Q&A

MÁRIO CENTENO

Governor,
Banco de Portugal

Building upon the integration leap we experienced with the crisis

What are the implications of prolonged monetary policy easing in terms of financial stability?

Given the pandemic's abrupt, intense, persistent and asymmetric effects on economic activity it has justified the adoption of massive and timely policy support. These measures redistribute, across agents and over time, the costs of the pandemic. This is easier to implement this time because we have abundant liquidity and no moral hazard concerns. However, risks persist and have even been magnified by the crisis; its asymmetric nature. The policy action should proceed, now more targeted, in order to minimize this impact, allowing for an appropriate adaptation and phasing-out of existing measures.

It is hard to argue that this prolonged period of monetary easing has had a material and perilous effect on any of the dimensions referred.

First, one should notice that these very low nominal rates (short and long) have not corresponded to very low real rates, at least not in historical terms. This, coupled with the estimated natural real rate that has followed a downward path over the last decades, means that the stimulus provided is not has strong as suggested by the historically low nominal rates.
Second, there has been a response to those potential vulnerabilities from targeted macroprudential and microprudential policies, directed at banks and borrowers. Nonetheless, improvements are welcome: the enhancement of cross-country coordination mechanisms, or a focus on other parts of the financial system are dimensions deserving further development.

Third, monetary policy has been carefully designed to avoid undue distortions. For instance, to mitigate the effects of the proximity to the so-called reversal rate, the ECB has implemented a two-tier system for remunerating excess reserves, whereby a multiplier of required reserves is exempt from the negative deposit facility rate. All in all, it is conceivable that adverse side effects will tend to become more manageable, no matter for how long monetary accommodation persists.

A generalized backtracking in monetary policy may be ill-advised. Assessing the precise frictions that are at work, fine tuning the monetary policy instruments in view of those frictions or suggesting a relevant role for other policies seems more adequate. At the time of evaluating the success of our policies, it is perhaps useful to imagine the counterfactual scenario without a strong monetary response, both conventional and unconventional. In this case, the materialization of a disruptive scenario would be ever more likely, making the potential trade-offs we now face quite limited when compared to the welfare losses incurred in such scenario.

When and how should the Stability and Growth Pact rules be reactivated and should they be reviewed?

The crisis impacted severely on public finances. That was both inevitable and desirable. Moving forward, the focus for fiscal policy should be on the composition and the quality of public finances, prioritizing the implementation of growth-enhancing policies. The responsible use of the EU funds, also targeted at promoting investment in technologies, is crucial in this respect.

Over the cycle, active fiscal policy that goes beyond the impact of automatic stabilisers should be limited to bad economic times. This, however, requires achieving fiscal space and creating adequate buffers in good times.

An institutional framework that reliably creates the proper conditions for fiscal policy to operate is of utmost importance.

Although there is wide consensus on the need to simplify the Stability and Growth Pact, attaining a compromise solution on the design of the rules will be challenging, both technically and politically. Ideally, the debate on European fiscal rules should be concluded at the moment the decision to deactivate the general escape clause is adopted. Until then, the fiscal stance should continue to be supportive, taking into account the strength of the recovery and phasing out measures in a way that mitigates the social and productive impacts of the crisis.

Some sort of policy support will be needed as long as economies do not go back to full employment, as it is clear from the policy debate in other economic regions, most notably the US.

How can Europe correct the growing heterogeneity of economic performances among euro area countries? What impact is expected from the “Next Generation EU” package?

Divergences in productivity and GDP per capita are not desirable. The converge process shall remain high on our agenda. Before the pandemic crisis EU countries agreed on the first embryo of an Eurozone budgetary instrument. The so-called Budgetary Instrument for Convergence and Competitiveness (BICC) made already clear that the priority for convergence was adopted, and the crisis made it even more relevant.

The discussions that took place in the Eurogroup on the BICC were crucial for Member-States to better understand and assess the importance of convergence and the best way to support its promotion. They paved the way for the agreement on the Next Generation EU (NGEU), which over the next six years will leverage the digital and climate transitions and increase potential GDP growth rates across member countries. The size of the NGEU is not of an embryo anymore. Furthermore, the NGEU also represents an historical agreement on joint debt instruments. It is the response to the challenge outlined in the EG agreement exactly one year ago. This step forward should be stressed. It is an integration leap of major importance. Going forward, it is crucial that solidarity remains, and that domestic and EU level policies do not hurt the level playing field that characterizes the single market and its ability to promote growth. It is imperative that EU citizens benefit from the positive loop between growth and integration, also with a view of keeping public debt ratios on a sustainable path. Going back to the old days of mistrust and extreme moral hazard debates is something that we need to avoid at all costs.

Are further measures needed for enhancing the contribution of the EU banking industry to economic recovery in Europe? What role do the profitability and the competitiveness of the EU banking sector play in this regard and how may they be improved?

A bulk of measures adopted to mitigate the economic and financial impacts of the crisis were based on banks financing households and non-financial corporations. Measures ranged from prudential and macroprudential to fiscal and monetary. Different in nature but aligned in their objectives. Many are still in place and their phasing out should be carefully assessed. As we move to a phase in which a more targeted and state-dependent approach is needed, notably on the fiscal side to support viable, if financially stressed, firms, regulators and supervisors need to continue monitoring the risks to financial stability closely and take further actions if needed.

Banks profitability also plays an important role. The challenges that were already noticeable became more evident with the crisis. In addition to the increased competition in financial intermediation from new players, often using new technologies, the low interest rate context is challenging for banks. It is of utmost importance that banks continue the restructuring process that started in the aftermath of the previous crisis to become more efficient. Even if, in the short term, this may have a negative impact on profitability, banks need to continue investing more on the use of new technologies to decrease costs and assess (new) market opportunities.

Consolidation of the banking sector should also play a role. It delivers cost savings through economies of scale, in particular in less concentrated banking markets, and revenue synergies. However, the risks underlying the emergence of “too big to fail” or “too-complex-to resolve” institutions should not be disregarded. Also, it is necessary to distinguish domestic from cross-border consolidation in what concerns potential effectiveness in dealing with the overcapacity of the banking sector in member states and the impact in an incomplete Banking Union. The completeness of the Banking Union is a key condition to achieve a more sustainable process of cross-border bank consolidation in Europe.

What have been the impacts of the Covid crisis on the EU banking sector and in terms of financial stability? What are the prospects of the Banking Union in this context?

The COVID-19 crisis has led to an unprecedented, coordinated policy action in Europe. The various action taken were timely, coordinated and forceful, including in financial regulation and supervision. I do not think that the COVID crisis has further fragmented the Banking Union. It has made more evident the need to progress towards a complete Banking Union.

The EU banking sector is now in a more favourable situation than before the previous crisis, notably in terms of the quantity and quality of capital held. This represents a significant improvement in banks’ capacity to absorb the potential losses of this crisis. But, as I have mentioned, the financial stability risks underlying the current crisis have not disappeared yet. The measures adopted were key to mitigate the liquidity shortages of households and firms and indirectly limited the impact on the banking sector. However, the risks of a less pronounced recovery may lead to more acute solvency issues. These need to be addressed in the non-financial sector, to avoid a significant increase of losses in the financial sector.

As financial stability risks underlying the current institutional framework persist, both in the euro area and in Member States, it is key to move forward with the Banking Union. Procrastination is not a possibility. The Banking Union must be completed in the next couple of years.