EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability in the ECB's Monetary Policy Strategy

SUERF/NBS Workshop

'Macroprudential policy at the end of the zero-interest-rate environment'

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Monetary policy, financial stability and strategy review

Our job is to keep prices stable. We know that a stable financial system is good for price stability. Stable prices are good for the financial system too, as people and businesses are better able to plan and invest knowing prices will not change by much over time. That is why information about the health of the financial system plays an important role in our analysis and decisions.

Source: ECB website

Overview

1 Interplay of monetary policy and financial stability

2 Interaction of monetary and macroprudential policies

Financial stability considerations for monetary policy

Financial stability precondition for price stability and vice versa.

- **ECB's recent strategy review** included thorough assessment on importance and potential form of inclusion of financial stability considerations into monetary policy decision taking

[The role of financial stability considerations in monetary policy and the interaction with macroprudential policy in the euro area]

- Relevant issues:
  - **Side effects** of monetary policy on financial stability
  - **Medium-term orientation** of ECB's price stability objective as potential way to cater for financial stability considerations
  - Interactions between **monetary and macroprudential policies**
  - Options to integrate relevant financial stability analyses into **analytical framework** for monetary policy decisions taking

Side effects of monetary policy

Conventional and unconventional monetary policy measures may adversely affect financial stability.

- Lower interest rates:
  - Incentives to engage in more – potentially **excessive** – **risk-taking** leading to build-up of systemic risk
  - Financial intermediaries may assume more credit, liquidity and duration risks in **search for yield** and due to associated asset price misalignments
  - Affect **resilience of financial intermediaries**
- Higher interest rates:
  - Potential to **amplify fragile** public and private sector **balance sheet conditions**

Medium-term orientation of price stability objective and financial stability considerations

Financial stability risks and horizon for achieving price stability – ex ante case (normal times)

		Expected inflation at the end of the horizon ($EE(\pi\pi)$) compared with the target ($\pi\pi^*$)	
		$EE(\pi\pi) < \pi\pi^*$	$EE(\pi\pi) > \pi\pi^*$
State of financial stability risks	**No exuberance detected**	Maintain standard horizon	
	Exuberance detected	Extend horizon (and allow temporarily for a slightly tighter monetary policy than that required by price stability considerations alone)	Maintain or shorten standard horizon (and allow for a much tighter monetary policy than that required by price stability)

Source: ECB Occasional Paper No. 272, The role of financial stability considerations in monetary policy and the interaction with macroprudential policy in the euro area

Current policy trade-offs

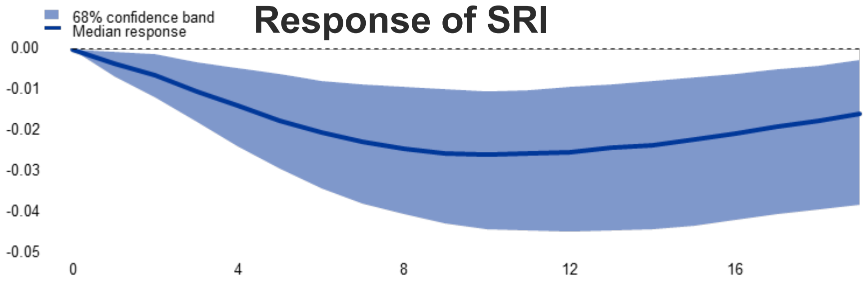
Term structure of main potential financial stability risks from Monetary policy normalisation

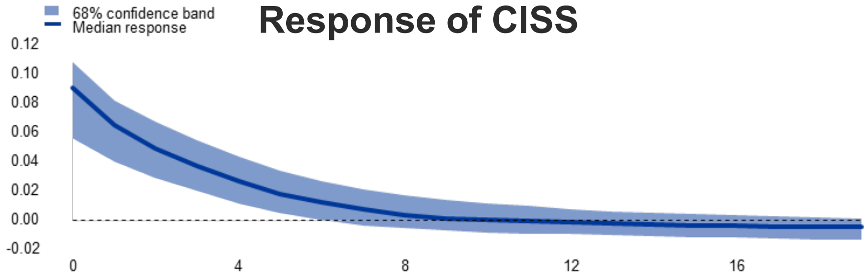
	Too slow normalisation	Too rapid normalisation
short-term financial stability concerns		▪ Risks of abrupt **repricing in fixed income markets and other assets**, and disruptions for some (non-)banks ▪ revival of **risk of fragmentation** and, if this persists, reactivation of the corporate-bank-sovereign nexus
longer-term financial stability concerns	▪ Continued **build-up of vulnerabilities and leverage** ▪ continued risk taking and **asset bubble creation** in equities, credit and real estate markets	

Short-/long-term financial stability trade-offs associated with monetary policy tightening

Impulse response of the SRI and CISS to a monetary policy tightening shock

(Shock of +18bps to the shadow rate)





- **Tighter monetary policy** can **mitigate cyclical vulnerabilities**, as captured by the Systemic Risk Indicator (SRI)…
- …but **only over the medium-term** …
- leaving the economy and the financial system exposed to the currently elevated levels of systemic risk in the short term …
- Tighter monetary policy also tends to **increase financial stress** in the **short-term**

Sources: ECB calculations.
Notes: Euro area BVAR model with four lags. Variables included: real GDP growth, inflation, SRI, CISS, shadow rate. Monetary policy shocks are identified with sign and zero restrictions. Shaded area denotes 68% confidence band.

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Overview

Macroprudential policy in the euro area

Macroprudential policy seeks to address or mitigate systemic risk to financial stability by

- Enhancing the **resilience of the financial sector** and
- Ensuring the ongoing **effective provision of financial services to the real economy**.

Macroprudential capital buffers ensure an additional layer of capital that banks can drawn on when losses are incurred in periods of stress

- The **capital buffer framework** comprises the capital conservation buffer, the countercyclical capital buffer, buffers for global and other systemically important institutions, and the systemic risk buffer.
- The various buffers are subsumed in the **combined buffer requirement**, and **automatic restrictions on profit distributions** such as dividends or bonuses kick in whenever a bank's capital ratio falls below this requirement.

Available macroprudential instruments

	CRD Tools	CRR Tools	Other Tools
Capital-based measures	• **<u>Countercyclical capital buffer</u>** • **<u>Systemic risk buffer</u>**, incl. sectoral systemic risk buffer • **<u>Global and other systemically important institutions buffer</u>**	• **<u>Risk weights for real estate sector</u>** and intra-financial sector exposures • **Capital conservation buffer** • **Own funds level** (incl. leverage ratio)	
Liquidity-based measures		• **Liquidity Coverage Ratio** • **Net Stable Funding Ratio**	• **Non-stable funding levy** • **Loan to dep. ratio caps**
Borrower-based measures			• **<u>LTV, LTI, DSTI and DTI ratio caps</u>**
Other measures		• **Large exposure limits** **Disclosure requirements**	

Based on the Single Rulebook (CRD/CRR), can be used by **national authorities** <u>and the **ECB** (top-up powers)</u>

Can only be used by **national authorities**

Notes: Underlined instruments are most commonly used.
CRD = Capital Requirements Directive; CRR = Capital Requirements Regulation; LTV = loan-to-value ratio; DSTI = debt-service-to-income ratio; DTI = debt-to-income ratio

Macroprudential policy first line of defence given limits of ‘leaning against the wind’

Macroprudential policy first line of defence against build-up of systemic risk

- Micro- and macroprudential measures targeted to affected subset of financial system can address **precisely underlying vulnerabilities** (macroprudential framework does not adequately cover non-bank financial intermediaries so far)
- However, **limited ability** of macroprudential policies to affect bank lending countercyclically (by releasing macroprudential buffers) **in downturn**

Conceptual and practical difficulties of systematic ‘leaning against the wind’:

- Given slow-moving nature of financial cycles it may render long periods of **inflation undershooting**
- **Too blunt** a tool for addressing sector or country-specific financial imbalances; particularly relevant in **monetary union with heterogenous financial cycles** across member states

Complementarity of price stability and financial stability

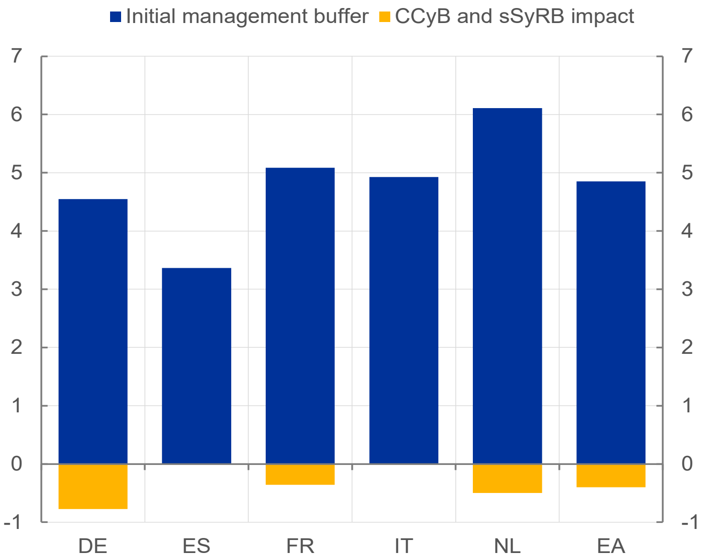
Pursuit of price stability via monetary policy and financial stability primarily via macroprudential policy largely complementary

- Monetary policy and macroprudential policy operate through **common transmission channels**
- **Financial crises** associated with sharp de-risking and deleveraging; resulting impairments in transmission mechanism of monetary policy render maintaining **price stability more difficult**
- **Prudential policies** safeguard smooth monetary policy transmission and thereby **support price stability** by preventing systemic crises and increasing resilience of financial sector
- **Monetary policy** supports financial stability via number of channels:
    - **Stabilises economy** during recessions, thereby reducing losses for financial sector and potential knock-on effects
    - **Contains** episodes of bank runs and fire sales during **outright financial stress**

Targeted macroprudential policies complement monetary policy normalisation

Banks' current capital headroom and impact of announced CCyB and sectoral SyRB increases

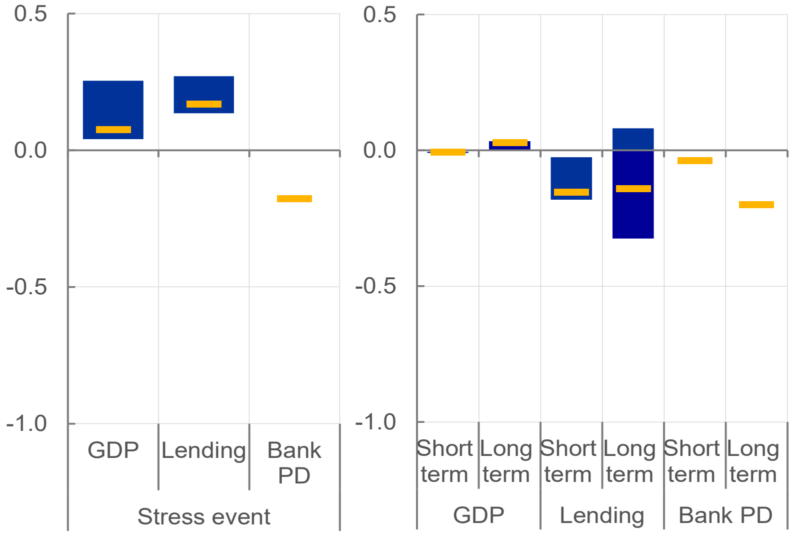
(percentage of risk weighted assets)



Sources: ECB and ECB calculations. – Sample of banks covers Significant and Less Significant Institutions, consolidated at country level using 2021-Q4 data. Aggregation at country level with averages weighted by RWA. CCyB - counter cyclical buffer, sSyRB sectoral systemic risk buffer, P2G (Pillar 2 Guidance).

Impact of the current macroprudential tightening for the activating countries

(percentage deviation from baseline level in 2024)



Sources: ECB and ECB calculations.

Background

2021 ECB approved new monetary policy strategy

Relevant extracts from the Monetary policy strategy statement

- Integrated assessment comprising two interdependent analyses: the economic analysis and the **monetary and financial analysis**
- Monetary and financial analysis focuses on the transmission mechanism and the **possible risks to medium-term price stability from financial imbalances and monetary factors**
- **Interdependencies across the two analyses are fully incorporated**
- This framework reflects…the importance of monitoring the transmission mechanism… and the recognition that **financial stability is a precondition for price stability**

Source: ECB's monetary policy strategy statement, see also Overview note

Implementation of financial stability considerations in revised monetary policy strategy

Recognition of financial stability as precondition for price stability

- **Medium-term orientation of ECB's price stability objective** allows to consider financial stability in monetary policy decisions whenever relevant to pursuit of price stability
- In-depth assessment of **interaction between monetary policy and financial stability** conducted at regular intervals as part of monetary and financial analysis and **considered at Governing Council's monetary policy meetings**
  - Provide more systematic evaluation of longer-term **build-up of financial vulnerabilities** and their implications for tail risks to output and inflation
  - Gauge extent to which **macroprudential policies** can mitigate possible financial stability risks relevant from a monetary policy perspective

Source: ECB Nov'21 FSR Box 8 'The role of financial stability in the ECB's new monetary policy strategy'

Macroprudential policy in the euro area

SSM

National authorities

European Central Bank

consultation on national policy actions and more stringent measures*

European Systemic Risk Board (ESRB)

"soft powers" for all EU Member states

* Art. 5 SSM Regulation

- **Institutional setting:** Co-responsibility of national authorities and ECB
- **Strong role of GovC:** Process different from microprudential decision-making
  - **Early involvement of GovC**
  - SB proposes policy measure
  - GovC decides and **can amend SB proposal**
  - **In absence of SB proposal, GovC can still take decision**

➔ Foster **timely policy action** at national level as well as **cross-country consistency** and **internalize spill-overs**