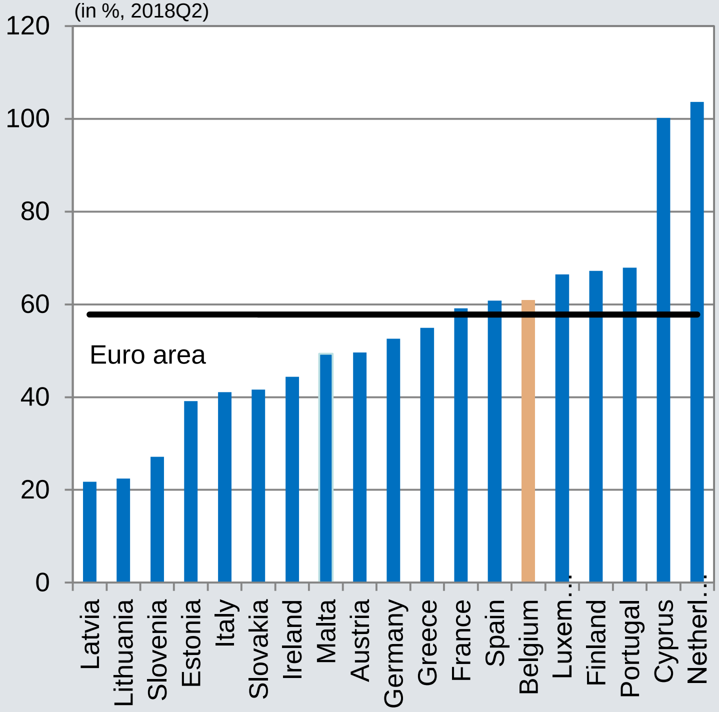

Sources: ECB, NBB.
* 2018Q1 data for Luxembourg.

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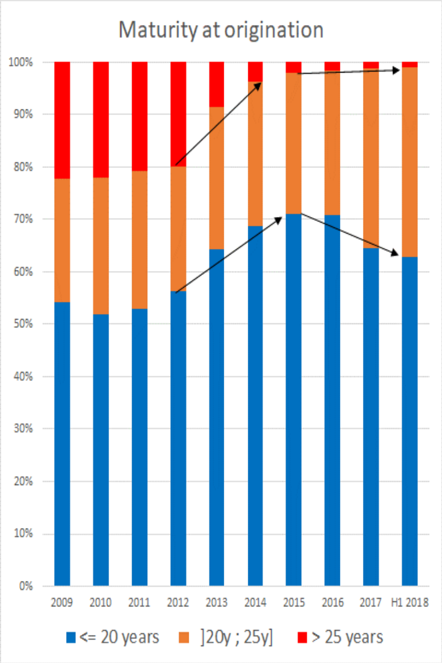
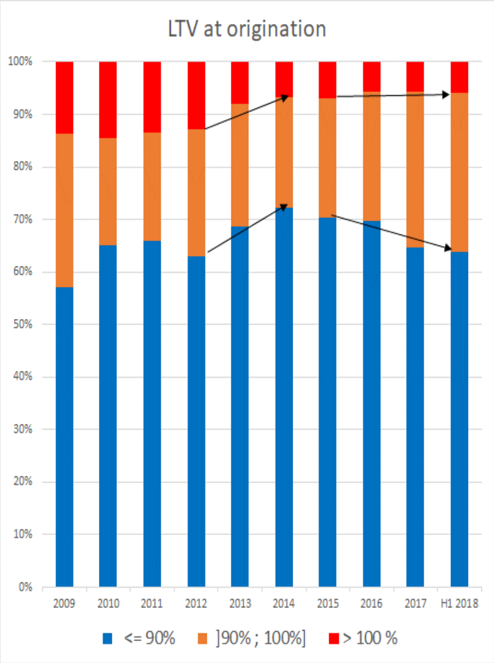
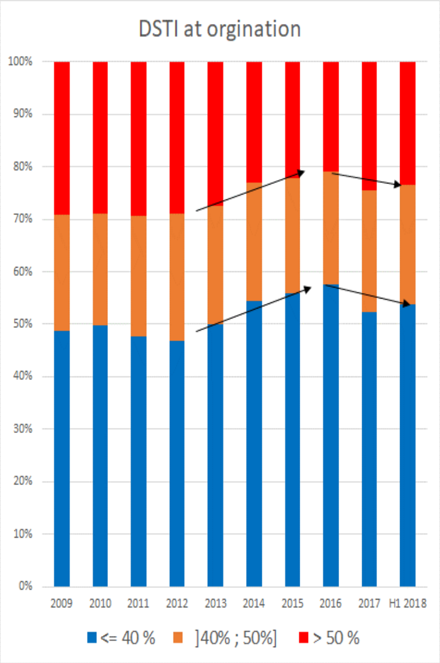
Deteriorating credit standards create a build-up of risk in RRE portfolios



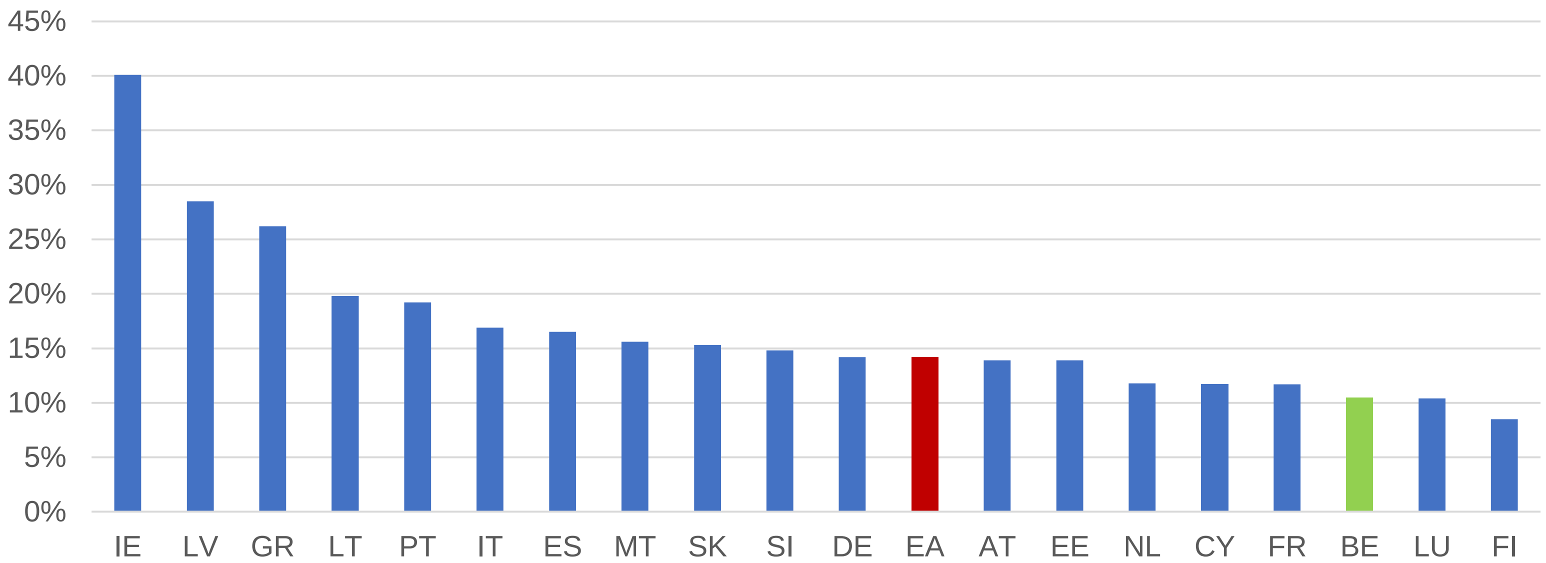




Background slides

Belgian banks are vulnerable for RRE risks: applied risk weights are among the lowest in the EA, not reflecting systemic risk build-up

AVERAGE APPLIED MICROPRUDENTIAL IRB RISK WEIGHTS (RWA/EAD) FOR RRE EXPOSURES
(in %, reference date: June 2017)

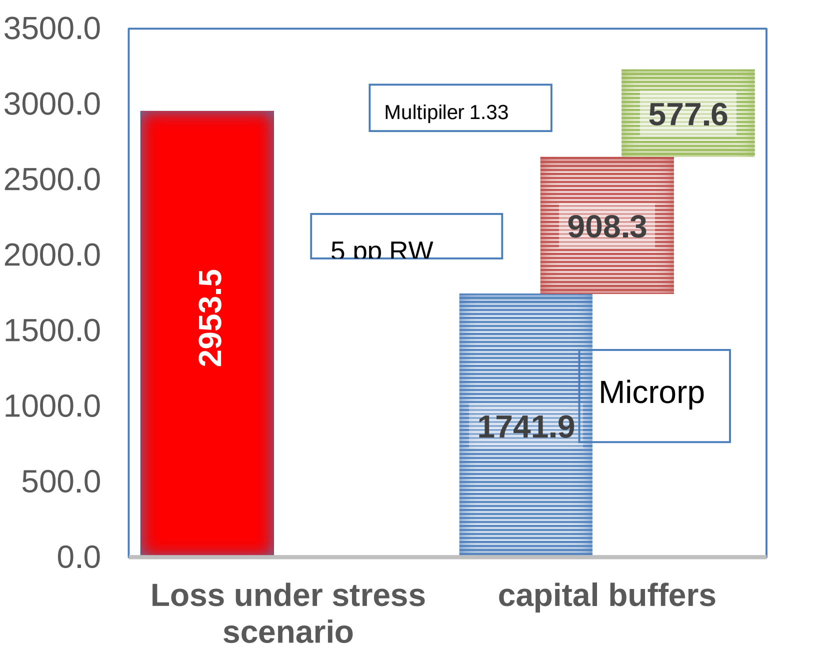


Source: ECB SSM DGIV - RIA Real Estate Project, RRE Factsheets (COREP, June 2017)

Background slides

Macroprudential measure builds up additional buffers to accommodate credit loss uncder severe RRE crisis scenario

CALIBRATED MACROPRUDENTIAL CAPITAL BUFFERS (in € mln.)



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