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ECB's monetary accommodation should be used to strengthen public sector balance sheets

The ECB's accommodative monetary policy has buoyed financial and credit conditions through various channels. But at the same time, countries with high debt should use the space created by accommodative ECB policies to consolidate so that they can continue to access markets at favorable rates when the ECB eventually starts raising rates.

The combined ammunition provided by the asset purchase program, negative interest rate policy and long-term refinancing operations has improved the funding and income conditions of various players in the economy. Public sector asset purchases compressed sovereign risk premia and supported portfolio rebalancing. Sovereign yields have fallen substantially since the announcement of QE in January 2015. Corporate issuances also picked up significantly after the announcement of the corporate bond purchase program in March 2016. SME lending rates have fallen, while credit standards and conditions have eased. The ECB's Bank Lending Survey suggests that most banks used long-term refinancing operations to increase corporate and household lending, as intended.

More recently, the negative interest rate policy has helped provide further accommodation. Negative policy rates were quickly transmitted to various key rates. Money-market rates have closely tracked the policy rate due to excess liquidity pushing interbank trading towards the deposit rate. Moreover, expectations of future money market rates decreased, in response to the ECB's forward guidance. Lending rates for both corporates and households also decreased, and as a result, credit has expanded modestly. Initially, a flatter yield curve due to the QE hurt bank profitability. However, the ECB's flexibility in purchasing assets at yields below the (negative) deposit rate floor, announced in December 2016 helped steepen the yield curve by lowering the short-end.

However, economies with lingering crisis legacies need to act to reap real benefits from ECB's accommodative policies. The high stock of nonperforming loans, especially in high-debt countries, need systematic resolution to reduce sovereign-bank linkages and to enable banks to lend again. Supervisory monitoring of NPL targets have to go hand in hand with encouraging the creation of distressed debt markets.

Finally, banks need to restructure and consolidate to ensure viability. More mergers and acquisitions would help the system navigate the testing profitability environment, where factors include still under-provisioned NPLs and high operating costs. Credit losses have been a significant drag, as have rigid cost structures, reducing aggregate returns on assets to levels well below the cost of new equity.

There is a need for further consolidation and restructuring, including to rationalize branch networks. In addition to many of these legacy issues, banks globally are facing competition from new (and disruptive) technologies, which will force, possibly very substantial structural change. ●