Financial stability risks and Euro Area policies

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Outline

- Focus on monetary policy.
- From the “too-low-inflation” environment…
- …to the current context of stagflationary pressures.
- Monetary policy: walking on thin ice.

From the “too-low inflation” environment…

- A number of financial instability episodes since the late 2000.
- Context of persisting downwards price pressures until recently
- Weak crisis prevention/ mgt institutions—> High **costs** and tendency to **overburden** the central bank .
- Important **institutional reforms…** but important **gaps** remain.
- Prominence of the **risk channel** in monetary policy. Combination of asset purchases <u>and</u> liquidity backstops under stress→ accommodative financing conditions.
- More than a decade of low/negative interest rates and expectations of low rates for long time. Bold forward guidance. eg:“**ensuring** easy financing conditions in all jurisdictions ” and “ample liquidity”.
- How resilient to a regime change ?

…to the current context of stagflationary pressures

- **—>** An environment of persisting **stagflationary** pressures.
- Elevated risks of adverse debt dynamics. Tense market liquidity.
- Assessing financial vulnerabilities: FSRs, Stress testing, war games.
- High **risks of policy mistakes**. *(ChL : " By itself, a mild recession would not be enough to bring down current inflation levels").*
- **Two major uncertainties**: production capacity and fiscal stance (—>output gap ?); financial vulnerabilities and the effectiveness of the crisis management framework.
- **Risk of Financial amplification** in the monetary tightening process (r* # r**, the level of interest rate that might generate financial instability dynamics (Ozge Akinci et al, Fed Jan 2021)).
- →Uncertainty on the lags in monetary policy transmission. Non-linearities.
- ECB accounts provide little information on how financial stability considerations intervene in monetary policy decision making

Recent warnings

- **European Systemic Risk Board:** “The **ESRB** has repeatedly noted that a **lack of tools** is hampering authorities’ ability to address financial stability risks beyond the banking sector. It has called for authorities to be provided with such tools…The current heightened risk environment makes this more urgent.” (Sept 2022).
- **ECB banking supervisor warning:** “ An increasingly optimistic attitude is spreading, which generates a certain reluctance on the part of banks to seriously engage in supervisory discussions on the downside risks…… A root cause of this attitude lies in the warning we….issued at the onset of the pandemic in 2020, when we expressed our concerns about a massive deterioration in asset quality. Our estimates of ……. non-performing loans in hindsight proved, to say the least, overly pessimistic” (A Enria, Oct 2022)

Monetary policy: walking on thin ice

- Bringing inflation down under high uncertainty.
- Brainard's principle of "***attenuation***" / "***gradualism***" **vs** *"Regaining and preserving trust requires us to bring inflation back to target* ***quickly****" (I Schnabel*)—> "**timely" and "orderly".**
- —> Signals through pace and peak of rate increases. Little granular info on pass-through.
- —>The "**separation**" principle: monetary tightening **&** liquidity backstops. Premised on favourable solvency assessments.
- The **Transmission Protection Instrument:** "*to counter unwarranted, disorderly market dynamics that pose a threat to the transmission of monetary policy across the euro area*". Note that purchases of private securities "*could be considered*".
- —> Principles for reduction of the monetary portfolio (**QT**). Clarifying the objective. Combining rate hikes with QT ? QT + TLTRO reimbursements ? Reinvestment caps vs sales ? QT & "Market Functioning" backstops ?