DG INTERNAL POLICIES OF THE UNION
- Directorate A -
ECONOMIC AND SCIENTIFIC POLICY
POLICY DEPARTMENT

Monetary Dialogue – 3 February 2020

Executive summaries of the papers prepared by the Monetary Expert Panel[1]

1. FINANCIAL STABILITY IN THE EURO AREA: ASSESSMENT OF RISKS AND POLICY OPTIONS

Background

The ECB's November 2019 Financial Stability Review identified a number of risks to the stability of the euro area financial system, such as potential future asset price corrections, increased risk-taking in the non-bank sector, lingering public and private debt sustainability concerns, challenges to bank profitability, and rapid growth of house prices and mortgage lending in some regions. Experts were asked to assess these and other risks for the financial system, to reflect on available policy options to mitigate those risks as well as to discuss the wider issue of limited monetary and fiscal space to deal with a recession should such or other adverse risks materialise.

Papers:

From Climate Change to Cyber-attacks: Incipient Financial Stability Risks for the Euro Area by Zsolt DARVAS, Marta DOMÍNGUEZ-JIMÉNEZ and Guntram B. WOLFF (Bruegel)

- **We analyse critically the European Central Bank's November 2019 *Financial Stability Review***, which highlights the downside risks to economic growth in an environment of global uncertainty. It also discusses sovereign-debt concerns in case interest rates increase, and risks stemming from household and corporate debt. It provides an assessment of the risks arising from a possible overvaluation of asset prices and especially stock prices. Finally, the report evaluates risks within the banking and non-banking system, and risks related to climate change.
- On the whole, **we think the ECB report is very comprehensive and covers the key risks to euro area financial stability**. While radical uncertainty makes the prioritisation of risks difficult, we broadly concur that one of the main current risks to financial stability is the risk of a macroeconomic downturn in both the global and EU economies. The global economy has seen an upswing of unprecedented length, which has been supported more recently by continued monetary and fiscal accommodation in the US and in the EU. Should this upswing end, either because of political risks or external shocks, asset prices and interest rates could change. Such developments would put a strain on the balance sheets of financial and non-financial companies and institutions, and could create financial instability.

[1] also available at http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html

- **We discuss in some detail the aspects of financial stability that in our assessment deserve more attention** than they receive in the ECB report, and augment the discussion with new evidence.
- First, we argue that **the assessment of risks in the housing market needs to be more nuanced**. A striking feature of current housing markets relative to those pre-crisis is that they seem to be far less driven by mortgage credit. This is possibly good news for financial stability because an eventual house price correction would transmit less into mortgage defaults. Moreover, we find that the size of the construction sector hasn't increased with recent house price increases, unlike in the pre-crisis period. An eventual correction to house prices might therefore be less likely to lead to corrections to economic activity.
- Second, we argue that **there should be greater emphasis on changes in market expectations of interest rates**. In recent years, changes in forward-looking market expectations have been very significant. Such changes, especially when interest rates are close to zero, can have substantial effects on asset prices because they might change substantially the discount rate of expected future profits. This could be particularly relevant if interest rate changes are not driven by real-economy developments.
- Third, **the financial system crucially relies on a safe asset as a reference for its entire pricing curve of all assets**. We show that the supply of safe sovereign assets in the euro area has fallen dramatically in the last 10 years, and is expected to fall further. This fall has been driven by two main factors. On the one hand, countries have seen their credit ratings deteriorate. On the other hand, the safest countries and in particular Germany, have decreased their absolute supplies of bonds as they reduced their debt levels. An increase in the supply of safe assets via greater issuance by Germany, structural reforms that lift productivity growth and ratings in the weaker euro area countries, and greater supply from EU institutions such as the European Investment Bank, would support financial stability, in particular if additional borrowing was used in economically productive ways.
- Fourth, **we strongly support the ECB in its assessment that climate risks to financial stability need to be taken seriously**, and we would advise the European Parliament to prioritise work on this. We also argue that it is not advisable to reduce risk weights on green assets since they still contain normal financial stability risks. Instead, the debate should concentrate on increased risk weights for brown assets.
- Fifth, **we worry that the ECB does not consider cybersecurity and hybrid threats in its financial stability assessment**. These threats are significant operational risks for individual financial institutions. But more worryingly, the EU is badly prepared to deal with such threats should they materialise at a more systemic level. The financial consequences thereof would be substantial.
- **One important set of policy instruments to address financial stability concerns is macroprudential measures**. While assessment of macroprudential policy measures adopted in various euro area countries is hindered by lack of experience with the impacts of these measures, we discover notable discrepancies between Member States: countries with the same levels of housing price overvaluation have adopted markedly different macroprudential measures. This suggests that some countries might have done too much, while others have done too little. We call for a thorough cross-country analysis of macroprudential policy measures, in light of the vulnerabilities countries face.

- **When it comes to preventing the next recession or at least reducing its impact on financial stability and the economy more broadly, we argue that EU policymakers need to be better prepared to use discretionary fiscal policy earlier and more forcefully**. The ability of monetary authorities to react to the next cyclical downturn is very limited because rates cannot be reduced much further and the effectiveness of bond purchase programmes might also be more limited. The main remaining tool to respond to a downturn is fiscal policy, and its earlier and more proactive use would be necessary.

Financial Risks in Europe: The End of the Beginning by Christopher A. HARTWELL (CASE)

- **The global economy appears to be heading for a recession in 2020, and the euro area is not immune**. Indicators throughout Europe show slowing growth, slack demand, and a number of risks both internally and externally.
- **The financial sector in the euro area has been operating on the edge for the past decade**, buoyed by excessively loose monetary policy but without fundamental improvements within the euro area to make the recovery sustainable. Any recession could strike the financial sector quite harshly, albeit with effects differentiated across Member States and to different degrees.
- **This paper examines the internal and external risks to the euro area financial sector**, concentrating on the broader macroeconomic threats but also focusing on the political issues globally which could push the financial sector over the edge.
- **Internally, banks in the euro area are facing a higher and similar risk profile**, occasioned by the regulations put in place in response to the global financial crisis. At the same time, unconventional monetary policy has made many banks far less profitable, reducing their own buffers to be able to weather an economic downturn. Compounding this all is continued political uncertainty, including still surrounding the aftermath of Brexit but extending to the ECB's own policies, which is holding back real progress.
- **Externally, a phalanx of threats are arrayed against the financial sector in the euro area**. Possible slowdowns in the US, precipitated by a crash of asset prices, and in China, as it reaches the limits of growth, have negative consequences for the entire euro area. Meanwhile, the populist wave which has hit the world post-global financial crisis may have crested but it shows no sign of heading out to sea, meaning more protectionist and anti-growth policies to threaten the global economy.
- **These internal and external threats may do more damage than is usual in an economic downturn due to the fact that both the ECB and Member States have little ammunition to fight.** With the ECB's foot on the gas pedal throughout the tepid recovery of the past decade, the only monetary solutions that can go beyond current levels are patently absurd. On the fiscal policy side as well, governments have been expanded in the midst of a recovery, leaving little that can be done in terms of spending.
- This paper recommends that **the coming recession should be seen as an opportunity for re-normalisation of monetary policy**, a **re-set of monetary expectations**, and in particular a **pullback from the ECB as the driver of the euro area economy**. This means letting the chips fall as they may, as occurred in the United States during the 'forgotten depression' of 1920 to 1921. This will entail some painful adjustments, especially in the financial sector, but the euro area economy which emerges will be stronger for it.

Financial Stability in the Euro Area by Salomon FIEDLER and Klaus-Jürgen GERN (Kiel Institute for the World Economy)

- Diminishing expectations for growth and inflation have led to an easing of monetary policies and a significant reduction in government bond yields. **Improved financing conditions across the euro area are mitigating debt sustainability concerns in the public sector as well as in the private sector**, for the time being.
- **The combination of extremely low interest rates and elevated asset prices implies risks for financial stability** as banks and non-banks have increased their exposure to the risk of a reversal of interest rates and an eventual sudden repricing of assets. These risks appear to be contained for the time being, but could be substantial in the longer run.
- While banks in the euro area have increased their resilience in recent years, **capital buffers could prove insufficient in case of a serious downturn**, and **bank profitability continues to be a major concern**.
- **We are not convinced that the plethora of regulatory changes for the financial sector since the last crisis will be able to prevent another one from occurring**, partly because they potentially lead to higher correlated risks. Bank runs are a major source of financial trouble and are caused by banks financing long-term illiquid assets with short-term fixed-value liabilities.
- **Deposit insurance schemes lead to excessive risk-taking in the banking system and are not a good option to increase overall financial stability**. While credible deposit insurance schemes can prevent certain types of bank runs, empirical evidence suggests that this advantage is overwhelmed by the excessive risk-taking due the moral hazard introduced by these schemes, such that their net effect is negative. Beyond that, a European Deposit Insurance Scheme would come with additional drawbacks: its implementation would mean significant fiscal transfers between Member States and guaranteeing all European bank deposits also threatens to eventually exceed the capacities of those Member States that still are in a relatively good fiscal position.
- **Higher equity ratios for banks are needed to make the financial system safer**. Equity provides a cushion against losses on the balance sheet and is unable to run in a panic. The amount of equity required to make banks safe is still subject to debate, but it is most likely considerably higher than today.
- **Currently, monetary policy does not have good options to produce significant additional expansionary impulses without major side-effects**. While a financial crisis in general may increase the effectiveness of monetary policy, it may also further erode the quality of the assets held by certain euro area banks, such that they would not be able to post acceptable collateral to take advantage of central bank loans.
- **The potential of fiscal policy to actively support growth is currently also restrained with fiscal space available only in a few countries**. Pushing national governments to engage in fiscal policy oriented at an aggregate euro area fiscal stance in order to substitute for fiscal risk-sharing institutions that are not available is not going to work, however.
- **Apparently, traditional macroeconomic demand management policies have come to a limit**, suggesting that more structural policy responses may be necessary to shore up confidence and arrest an eventual decline in activity.

Financial Stability Risks and Policy Options by Christophe BLOT, Jérôme CREEL and Paul HUBERT (Sciences Po – OFCE)

- **It is crucial to monitor financial risks regularly** and to account for the multiple sources of these risks.
- **The valuation level of equity markets in the euro area is still 20 % below its peak of 2007**. Comparatively, the US Standard and Poors' index is twice its value of 2007.
- **Risks have emerged for corporate debt and notably leveraged loans, which share some similarities with the subprime market**. However, securitisation of these loans is less important than it was for subprime loans. These markets also differ in terms of the underlying nature of risk.
- **House prices in the euro area are synchronised and risks remain moderate** except in Germany where house price have sharply risen and are disconnected from house price cycles in other countries. However, credit dynamics in Germany remain subdued.
- The argument that banks' profitability is negatively affected by low interest rates is often made. Yet, **banks' and insurance companies' profits are steady and are recovering** since 2012.
- Although monetary policy is expected to influence asset prices, there is evidence that **central banks may affect stock price imbalances but no evidence that they could do so for housing markets**.
- **Policy options in case of a recession range from an extension of QE towards corporates and households** – to support investment and consumption – the **use of macroprudential tools** – to mitigate the effect of financial risks – and **fiscal policy** notably in an environment characterised by low interest rates.

2. WALKING THE THIN LINE: CENTRAL BANK COMMUNICATION

Background

Communication has become an essential element of central banking. This evolution is due to at least two reasons: a) as a tool of accountability, communication helps explain the central bank's actions to the general public; and b) as a monetary policy instrument, it enables the central bank to influence interest rates at longer maturities and steer broader financial and economic conditions. While the ECB's communication practices have changed significantly in recent years, new challenges are now emerging, for example, from recent public disagreements between its Governing Council members on the desired course of monetary policy. The new ECB President, Ms Christine Lagarde, has stressed that she sees the general public as the "next frontier" of central bank communication. Experts were asked to reflect on the ECB's effectiveness in using communication for accountability purposes and for influencing expectations, both of financial markets as well as of firms and households.

Papers:

Reaching a Wider Audience: Is the ECB Trending? by Daniel GROS and Angela CAPOLONGO (CEPS)

- **Central banks traditionally focussed on communicating with the financial markets** because the most direct channel of transmission of monetary policy works via interest rates and financial market conditions in general.
- However, **the beliefs and expectations of the wider public also have important economic implications.** Central banks are thus also increasingly recognising the importance of communicating with a broader audience.
- Nevertheless, **the interest of the wider public for monetary policy is intermittent**, linked to major decisions points and/or personnel changes.
- **The ECB should thus not try to reach a wider audience with every decision on monetary policy**.
- Communication on 'high frequency' decisions can remain targeted at specialists in the media and financial markets. However, **low-frequency, strategic decisions can and should be communicated to the general public**.
- **It is difficult to judge how well the ECB communicates with the wider public**. The ECB reaches a much wider audience through social media channels than national central banks. But even with its 500 000 followers on Twitter, for example, the ECB can directly reach only a small elite.
- **Opinion polls show a drop in trust in the ECB in the wake of the financial crises; and more recently a strong increase**. However, this might have to do more with the recovery of the economy than with improved communication.
- **The Monetary Dialogue plays a key, and natural role** in representing the interests of the wider public, which is generally not interested in high frequency decisions.

The ECB's Communication Strategy: Limits and Challenges After the Financial Crisis by Kerstin BERNOTH and Geraldine DANY-KNEDLIK (DIW Berlin)

- **Central bank communication should not generally strive for maximum transparency**. The optimum degree of transparency varies between different aspects of monetary policy. The reasons for a certain lack of transparency in central bank communication include legal constraints, uncertainties about the reliability of economic data and modelling results, as well that this information could pose a threat to financial stability.
- **Overall, the ECB communicates openly with the public and achieves a high level of transparency in all aspects**. However, in the course of the global financial crisis (GFC), central bank communication has become more important, as market participants have found it more difficult to predict monetary policy (re)actions.
- **The new Presidency and the ongoing strategy review present an opportunity** for the ECB to improve and refocus its monetary policy strategy in the light of changing economic and financial conditions and new challenges.
- **The new tasks that the ECB has taken in the last decade make it more difficult to delineate the ECB's mandate across these fields**, e.g. the separation of monetary and supervisory functions. Clarifying the interaction between its supervisory activities and monetary policy is essential.
- In light of persistently low inflation rates since 2009, **the ECB should also consider to reformulate its definition of price stability** by announcing a quantitative target range for inflation in addition to a point target.
- **The more open the ECB gets, the more important it becomes that it communicate clearly to the public that it is operating under considerable uncertainty**, so that deviations from monetary objectives can be properly assessed without a gradual loss in confidence.
- **Since the ECB has only recently taken up supervisory responsibilities, it has had little opportunity to build up a reputation in this field**. Against this background, transparency in the area of financial supervision is even more important. In order to increase accountability, the ECB should at some point consider publishing the minutes of the SSM Supervisory Board with appropriate time lag and redacting overly sensitive parts.
- To avoid unnecessary market volatility and uncertainty, **the information content of speeches by individual Governing Council members should, as far as possible, be aligned with the ECB's official position**. In addition, official statements by central bankers should refrain from using emotional formulations as far as possible in order to increase clarity and credibility.
- Faced with inflation, which has been most of the time below the inflation target since 2009, **the ECB is surprisingly reluctant to provide a detailed assessment explaining why the policy outcome is not as intended** despite increased policy efforts. More transparency in this respect is essential to maintain the ECB's credibility.

Communication During Unconventional Times: The ECB's Approach by Eddie GERBA (London School of Economics and Political Science) and Corrado MACCHIARELLI (National Institute of Economic and Social Research)

- **In terms of communication, the central bank must strike a delicate balance** between providing enough information to markets to remove some of the uncertainty regarding the policy effects, to guide the public through the operations that will be implemented, build time consistency, and attempt to boost confidence in its strategy such that expectations begin to align to the stated objective. However, the central bank also faces incentives to keep the information diffuse so to guard against the unintended effects of policies, avoid overstating their (final) success, keep some degree of discretion, and (re)-install authority on markets and project a sense of control.
- **Insights from financial markets over the past years have shown that markets have repeatedly questioned the operational success of the quantitative easing (QE) programmes**. Initially, they feared that the ECB would not be able to find sufficient bonds to fulfil its targets. When the extension of the initial program was announced in 2016, the fear was that the success of the unconventional measures would fail to materialise if businesses and consumers believed that the policy stance was ambiguous. Later the same year, serious concerns about the medium to long-term effects of QE were raised in relation to the market signalling by the ECB.
- **In September 2019, the ECB shifted its forward guidance on rates from a short-term calendar-based type to state contingency**. This was a welcomed strategy as it went beyond the usual date-based communication. The latter may generate ambiguity because people may speculate on the reason behind the choice of a specific date. Having said that, while forward guidance strongly indicates that more accommodation is on the way, it may also signal to the public that a long-term policy stance is in place to disguise a bad-shaped economy.
- **The literature sheds more light on the degree of success of the ECB's communication strategy during times of unconventional policy compared to the opinions and indirect signals from the financial market but leave a lot of questions unanswered**. In particular, it is not clear whether the existing communication approach reduces uncertainty or adds to the existing one, in particular in the medium-run spectrum of expectation anchoring.
- **Looking at the empirical evidence**, the ECB missed its target in no small degree, particularly over the period 2013-17. While the interaction between forward guidance and the purchase program seem to have had its grip over inflation expectations over the last couple of years, the association between inflation and inflation expectations remains weak. It is thus of paramount importance for the ECB to keep enhancing transparency and communication in order to avoid a setback.