Q&A

BOŠTJAN VASLE

Governor, Banka Slovenije

Supporting economic recovery and further financial integration

What are the key financial stability risks and the main vulnerabilities in the financial sector at the EU level in the context of lasting very low interest rates, the deterioration of credit risk, the inflationary pressures, and very accommodative fiscal policies ?

As the main challenge remains the pandemic with all the associated adverse effects, it is our priority to provide the necessary support for the economic recovery and in this way protect financial stability, economic potential and the sustained convergence of inflation to our target. Looking back, the prompt and bold response of macroeconomic policies was crucial for maintaining financial stability during the outbreak of the COVID-19 epidemic. In the Eurosystem, we acted early and decisively, deploying both monetary and supervisory policies. With such support, banks and thus businesses and households as well as sovereigns have had uninterrupted access to financing under favourable conditions throughout the crisis.

Nevertheless, due to uncertain developments regarding the health situation and consequently further rebound of our economies, we still see some financial risks. While the number of insolvencies of businesses and households has been limited so far due to extraordinary economic policy intervention measures and temporary suspension of initiation of insolvency proceedings, we may see their increase in the years ahead. Some sectors have been hit extremely hard and some businesses were highly indebted and vulnerable even before the pandemic crisis. Another challenge further exposed by the pandemic is the profitability of banks. So far, due to their favourable starting position and numerous policy measures, the position of banks has not deteriorated, and regarding credit risk management, they also have knowledge and experience from the previous crisis. Third, in some countries and regions, there are signs of residential real estate overvaluation, after house prices have been growing steadily for many years. But overall, rather than the realisation of individual risks, the stability of the financial system might be challenged by a combination thereof, potentially triggered by a significant deterioration in the economic situation or external shocks.

As we are getting out of the pandemic, what should be the appropriate approach to monetary policy: i.e. stick to the present unconventional stance or to start changing gears? To what extent does this depend on the level of inflation?

The unconventional monetary policy measures deployed during the pandemic prevented the effects of the shock from spilling over to financial markets, stimulated aggregate demand through maintaining generally favourable financing conditions and mitigated the negative effects of the crisis on inflation. Pandemic measures, temporary in their nature, will be phased out eventually, but the current situation still calls for monetary policy to remain highly accommodative. Recovery is underway, but new waves of the pandemic may slow it down, and we expect inflation to return below the 2-percent target after a temporary rise.

In addition, long-term trends will presumably continue to contribute to the narrowed monetary policy space and could warrant longer and more frequent use of unconventional measures in the post-pandemic recovery phase and beyond. Accordingly, the ECB's renewed monetary policy strategy reinforces so-called unconventional measures as an integral part of its toolkit.

Unconventional measures, such as negative overnight rates and asset purchases, not only serve our primary purpose, i.e.

price stabilisation, but also have side effects. One concern is that high dependence of the banking sector on longer-term refinancing operations might have longer-term consequences for their incentives to refinance themselves through financial markets. In addition, our measures have, alongside other factors, most probably contributed to relatively rapid growth in residential property prices, which have accelerated in the last year. Another concern is the large volumes of debt undertaken by sovereigns to tackle the pandemic-induced crisis, which could pose a risk for some sovereigns of a more marked increase in borrowing costs once monetary policy moves away from the pandemic measures.

Being aware of possible side effects, monetary policy decisions are accompanied by the assessment of the benefits of respective measures for the economy (in the pursuit of price stability) and their possible side effects. For now, the indication is that the benefits of a highly accommodative stance, supported by unconventional measures, outweigh the cost but that going forward vigilance is warranted. In this regard, an integral part of our new monetary policy strategy is an enhanced proportionality analysis.

When the pandemic is under control, what should be the timetable and measures for returning to normal prudential and accounting requirements in Europe? How to phase out current measures in an appropriate way?

Prompt and exceptional support measures taken in response to the outbreak of the pandemic have strongly limited the effects of the pandemic on our economies. Once we assess that the pandemic phase is over and that the rebound of the euro area economy is set to last, unwinding of the pandemic measures will take place.

The eventual unwinding of policy measures will be guided by the improvement of economic data and will be aligned with maintaining an appropriate monetary policy stance. Our decisions will therefore be significantly influenced by (dis) inflationary pressures and other concerns, including prevailing financing conditions for sovereigns, banks and thus also households and businesses.

Overall, introducing and to great extent maintaining support measures has been necessary to maintain financial and price stability, but structural changes should not be hindered. For instance, after a year of crisis, it was necessary to start restoring the transparency of bank balance sheets and to return to banks the responsibility to judge which companies are viable and eligible for loan restructuring. As regards policy support in this context, one possibility could be a more favourable prudential treatment for banks which support viable firms.

Which EU policy priorities are needed to overcome the fragmentation of the EU banking sector?

The pandemic crisis, with its asymmetric impact on sectors and national economies, has increased the risk of further fragmentation of the EU banking sector. At the ECB level, we have mitigated the risk by preserving generally favourable financing conditions, while the European Commission and EU leaders contributed their part by adopting stabilisation instruments, such as the Next Generation EU. In the face of future crises, it would make sense to strengthen the EU's fiscal stabilisation function with some degree of automation.

More generally, the issue of further integration of the banking system is closely linked to completion of the banking union, including the missing block – the EDIS. After years of discussions, views of stakeholders still differ in terms of the elements and their architecture and sequence of implementation. We at the Bank of Slovenia believe that the completion of the banking union would significantly strengthen financial stability across the EU, create a level playing field for banks operating in different EU countries, and thus stimulate cross-border financial and capital flows.

Harmonisation of bank insolvency laws and the completion of the resolution framework, including a common backstop, are important elements of the roadmap towards the banking union. Progress in this field would enhance the legal certainty and predictability of the resolution regime and inherent litigation risks. Implementation of EDIS together with an improved regulatory and resolution framework should be seen as a precondition and a starting point for further integration of the EU banking market. Only a complete institutional set-up can provide the basis for a more integrated and consequently also safer and more profitable EU banking sector.

The fragmentation of the EU banking sector and readiness to take steps forward at the EU level are importantly influenced by country-specific policies. Sound fiscal policies and speedier progress in pension, labour market and other structural reforms would thus help to improve the market perception of sovereign and bank credit risk and could help to dispel much of the atmosphere of distrust.