

# Background note for Financial Stability Conference (Berlin)

[View PDF](#)

28/10/2015

Speeches

ESM

Berlin, Germany

**Rolf Strauch, Member of ESM Management Board**

"Macroprudential policy and euro area resilience" 1

Background note for panel intervention at Financial Stability Conference,

Berlin, 28 October 2015

With the outbreak of the financial crisis in 2008, the international community became aware of the destructive potential that systemic risk in a globalised financial sector can unleash. The focus shifted increasingly towards macroprudential oversight and policy. As Claudio Borio, paraphrasing Milton Friedman, put it in 2009: "We are all macroprudentialists now".<sup>2</sup> A key feature of macroprudential measures is that they are expected to work pre-emptively to address risks in the banking sector at an early stage, before they build and erupt. Implementing a macroprudential framework is therefore a key step to improving the resilience of the euro area, and of Europe more broadly. Now that Europe has put a macroprudential framework in place, the question arises as to how effectively it can address the current financial stability risks and what its long-term contribution to the euro area's resilience will be. Against the background of the recent five presidents' report on deepening EMU, I will discuss this issue from our perspective as a crisis resolution mechanism.

## 1. WHAT HAS BEEN ACHIEVED

Beyond the immediate stabilisation measures, Europe has done considerable work since 2008 to shore up the stability of its financial sector. Given the banking sector's key role in financial intermediation in Europe, it is natural that the first aim of macroprudential policy be to prevent systemic risk from emerging from the banking sector. And, considering how the European financial crisis developed, it also makes sense that many of the instruments created are geared towards constraining excessive credit and avoiding bubbles in particular markets, most notably in real estate.

The banking union framework was conceived to counter systemic risk from the top. By moving supervision and resolution to the EU level, the new framework minimises the risk of cross-border linkages in the banking system. The ESAs (EBA, ESMA and EIOPA) together present a harmonised single rulebook. In parallel, Europe created the ESRB to monitor systemic risk and issue recommendations. The macroprudential toolbox was broadened, and a governance framework created, with some instruments targeting the EU level and others, the national. European micro-supervision and macroprudential management are complementary. They differ by objective, but some instruments may target similar parameters. The capital conservation buffer, for example, works through a bank's capital adequacy ratio, but the systemic risk the institution faces guides it. Pillar 2 capital requirements take account of market risk.

The ESM complements the banking and governance framework and the macroprudential policy kit as a financial backstop, or 'lender of last resort' to sovereigns. With significant funds at its disposal, the ESM serves as a credible liquidity provider that euro area Member States can turn to if things go wrong. It also enforces policy adjustments. ESM adjustment programmes and financial assistance have led peripheral countries to redress past imbalances, regain competitiveness, and significantly strengthen their banking sectors. In this respect, the ESM helps after the fact, once crisis has struck. But it also works pre-emptively, acting as a 'firewall' to calm markets through its remaining support capacity. During the recent turmoil in Greece, spreads of peripheral sovereigns other than Greece widened only on a limited scale, among others, because the ESM has successfully established itself as a rescue mechanism.

## **2. SHORT-TERM CHALLENGES TO MACROPRUDENTIAL POLICY**

The success of the financial assistance programmes, banking union, improvements in the euro area governance structure, and determined ECB action have made it possible to overcome the market turmoil of the financial and sovereign debt crisis. Now the euro area is on a moderate recovery path, but financial stability risks have not fully vanished and are in part re-emerging.

Continuous warning signals have been sent on financial risks globally and for the euro area over the past two years. They stem mainly from a renewed growth slowdown and from the liabilities of the past. In recent publications, the ESRB and the IMF identified a number of key risks. They see emerging markets weakening, which is putting a lid on growth and inflation. They point to high debt levels in the public and in part in the private sector, which they see leading to a resurgence of sustainability problems in a low-growth low-inflation environment. They note increased risk-taking in asset markets as investors search for yield in a low-interest rate environment. The latter could lead to an abrupt price correction with a more risk-averse stance then kicking in. Finally, they also see: low returns in the insurance sector leading to liquidity issues; low bank profitability in many euro area countries coupled with sizeable non-performing loans (NPLs) in some peripheral countries; significant short-term market volatility and reduced liquidity in the sovereign bond market.

In this environment, macroprudential policies may be helpful when a recovery has gained sufficient pace and asset prices are increasing, but they may be burdensome or inapplicable in other cases. The banking sector, for example, is now well capitalised and is recovering. Important parts of the euro area banking sector, however, are still struggling with the legacy of the crisis which continues to impose costs and depress profitability. The risk arising from this situation is systemic in that it hampers economic recovery by depressing the supply of credit. At the same time, households that are mending their balance sheets will likely consume and invest less and not demand new credit. A renewed downward spiral could occur, for example, if an exogenous shock pushes an economy towards deflation. Current macroprudential instruments are not suited to addressing the legacies of the past, specifically NPLs. Moreover, they can only be used to relax credit conditions and facilitate lending where buffers have been built up in advance. However, in many

countries this preventive policy stance has yet to materialise as macroprudential supervision was introduced primarily during the crisis.

While most countries are experiencing better financing conditions and improved banking sector profitability, the combination of high public and private sector debt and a strained banking sector continue to pose a risk to financial stability. Banks in peripheral countries which benefited from an ESM programme – with the exception of Greek banks – have now regained profitability. But interest income remains stressed. At the same time, impairments and the need for additional provision coverage create extra costs. The NPLs on banks' balance sheets also block lending given the high risk weight assigned them. In this case, the problem is not that too much unsustainable credit is threatening the economy. It is instead that in some countries the legacy of the crisis is holding back the financial sector.

Member States with these legacy problems need to address NPLs. This challenge is even more compelling because of restrictions on the use of macroprudential tools in addressing downside macroeconomic risks. Dealing forcefully with NPLs could free up substantial lending capacity on bank balance sheets without increasing capital requirements. The IMF has calculated that resolving NPL legacies would create an additional lending volume of €600 billion,<sup>3</sup> or roughly double the European Union's current flagship investment plan, the Juncker plan. Countries with an EFSF or ESM adjustment programme have taken significant measures to improve their insolvency and foreclosure rules. Creating the legal framework is, however, only the first step. The rules now need to become bank practice and foster the creation of appropriate servicing structures. Progress in securitisation or other elements of the banking union would complement these efforts by allowing banks to offload these assets from their balance sheets.

### **3. MEDIUM- TO LONG-TERM CHALLENGES TO MACROPRUDENTIAL POLICY**

The role of macroprudential supervision in the medium to long run needs to be viewed in the context of banking union and ongoing initiatives included in the five presidents' report, put forward a strategy to overcome the crisis and further enhance the euro area's resilience. In this context, I understand resilience as the ability of national economies to weather idiosyncratic shocks or crises. A more integrated euro area will determine how effectively macroprudential instruments, in

interaction with monetary policy and fiscal policies, deliver that resilience.

Banking union was initiated to create a truly European banking market. It leads to a more homogeneous functioning of the monetary policy transmission mechanism, but it does not address national divergence in credit cycles. Overall, the regulatory changes in micro-surveillance have made the banking systems safer and better able to address the effects of cross-border bank holdings. Banking union should reduce the need to resort to macroprudential tools to deal with the idiosyncrasies in credit supply of national banking systems, as a common monetary policy more directly determines prices. However, compensating for differences in regulatory practices and banking behaviour through macropudential measures would be only a 'second-best use of policy tools'. Despite a more homogeneous monetary policy transmission mechanism, national or regional differences in credit demand and asset price bubbles, for example in the housing sector, can still arise. Arguably, bubbles could emerge even more easily with better access to financing through cross-border funding of banks and lending in a more integrated banking market. In this regard, the banking union increases the 'safety margin' in the banking system, but it does not genuinely reduce the scope for macroprudential instruments to support resilience.

Europe is also aiming at broadening the funding sources available to the private sector, by emphasising capital markets through the founding of a capital markets union (CMU). The CMU should support resilience through access to a greater variety of financing sources as well as through the diversification of asset holdings. Numerous developments have diverted financial activity away from the banking sector in Europe over recent years. Stricter regulation, coupled with abundant liquidity, a search-for-yield environment, and the weakness of the banking sector have led to strong growth in both non-bank credit intermediation, so-called shadow banking, and investment fund industries. This phenomenon will likely continue, supported by the CMU. Recently the European Commission issued an action plan mainly aimed at improving standardisation of contracts and regulation, and fostering cross-border competition and enforceability of creditor claims. While this project is still in its infancy, it clearly has the potential to reshape European financial intermediation and, hence, financial markets. Moving towards a complete euro area capital market that would unleash the full potential of diversification and operate as a single market, comparable to the US capital market, requires far-reaching initiatives.

Macroprudential policy will have to adapt to this going forward. New markets will create scope for new types of market failures and externalities. If financial intermediation moves away from a small, rather homogenous, and well-regulated set of actors, a loss of control might ensue. Also, more finance per se could suggest that if things go wrong the shocks would be worse. To address this, the ECB has urged policymakers to broaden the macro-prudential toolbox to also cover the shadow-banking sector<sup>4</sup>.

The strengthening of the European governance framework to track and reverse macro-economic imbalances complements macroprudential policies. As a European crisis response, policymakers have created the macro-economic imbalance procedure (MIP). This should help to detect imbalances early and trigger structural reforms for competitiveness and growth. The five presidents' proposal envisages further steps in this direction. Most recently, the European Commission has proposed establishing national competitiveness boards to support the MIP's implementation and enhance national ownership. The European Commission's monitoring in the context of the European Semester and the MIP, and the activity of the ESRB are closely intertwined. They address the problem of boom-bust cycles by focusing on different policy fields: the MIP addresses national policies and the real economy; while macroprudential instruments curb the credit or financial cycle.

Improving the European fiscal framework and a limited fiscal capacity at the euro area level can further strengthen resilience. The five presidents' report therefore envisages to adjust the fiscal framework. The objective of the Stability and Growth Pact, the basis of a European fiscal framework, is to ensure fiscal stringency while also allowing for flexibility in addressing cyclical fluctuations. Yet the crisis has tested the delicate balance between these two goals: stringency and flexibility. While overall fiscal governance has been significantly strengthened, the complexity of the rules requires reforms. The five presidents' report also proposes building up a central fiscal capacity at the euro area level, which could help smooth short-term divergences among Member States and deal with idiosyncratic shocks. Such a 'risk-sharing' mechanism, which could be implemented without permanent transfers or debt mutualisation, would allow for fiscal rules to be more clearly focused on fiscal stringency rather than on flexibility.

Budgetary consumption smoothing is complementary to the objective of macroprudential policy in attenuating boom-bust cycles. The question of the right policy mix emerges. Studies suggest that in existing federal states, and in particular

in the US, private savings and financial markets, rather than fiscal transfers, account for by far the largest part in smoothing crises and addressing economic fluctuations across regions.<sup>5</sup> Financial markets smooth income and consumption through the diversification of asset holdings and income flows. As discussed earlier in the context of CMU, macroprudential policy therefore remains a key ingredient of a resilient euro area architecture; an adequate instrument set must be supportive to help fulfil this role successfully.

## 4. CONCLUSIONS

Europe has achieved a good deal in recent years. But pockets of vulnerability to systemic risk remain in the banking sector. Macroprudential policy, which aims to capture and deal with these risks, is still evolving. Going forward, expected and desired changes to Europe's financial architecture will pose new challenges and affect the policy mix required to attain a resilient euro area. In the short-run, countries without macroprudential buffers should attempt to shield themselves from the risks of a downturn by vigorously tackling legacy issues and fostering growth. In the medium to long run, the five presidents' report's initiatives and proposals would strengthen structural and fiscal governance and reduce economic and financial misalignments, thereby complementing macroprudential action in enforcing financial stability.

1 Dirk Mevis has provided valuable assistance in preparing this presentation.

2 <http://www.voxeu.org/article/we-are-all-macroprudentialists-now>.

## Author



[Rolf Strauch](#)

Chief Economist and Management Board Member

# Contacts



## [Cédric Crelo](#)

Head of Communications and Chief Spokesperson

+352 260 962 205

[c.crelo@esm.europa.eu](mailto:c.crelo@esm.europa.eu)



## [Anabela Reis](#)

Deputy Head of Communications and Deputy Chief Spokesperson

+352 260 962 551

[a.reis@esm.europa.eu](mailto:a.reis@esm.europa.eu)



## [Juliana Dahl](#)

Principal Speechwriter and Principal Spokesperson

+352 260 962 654

[j.dahl@esm.europa.eu](mailto:j.dahl@esm.europa.eu)



## [George Matlock](#)

Senior Financial Spokesperson

+352 260 962 232

[g.matlock@esm.europa.eu](mailto:g.matlock@esm.europa.eu)