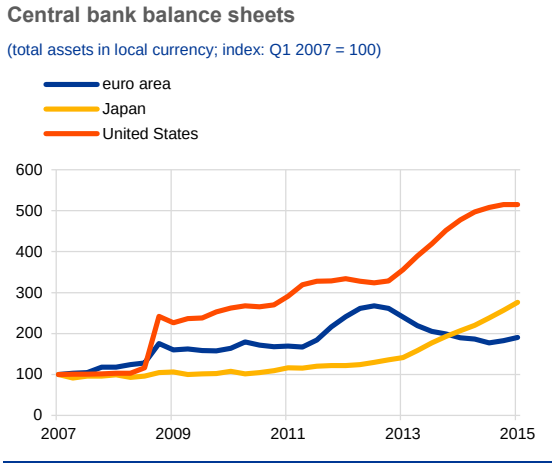
Box 1

Accommodative monetary policy and euro area financial stability

Chart A

Abundant central bank liquidity provision



Sources: Haver Analytics, ECB and ECB calculations.

Amid concerns that inflation would remain too low for a prolonged period, implying risks to medium-term price stability, the ECB's Governing Council has implemented a number of monetary policy measures since June 2014 to provide further monetary policy accommodation to the euro area economy.[1] Most recently, in March 2015 the expanded asset purchase programme (APP) was launched encompassing a set of euro-denominated investment-grade public sector securities. In addition, the expanded APP integrates the existing purchase programmes for asset-backed securities (ABSPP) and covered bonds (CBPP3) that were launched in autumn 2014. Under this expanded programme, which is intended to be carried out at least until the end of September 2016, the combined monthly purchases will amount to €60 billion per month or €1,140 billion in total. As there had been market expectations for some time of a purchase programme and because its size exceeded expectations, it has already produced a substantial easing of broad financial conditions, which is expected to support price stability and foster financial stability in the euro area. At the same time, unintended side effects on financial stability cannot be ruled out as very accommodative monetary conditions stimulate not only economic risk-taking – as intended – but may also lead to excessive financial risk-taking. It should be borne in mind that the prices of financial assets traded across borders are affected not only by the ECB's monetary policy stance, but also by global monetary conditions, which have remained very accommodative for some years now, as reflected e.g. in central bank

[1] For details, see the Overview section of *Economic Bulletin*, Issue 2/2015, ECB.

balance sheet sizes (see Chart A) and general reductions in market interest rates. In this environment, financial stability has to be monitored closely to inform the potential activation of macroprudential policy instruments best suited to addressing in a targeted manner associated risks specific to particular countries, sectors or institutions.

From the viewpoint of the main prevailing risks for financial stability, a lack of ECB monetary policy action would have been detrimental not only to the maintenance of price stability, but also to the safeguarding of financial stability in the euro area. Not taking additional action could have triggered a further reduction of inflation expectations with a direct impact on real interest rates, thus leading to an unwarranted tightening of financial conditions and ultimately lower nominal growth. In this sense, the ECB's expanded APP should be beneficial for financial stability in the euro area. First, in pursuit of price stability, the further easing of the monetary policy stance strengthens aggregate demand via improved confidence and lower real interest rates, increasing capacity utilisation and supporting money and credit growth. Second, it also helps to alleviate the real debt burdens of households, firms and governments, which otherwise could have been subject to adverse debt dynamics with ramifications for financial stability.[2] In addition, rising asset prices improve the net worth of firms and households, enhancing borrowers' creditworthiness and thereby providing scope for banks to further ease their credit standards without endangering financial stability. Lastly, the ECB's monetary policy measures provide additional funding cost relief for banks via targeted longer-term refinancing operations (TLTROs) and a reduction in long-term government bond yields, which are the basis for the pricing of a large variety of assets and loan contracts. This will support banks' essential financial intermediation function for the real economy.

Notwithstanding these financial stability benefits, an accommodative monetary policy stance geared towards maintaining price stability can, in principle, lead to potential risks to financial stability that supervision and macroprudential policy have to address.[3] For example, the direct reduction in interest rates of asset classes purchased by the Eurosystem and other asset classes indirectly affected via portfolio rebalancing activities boosts asset and collateral values, by increasing the net present value of future cash flows, as well as income and profits. This fact provides the potential for increased risk tolerance or reduced levels of risk perception and would be reflected in lower risk premia and lower volatility. Greater appetite for risk in the presence of abundantly available liquidity may have the potential to push certain asset prices to values that are not justified by their fundamental values, a development that could be amplified by herding behaviour of investors in an environment of over-optimistic beliefs. Notably, in the residential property sector, which has been at the heart of many previous episodes of financial distress, such developments would be accompanied by strong credit growth. Therefore, there is a need to monitor risk-taking behaviour and specifically asset price growth that is accompanied by increased leverage as such developments could amplify the risk of an abrupt asset price correction. If such developments were to be widespread, they would lead to instability in the financial system, thereby hampering monetary policy transmission and ultimately price stability.

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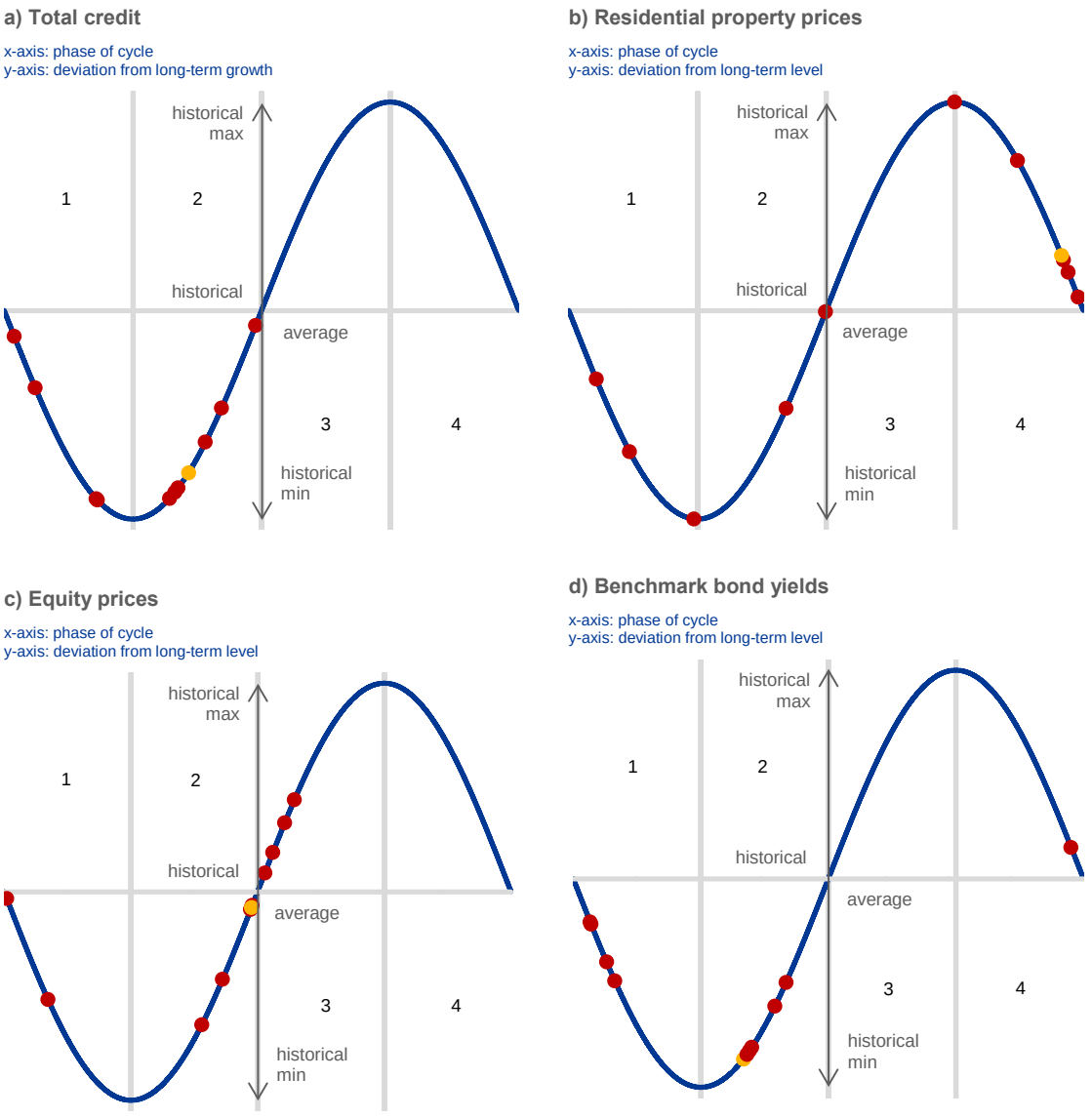
2 See the box entitled "Financial stability challenges posed by very low rates of consumer price inflation", *Financial Stability Review*, ECB, May 2014.

3 For theoretical arguments, see Borio, C. and Zhu, H., "Capital regulation, risk-taking and monetary policy: A missing link in the transmission mechanism?", *Journal of Financial Stability*, Vol. 8, 2012, pp. 236-251. Empirical evidence is provided in e.g. Altunbas, Y., Gambacorta, L. and Marqués-Ibáñez, D., "Do bank characteristics influence the effect of monetary policy on bank risk?", *Working Paper Series*, No 1427, ECB, 2012 and references therein.

Chart B

Stylised financial cycle estimates suggest limited broad-based excesses in euro area credit or asset prices



Sources: ECB and ECB calculations.
Notes: Based on the computations in Schüler, Y., Hiebert, P. and Peltonen, T., "Characterising financial cycles across Europe: One size does not fit all", *Working Paper Series*, ECB (forthcoming). The charts show the cyclical position of ten euro area countries (AT, BE, DE, ES, FI, FR, IE, IT, NL and PT), denoted by red dots, and the euro area aggregate (yellow dot) for credit and property prices for Q3 2014 (Q4 2014 for total credit in the euro area and for house prices in FI, IE and NL) and for equity prices and benchmark bond yields for Q4 2014 (Q3 2014 for benchmark bond yields in PT). Historical minima, maxima and averages are country-specific. The cycle is shown in a stylised fashion divided into its four phases: 1. growth/level below trend and deviating further from trend; 2. growth/level below trend and increasing towards the trend; 3. growth/level above trend and deviating further from trend; and 4. growth/level above trend and declining towards the trend. The cycles are based on the following measurements: panel a): quarterly percentage change in real total credit to the non-financial private sector; panel b): quarterly percentage change in real residential property prices; panel c): index of real equity prices; and panel d): real ten-year government bond yields. Real concepts are deflated by annual HICP inflation.

To date, broad-based risks stemming from excessive risk-taking or asset price developments are contained in the euro area. Estimates of financial cycle sub-components generally provide additional evidence for that assessment (see Chart B), though financial asset prices in some countries appear to have been drifting away from historical norms at the end of 2014. Most notably, the credit cycle component (see Chart B, panel a) estimated for the euro area and euro area countries does not support the view of a credit-driven asset price boom. All countries experience cyclical real credit growth rates below their long-term average, but in a number of euro area

countries credit growth has started to recover even if remaining below its long-term value. These developments are also confirmed by the growth rates for loans to the non-financial private sector, notably mortgage lending, and are reflected in the cyclical component of real residential property prices (see Chart B, panel b). With regard to financial asset prices, equity prices are in an upswing phase of the cycle (see Chart B, panel c), but are still close to associated long-run values, while long-term real interest rates have come down further and appear to be below long-run values in almost all euro area countries (see Chart B, panel d).

With financial cycles and business cycles not always synchronised across countries in the euro area, the price stability-oriented monetary policy stance influencing all sectors of the euro area economy needs to be complemented by policy measures that can be used in a targeted manner to address country, sector or institution-specific systemic risks. Macroprudential policy, comprising a set of granular measures in this vein, provides the most appropriate instruments for staving off risks to financial stability and containing systemic risks to support monetary policy that is clearly focused on fulfilling its price stability mandate. This requires close monitoring not only of asset markets, but also of regulated financial institutions (i.e. banks, insurance corporations and pension funds) and the less regulated non-bank financial sector, as well as broader financial developments in the non-financial private sector. Indeed, since the beginning of 2014 a number of macroprudential policy instruments have been implemented in euro area countries, including the activation of capital instruments available under the Capital Requirements Directive IV and the Capital Requirements Regulation, as well as other instruments available under national legislation, such as loan-to-value limits. Notably, a number of these measures address the property sector – for example, in terms of adjustments to the risk weights applicable to property lending, as well as loan-to-value and loan-to-income limits.

All in all, while the recent further substantial easing of the monetary policy stance may contribute to financial stability in the euro area by increasing nominal growth, any potential for unintended adverse ramifications requires close monitoring. However, to date, such unintended consequences appear to be contained for the euro area as a whole. Any possible emergence of major side-effects in specific sectors and countries would call for the activation of macroprudential policy instruments, as monetary policy retains a necessary focus on maintaining price stability.