ADDRESSING FINANCIAL STABILITY RISKS

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We are not out of the woods yet

In horror movies, every time that the main character seemingly escapes a suspenseful situation, you can expect a jump-scare to immediately follow. On the way out of a dark forest, there is always something awaiting the main character at its very edge. The audience knows this, but never fails to get shocked when the plot delivers on expectations. First, the emergence of a pandemic after the GFC, and now even the potential implications of the current pandemic crisis for financial stability appear to follow such a script. The remarkable recovery on the back of vaccines and extremely supportive economic policies have prevented the fallout in the financial sector. Reforms pursued over the post global financial crisis decade also helped to turn the financial system into a part of the solution, rather than the source of problems. However, the potential issues that are lurking in the background while we are heading for the exit are worrisome. And very much like in a horror movie, we cannot know in advance whether a sudden strange noise in the bushes will turn out to be just a small animal passing by or a Roubini-style mother of all crises.

The first warning sign of trouble ahead is an «overwhelming silence» - the number of corporate bankruptcies tanked during the pandemic, which is in a sharp contrast to any previous crisis episode. Exceptional public support and temporary regulatory forbearance allowed for the continuous operations even of the companies that would have exited the market under normal circumstances. Certainly, when faced with such a major shock it makes perfect sense to postpone corporate bankruptcies until uncertainty created by the pandemic somewhat recedes and to spread the inevitable bankruptcies over time in order to ease labour reallocation. But maintaining the support for too long – in another apt reference to the movie industry – creates a zombification risk over the large swathes of the corporate sector. Also, at the moment we cannot be sure how large the final tab for corporate bankruptcies will be, once it comes. Banks have heavily provisioned for potential risks arising from latent non-performing loans, but until the ending we cannot assess residual risks with a fair degree of reliability.

The unprecedented fiscal expansion has supported the corporate sector and shielded household incomes from the crisis. But it has saddled governments with substantial additional debt. The rise in indebtedness comes on top of an unfinished banking union, where the sovereign-bank nexus remains one of key vulnerabilities of the monetary union. Admittedly, the prolonged low interest rate environment eased the management of government debt, but the cost savings have already been to a great extent absorbed by government budgets and the remaining risk is for the CBs asset purchases to come to an end and rates to rise. Even if such a scenario turns out to be benign as economic growth keeps track with higher inflation and interest rates, it exacerbates the risk of a sudden asset price collapse.

There is a long and constantly evolving list of things to do and things to avoid for any movie character. Unfortunately, in the case of a financial crisis, the to-do list for policymakers mostly comprises actions that need to be taken well in advance. Yet, there are still some things than can be done in order to cushion the blow.

As to use policy tools effectively in another crisis, we need to seek to regain our policy space.

The first on the list are bankruptcy procedures. In many European countries it takes far too long to complete a bankruptcy, which incurs losses for creditors and destroys economic value in the process. Improving these procedures may not yield much gain under normal conditions, but there is a large upside in terms of economic recovery in the crisis aftermath. Moreover, we need to take a fresh look at nascent risks, such as bubbles in the residential real estate market. Indeed, a number of countries has already resumed their previous course of tightening macroprudential tools aimed at real estate, in a sharp contrast to what was done during the pandemic crisis. Finally, the same principle applies to all other policy tools: in order to be able to use them effectively in another crisis, we need to start regaining policy space as soon as realistically possible. Only if we take these steps, we will be able to shrug off the jump-scare that awaits us at some point before or at the edge of the forest.

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Underlying trade-offs of policies promoting growth and financial stability

"Great things are not done by impulse, but by a seires of small things brought together"

- Vincent van Gogh

In a context of heightened vulnerabilities and risks to financial stability, the COVID 19 pandemic confirmed the importance of the regulatory reforms adopted in the aftermath of the Great Financial Crisis (GFC) and of the economic and financial adjustments observed in European Union countries. The authorities were able to curb, promptly, the effect of the shock, redistributing the underlying costs across agents, sectors and over time. Significant, swift and broad-based action was taken by monetary authorities, by supra and national government entities and by supervisory and regulatory authorities, both at the micro and macroprudential levels.

The materialization of risks has been limited, but the build-up of vulnerabilities was inevitable. The policy action was proportionate, but we must be cautious about possible side effects. For instance, policies adopted to mitigate corporate insolvencies and to preserve employment and household income had a positive impact on the financial sector, but led also to an increase in sovereign debt and, to a lesser extent, in firms' indebtedness. Thus, the reversal of the current benign financing conditions is a challenging task, requiring a fine-tuning equilibrium between these opposing forces.

The low profitability of the banking sector, in a low-interest-rate context and with increased competition from technology companies, may hamper banks' capacity to deal with the current challenges, including an increased credit risk due to the pandemic crisis. The extraordinary effort of coordination of fiscal, monetary and regulatory and supervision policies must continue and be adapted to each stage of the crisis.

Climate change and cyber risks arising from increased digitalization in our economies and, in particular, in the financial sector, have been gaining relevance. The frequency of events related with these risks is reinforcing the urge to adopt adequate policy initiatives. In what concerns climate change risks, the transition itself will be a challenge to be faced, with potential relevant financial implications. Despite subsisting insufficiencies in data gathering and concept harmonization, regulators, supervisors and supervised entities are preparing to face and mitigate these emerging risks.

When assessing the importance of the existing challenges, we need to take into account the existence of important mitigants. Among these, it is worth mention several pre-crisis outcomes. The reduction in private sector debt in many European countries, in particular in those most affected by the GFC; the improvement in government primary balance and the compliance with European fiscal targets, namely, the medium-term objective; the increased resilience of the banking sector, namely in terms of liquidity, solvency and reduction of NPLs; and the deepening of the European financial institutional framework. All of which have evolved favorably in recent years, even if we should resume them as they remain incomplete.

We have reasons to be optimistic. Uncertainty about the recovery path subsists, in terms of timing but also of its nature/composition, considering the uneven position among sectors.

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The mile ahead of us is the one where we can expect more intense economic adjustment – in a context of increased insolvencies and changes in consumer patterns. We do not need to be a devoted Schumpeterian to express this expectation. Consumers will resume benefiting from a substantial accumulation of savings, but again low-income households may face strong challenge in the recovery and in the adjustment to the digitization and automation processes, and those firms ill prepared to face a crisis like this will require some degree of restructuring.

We cannot be complacent and rest on the early signs of recovery that economic data already reveal. We need to remain vigilant. As in Vicent van Gogh's painting, it is the overlapping of painstakingly and thoroughly thought solutions that will lead us out of this crisis to great things. Policy by impulse must be avoided; existing measures must be phased out, adapted and new measures adopted in tandem with the evolving economic situation. Maintaining measures for a too long may introduce distortions and contribute to the build-up of vulnerabilities, but their premature withdrawal is going to jeopardize economic recovery, which we should aim to be robust, sustainable and inclusive.

The pandemic reinforced our Economic and Monetary Union and strengthened the ground for further integration. European initiatives should maintain the same ambition. The Banking Union and the Capital Market Union have to be part of this effort. This is a privileged position to agree on the necessary adjustments to our single rulebook and for an improved framework design.