

Informal ECOFIN, September 7-8 2018

Financial stability implications of increasing interest rates

PRESIDENCY ISSUES NOTE

I. Introduction

Since the onset of the Great Recession in 2008, broad-based economic stimulus including increased government spending and highly accommodative monetary policy helped to contain output losses and supported the economic recovery. Economic developments have firmed in Europe, with many economic indicators, including employment and unemployment, back to their pre-crisis levels in many countries. In parallel, regulatory reforms have considerably strengthened the resilience of the European banking and insurance sector. Europe has also instituted a macro-prudential approach to supervision, which is being increasingly used. In 2015, the ECB launched a EUR 2,600bn expanded asset purchase programme (APP) to address low inflation. As of the beginning of 2018 monthly net asset purchases have been halved and will phase out in the course of 2018. Whilst headline inflation is currently driven by energy prices, underlying inflation is expected to steadily gather pace as labour markets become progressively tighter, wages accelerate and estimated output gaps become increasingly positive in a larger number of Member States.

In the USA, the FED, which implemented its measures in times of financial turmoil, has already started to increase policy rates with no major economic disruptions yet.

II. CEPS-paper

In the background paper and drawing from US-experience, Daniel Gros sees little reason to worry about the impact of policy normalisation on the real economy or its global impact. The ECB has a well-established communication strategy, which is well understood by market participants, and there is little reason to fear that policy normalisation should lead to an abrupt risk aversion or risk premia. In an overall fiscal perspective, the APP has somewhat counteracted the lengthening of the maturities of public debt.

The paper argues that policy normalisation might have some stabilising impact on the banking system, as it would tend to improve net interest margins and the profitability of banks which could have positive impacts on the bank's ability to lend. Also, insurance companies should benefit as returns will increase with no effect on the liabilities.

While elevated private indebtedness and sharply higher debt service costs would raise the spectre of defaults, the generally strong levels of banks' provisions and capital buffers built up since the financial crisis and the continued improvements of the overall quality of EU banks loans' portfolio – spurred by regulatory reforms and supervisory action – would likely help absorb the direct and indirect impact of credit losses.

III. Uncertainty and risks

Yet, borrowing in a number of countries and sectors, including the public sector, has taken debt to GDP ratios to historical highs. Households in some advanced economies and EMEs, as well as non-financial corporates more widely have also become highly indebted. To the extent that this debt is at a variable rate or would need to be rolled over soon, a sharp increase in interest rates would put a strain on borrowers' repayment and refinancing capacity.

As the European financial system is dominated by bank-financing the issue of “too-big-to-fail” is still a key issue. Given high indebtedness in Europe, an effective and credible resolution regime, including bail-ins, is therefore of the utmost importance. Bail-in is not a panacea, however, and some bank business models may require the use of other tools.

Thus, re-establishing or maintaining sound public finances as well as the completion of the banking union and capital markets union together with structural reforms are of paramount importance to improve the resilience of Europe.

IV. Issues for discussion

- 1) Do you agree that interest rate normalisation will in itself not generate problems in the financial sector and the tool-box of regulation and supervision can be regarded as adequate?**
- 2) Where would you see specific pockets of vulnerabilities and how should those be addressed?**