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What are the implications of recent monetary policy developments for financial stability?

Speech by Denis Beau, First Deputy Governor

Financial stability under the pressure of lower for longer [1]

From a macroeconomic and financial perspective, the recent period has been marked by an increase in macroeconomic risk, a further easing of monetary policies and the development of long-term low interest rate expectations. This situation, which was largely unforeseen a year ago, raises many questions about its origin and effects. As a central banker and supervisor mandated to contributing to ensuring financial stability, I am particularly interested and sensitive to the implications of this debate.

I have therefore focused my remarks on this topic and have grouped them around the following three questions:

1/What are we referring to and why are interest rates so low?

2/What are the associated financial stability challenges? and

3/ What policy-mix would be most effective?

[1] I would like to thank Jean Boissinot, special advisor to the Governors, for his contribution to this speech.

1. The rapid and ill-anticipated amplification of the low-for-long interest rate environment…

A change in the monetary policy stance

Since the end of last year, we have moved from a scenario of monetary policy normalisation that reflected a relatively stable global growth outlook to a more accommodating stance following a deterioration in the macroeconomic environment.

For instance, the IMF's global growth outlook has been systematically revised downwards since the summer of 2018. In April 2018, growth was expected to stand at 3.9% in 2019 and 3.8% in 2020. The latest forecasts (autumn 2019) are 3.0% and 3.4%[2] respectively.

In the euro area, the macroeconomic outlook has also been revised downwards. We currently expect growth of 1.1% in the euro area in 2019 compared with a forecast of 1.9% up to June 2018 and 1.7% at the end of last year. After a sharper and longer-than-expected slowdown, we now expect a gradual recovery in 2020 and 2021 for both GDP (1.2% and then 1.4%) and inflation, which should slow in 2020 (1.0%) but should remain at a low level in 2021 (1.5%).[3]

Against this backdrop, French growth is expected to be fairly resilient (1.3% in 2019 and 2020, and 1.4% in 2021).[4]

Why this unexpected deterioration in the economic environment?

As US growth has entered its longest expansion phase on record, there has been much debate about whether economic cycles are "dying of old age". This is not always the case, particularly in the euro area:[5] the current slowdown is less a case of growth running out of steam than the result of external shocks (trade tensions between the United States and China, Brexit-related events, political tensions in a number of emerging countries) and very high levels of uncertainty weighing on investment.

Faced with these shocks, which affect not only demand but also supply, the primary and most appropriate response should come from governments themselves, by addressing the problems that cause such tensions and uncertainties. However, in response to the deteriorating outlook, the main central banks had to ease their monetary policy.

Last September, the ECB decided to lower the interest rate on the deposit facility to -0.50% (with a two-tier system for reserve remuneration) alongside a resumption of net purchases under the asset purchase programme (APP) and a change in the modalities of the quarterly targeted longer-term refinancing operations (TLTRO III) to make them more favourable (lower

[2] World Economic Outlook forecasts published in April 2018, October 2018, April 2019 and October 2019.
[3] ECB staff macroeconomic projections (March 2018, September 2018, March 2019 and September 2019) or Eurosystem staff projections (June 2018, December 2018, and June 2019).
[4] Latest Banque de France macroeconomic projections for France (September 2019).
[5] See Lhuissier (2019) "Will the euro area's economic expansion die of old age?" Banque de France Blog Eco Notepad of 25 October 2019

rate applied and extension of the maturity from 2 to 3 years). This decision was accompanied by a strengthening of its forward guidance, stating in particular that it expected key ECB interest rates “to remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2%". At this juncture, the market believes that a further decline of 10bp is possible by the end of 2020.

For its part, the Fed cut the target for the federal funds rate three times in July, September and October to 1.50%-1.75% and slowed the pace of its balance sheet reduction. Markets are currently anticipating a further 25bp decrease by the end of 2020.

The shocks that have affected the global economy, combined with the change in monetary policy stance, have contributed to a sharp downward shift and a flattening of the yield curve since the beginning of the year, which worsened in the summer of 2019 and has only marginally corrected since then.

Overall, since the end of 2018, economic and financial players have unexpectedly started to factor in a low-for-long or lower-for-longer interest rate scenario.

Why have long-term interest rates fallen?

Before discussing the consequences of this development, it is necessary to consider an important question: are central banks responsible for this macro-financial environment?

It may be useful to put recent developments into a medium-term context. The decline in long-term interest rates is part of a nearly 40-year trend corresponding to a decline in the natural interest rate (r*) which can be explained by structural factors: slower productivity, an ageing population, the savings glut, etc.[6] A central bank has little control over any of these factors and cannot be held responsible for them: it simply adapts to such structural changes by adjusting its key rate to this lower natural interest rate. To give you an idea of this shift, while the natural interest rate cannot be directly observed and estimates may be rather conjectural, consensus points to a decrease of around 200bp since the 1990s.

In addition to the decline in the natural interest rate, monetary policy is also facing a new challenge. Since the early 1980s, its objective had been to fight inflation, which it had done relatively effectively. By contrast, since the crisis and against the background of persistently low inflation and declining expectations, it has had to fight not against but for inflation.

[6] For an introductory discussion of the issue, see Garnier, Lhuissier et Penalver (2019) « Taux d’intérêt bas, quelle responsabilité de la politique monétaire ? », Risques, n. 120 p. 79-86, Décembre (forthcoming).
For a more detailed examination of the evolution of r*, see Holston, Laubach and Williams (2017) “Measuring the natural rate of interest: International trends and determinants”, Journal of International Economics, 108 (supp. 1) pps. S59-S75 as well as the website https://www.newyorkfed.org/research/policy/rstar.
With regard more specifically for the euro area, see Claus Brand, Marcin Bielecki, Adrian Penalver (2018) “The natural rate of interest: estimates, drivers, and challenges to monetary policy”, ECB Occasional Paper Series, No.217.

Eventually, our monetary policy pursues its inflation target in a determined manner and our decisions are guided first and foremost by the macroeconomic situation. Interest rates are therefore likely to remain low for a long time, not so much because of monetary policies per se, but because of lasting changes in the factors that determine interest rates and inflation.

2. … whose effects on financial stability are mutually reinforcing…

This low-for-long interest rate environment has a series of effects on asset prices as well as on the financial behaviour of households and businesses and on the situation of financial intermediaries, which, from a financial stability perspective, can result in vulnerabilities in the event of a shock and thus become vectors for a new economic and financial crisis.

Increased sensitivity of markets to the interest rate environment

The first effect of the downward shift in the risk-free yield curve was to drag down a significant share of the bond market. Thus 60% of euro area sovereign bonds have negative yields, while a significant proportion (20%) of investment grade corporate bonds are also trading in negative territory.

Moreover, bond markets are not alone in experiencing record price increases. Equity markets have performed impressively since the beginning of the year (+20% for the EuroStoxx 600, +23% for the S&P 500, +25% for the CAC 40 and the DAX) and are displaying high valuation levels (price-earnings ratio of around 18 for the EuroStoxx 600).

Similar trends can be observed in other asset classes (private equity, real estate investment, etc.).

Overall, this results in financial asset prices that are, as a whole, more or less in line with each other. This can either be considered reassuring or rather worrying since a simultaneous correction across several asset classes is also possible in the event of a shock, especially since the search for yield gradually pushes investors to take more risk while receiving a lower return for the risks they take.

To sum up, the macrofinancial context combined with this "low-for-long" environment results in markets with high asset prices, conducive to risk-taking and subject to episodes of high volatility and the risk of a sudden correction.

Increasingly indebted economic players

The second effect of these very accommodative monetary conditions and, more broadly, of the decline in interest rates is to support credit dynamics and household and corporate debt.

Macroeconomic dynamics and household and corporate debt ratios

Personal loans grew at a rate of 6.5% (y-o-y., September 2019) driven by the growth in housing loans (up 6.6%) and, to a lesser extent, consumer loans (up 6.2%).

Outstanding loans to non-financial corporations (NFCs) increased by 6.4%, mainly driven by the 7.3% rise in investment loans. This increase concerns all sizes of companies: lending to VSEs grew by 8.4% (y-o-y, 2nd quarter 2019) while outstanding loans to SMEs, MTEs and large companies were up 6.2%, 3.8% and 6.7% respectively (y-o-y, September 2019)

Credit dynamics are particularly strong in France, but outstandings are also increasing in the euro area. Outstanding loans to NFCs and households increased by 5.7% and 4.2% respectively in Germany, and by an average of 3.4% and 3.4% respectively in the euro area.

Strong debt dynamics per se are not a cause for concern. The economy needs financing and a "vibrant" economy is also an economy in which credit and more generally debt and all other forms of financing (equity, trade receivables and payables, etc.) are buoyant.

Grounds for concern

Rather than outright solvency, our concern relates to the sustainability of household and corporate debt, which might be jeopardised by overly vigorous lending in the long term should there be an adverse macroeconomic shock. It also relates to the development of more specific vulnerabilities that could arise in a context of "benign neglect" which might result in lenders becoming somewhat complacent.

Let's start with the macroeconomic perspective –as a matter of fact, household and corporate debt has been growing faster than their incomes for a while.

The debt of French households (mainly housing loans) accounts for nearly 100% of their disposable income. French households are not (yet?) experiencing the debt levels of Spanish, British or US households just before the crisis (around 125%-135% of disposable income) but in 25 years of uninterrupted growth, the debt-to-income ratio of households rose from 55% in the early 2000s to 75% on the eve of the 2007-08 crisis and then continued to grow, exceeding the euro area average (93%) and making French households the most indebted among the major euro area economies (Italy: 60% Germany: 84%, Spain: 95%).

Corporate debt (loans and securities) has also risen sharply since the crisis to 200% of their value added, driven by both credit and market debt. This rise can be observed for all company sizes. Admittedly, companies also hold more cash, but net of these assets, corporate debt is nevertheless growing faster than the value added generated by non-financial corporations.

Concerns about the sustainability of overall debt dynamics and the development of "pockets" of risk

For both households and businesses, the current level of debt is not a cause for alarm. However, it does merit attention: the macroeconomic consequences of the overall increase in debt should be examined since a more indebted economy is also an economy that is less resilient to shocks.

Moreover, above this level, debt dynamics warrant very close vigilance: while debt growth tends to increase faster than income growth, the sustainability of these dynamics is not spontaneously guaranteed and, in the absence of any response from the authorities, debt could indeed reach alarming levels in the future.

Beyond these macroeconomic considerations, which are more related to the "quantity" of debt, the "quality" of debt also warrants some attention. Yet, in recent years, there has been a gradual easing of credit standards.

In the case of households, the amounts borrowed represent on average 5.2 years of income of borrowing households compared to 4.2 years in 2015. This increase in the amounts borrowed was made possible by longer maturities, an increase in debt service-to-income (DSTI) ratio and a decrease in down payments:

- while maturities rarely exceeded 20 years in the early 2000s, this has become a "normal" horizon today and loans with a maturity of less than 15 years have become marginal;
- similarly, while the DSTI ratio was hardly ever higher than 33% at the beginning of the 2000s, a quarter of new loans have a DSTI ratio of more than 35%;
- finally, 40% of new loans are granted for amounts exceeding 95% of the value of the property purchased.

In the case of companies, if we look at the global market for syndicated loans, for which we can find data on the clauses of the loan contract, we observe, in the most risky company segment ("leveraged loans"), a gradual disappearance of the covenants that regulate the borrower's behaviour or allow for the renegotiation of the contract terms in the event of deterioration in the company's financial position: 80% of leveraged loans are now covenant-lite loans.

To sum up, the "low-for-long" environment produces a strong incentive for households and businesses to increase their debt ratios. While debt levels are not alarming, this incentive comes in a context where the sustainability of these dynamics (observed over the past 25 years in the case of households and over the past ten years in the case of companies) does not seem to be spontaneously guaranteed. In addition, the increase in debt ratios also rely on and imply the development of riskier practices, which are, in themselves, sources of vulnerability.

Financial intermediaries under pressure

At the same time, the 'low-for-long' interest rate environment is putting pressure on financial intermediaries, banks and insurers alike.

Banks in a low interest rate environment

Banks derive a significant share of their profits from their intermediation activity and the difference between the cost of their liabilities and the rates paid to their depositors on the one hand, and the rates charged on the loans they grant on the other.

Given that the rates paid to their depositors are more rapidly constrained downward ("zero lower bound") than those charged on the loans they grant, the fall in interest rates exerts downward pressure on their intermediation margins.

In addition, maturity transformation also plays a key role in banking intermediation with the maturity of liabilities being typically shorter than that of loans on the assets side. Thus, the intermediation margin also depends on the slope of the yield curve: the recent flattening is further reducing intermediation margins.

Overall, the current macrofinancial environment is putting pressure on banks' intermediation activity, and may even, in some cases, call into question their business model.

In the case of French banks, this heightened pressure is accentuating an already unfavourable development: French banks' net intermediation margin, which has been traditionally low, has declined in recent years, in contrast with the recovery observed elsewhere, notably in the rest of Europe and the United States.

Part of this decrease is due to borrowers renegotiating their loans following the decline of interest rate in recent years. As an illustration, almost 50% of the current outstandings has been originated since the beginning of 2017. Given the fall in interest rates, this decline has not only led to a more rapid fall in the average rate of outstandings than what the repayment and "spontaneous" run-off of loans would have implied, but it has also given rise to fairly strong competition, which has resulted in a decrease in the margins on new loans. In this context, the strategy implemented by some banks to offset the fall in interest rates by originating more and/or bigger loans has become ineffective.

In total, this last wave of renegotiations has resulted in an annual reduction of around EUR 6 billion in French banks' net intermediation margin for the next few years. By way of illustration, this recurrent "loss" is to be compared to French banks' total intermediation margin of around EUR 70 billion in 2018.

The effect of low interest rates on the profitability of banking intermediation should nevertheless be qualified: the fall in interest rates since the start of the crisis has sustained the economy and, in so doing, has contributed to both supporting demand for credit and containing the cost of risk for banks. However, while forceful in the early recovery, these favourable effects are gradually fading. For example, it is neither likely (nor realistic) that the cost of risk will continue to fall.

Finally, this pressure on banks' profitability also comes at a time when other structural changes are calling for major investments and leading banks to ask themselves fundamental questions about their business model and how they operate. The digital transition ("digitalisation") represents a major challenge for institutions that already devote 15% to 20% of their income (net banking income) to maintaining their information systems. The additional investment effort required by "digitalisation" is constrained by the current circumstances.

Impact of low interest rates on insurance activities

Interest rate developments have also contributed to drawing attention to insurers for which the fall in interest rates has a two-pronged effect:

- On the one hand, the return on their assets has been steadily declining in recent years. The rate of return on assets stood at 2.7% in 2018, compared to nearly 4% in 2009. The decline is slow because insurers' assets still comprise securities, including bonds, originated at a time when rates were higher. Nevertheless, it will accelerate (as half of the bonds in their portfolio yield more than 3% with a residual maturity of less than 3 years) and, given the inertia of the portfolios (the corollary of the slow decline), yields will remain persistently low even if market rates were to rise again.

- On the other, the fall in long-term interest rates this summer has led to a decrease in the rate at which long-term commitments, such as life insurance, civil liability, construction insurance, etc. should be discounted.

In view of these two effects of a (delayed but instant) increase in insurers' liabilities and a (long-term and progressive) decline in returns on assets, insurers need to give serious thought to their offer and positioning. Beyond short-term solutions, such as promoting unit-linked products – which requires paying renewed attention to their responsibilities when advising clients – or developing new products, this should probably lead them to refocus on products and services with a greater insurance content.

Strengthening effects

Finally, it must be emphasised that these effects are mutually reinforcing.

For example, faced with declining returns on traditional asset classes, institutional investors are gradually upping their allocation in alternative asset classes.

Institutional investors' risk taking is mirrored by non-financial agents' growing indebtedness and by particularly high valuations for this type of assets for which maintaining a sufficient remuneration of risks, in particular the risk of illiquidity, is no longer obvious.

Thus, the very large amounts collected by private equity funds has led to unusually high levels of "dry powder" and strong competition that has resulted in transactions at very high multiples (most recently at around 10x EBITDA).

3. … and call for mobilising and well articulating public policies.

In this context, what should we do?

A structural response to structural problems

We first have to acknowledge the roots of the current situation: it would be desirable for interest rate to gradually increase and structural causes call for long term structural solutions. In particular, we need to strengthen the growth potential of our economies and to address the euro area's (private and public) investment shortfall relative to its abundant savings. This requires conducting structural policies to promote innovation and productivity. It also means improving the quality of public spending, by steering it more towards future-oriented spending and investment

In the shorter term and from a cyclical perspective, in a context of very low interest rates close to their lower bound, a more active counter-cyclical fiscal policy, becomes possible and desirable, alongside monetary policy. In the absence of a euro area fiscal capacity, this must be done at the level of national policies, but in a differentiated manner. Member States with fiscal leeway should use it, especially as some of them are facing a stalling economy. In the case of Member States that are constrained by their excessive debt levels, persistently lower interest rates may give them the possibility of spreading a little more over time the necessary adjustment of their primary structural balance, while letting the automatic stabilisers play their role.

Micro and macroprudential response

As regards the immediate consequences of the low interest rate environment for financial stability, it must first be emphasised that the financial sector's shock-absorbing capacity has been considerably strengthened since the crisis. By way of illustration, the capital supporting banks' activity has more than doubled since the crisis and banks' transformation activities are better regulated.

Nevertheless, the system's capacity to absorb shocks is still insufficient.

From a microprudential perspective (i.e. the perspective of institutions' individual stability), supervisors remain attentive that banks pursue their efforts to clean up their balance sheets (in particular, for institutions in some Member States still experiencing the after-effects of the crisis, to reduce the weight of non-performing loans). In a forward-looking manner, they expect financial institutions (banks and insurers) to exercise caution in assessing, for example, the credit or counterparty risk they take or the illiquidity of the investments they make, in managing the interest rate risks they are exposed to or, in general, in adopting sustainable business models.

At the same time, as risks increase, it is urgent to complete the efforts to strengthen the regulatory framework that have been conducted for the last 10 years, while new risks, such as the risks posed by digital disruption ("digitalisation"), for example cyber risks, or those posed by climate change must be well anticipated, better understood and effectively taken into account.

From a macroprudential perspective (i.e. that of the financial system's stability and resilience), a more active macroprudential policy is needed to prevent the emergence of pockets of vulnerabilities and to contribute, to the extent possible, to improving financial and macroeconomic resilience. This means dealing with greater structural risks such as the rise in cyclical risks.

In this context and in order to address the possible development of a population of large, highly-indebted companies, the Haut Conseil de stabilité financière (HCSF – French macroprudential authority) decided, in December 2017, to limit the exposure of major French banks vis-à-vis large, highly-indebted French companies (with a debt representing more than 100% of equity) and devoting an already large share (over 33%) of their income to the service of their debt.

Still in this context and taking note of the overall credit dynamics, it decided to raise the countercyclical capital buffer (CCyB) rate to 0.25% in July 2019 and 0.5% in April 2020 to strengthen banks' loss-absorbing capacity and have enough leeway to ease banks' capital constraint in the event of credit rationing in order to strengthen the resilience of the banking sector and the economy in the face of a possible financial shock.

The HCSF is now considering what needs to be done in terms of mortgage lending to ensure the sustainability of households' debt dynamics, avoid the development of riskier lending practices and limit the risk of having insufficiently profitable loan outstandings in banks' balance sheets.

France is not a special case in Europe:

- 13 EU (and EEA) Member States have also taken measures to strengthen banks' capital;

- 22 Member States have taken a total of 62 measures regarding their real estate market.

Conclusion: The limits of macro-prudential policy and the need for better articulated policies

While a more active macroprudential policy is absolutely essential, several limits should be borne in mind:

First of all, our range of instruments is currently rather narrowly focused on banks. We have made some progress towards extending macroprudential policy beyond the banking sector. But we must recognise that we still have some way to go and that this is becoming an urgent issue, as the non-banking sector is developing in reaction to the macro-financial environment and the changes in the regulatory framework.

In addition, given that our macroprudential arsenal is still relatively new and untested, uncertainty remains as to the quantitative magnitude of the effects of our interventions. Experience will teach us how to adapt and adjust our policies over time, but uncertainty will remain a hallmark of policy making under real conditions.

Finally, we must guard against complacency: over time, we will develop a more comprehensive set of macroprudential instruments and learn how to make the best use of them. But while macroprudential policies can certainly make a significant contribution, some of the ultimate causes of financial crises are deeper macroeconomic imbalances and will remain out of their reach: macroprudential policies alone are not sufficient to ensure financial stability.

It is therefore important that the different policies be conducted in a coordinated manner, without confusing their individual objectives nor the mandates of the authorities that implement them.

For example, insofar as certain financial developments may be encouraged by tax measures, such as a tax bias in favour of indebtedness in the area of corporate taxation and a tax treatment of real estate holdings relative to other types of assets, it is important, where possible, to correct these biases that contribute to the development of indebtedness that may become excessive.

This is also the case of the link between monetary policy and financial stability. Given that monetary policy has collateral effects on financial stability and that macroprudential policy is not omnipotent, we need to break out of a Manichean view that opposes an approach of separation, of strict indifference of monetary policy and financial stability concerns and a “lean against the wind” approach that would mobilise monetary policy to contain asset prices.

The binary opposition between the principle of a standard separation and the fact of "leaning against the wind" has less meaning when monetary policy itself has several instruments at its disposal. A middle ground that we might call "coordinated" or "integrated" is possible and desirable.