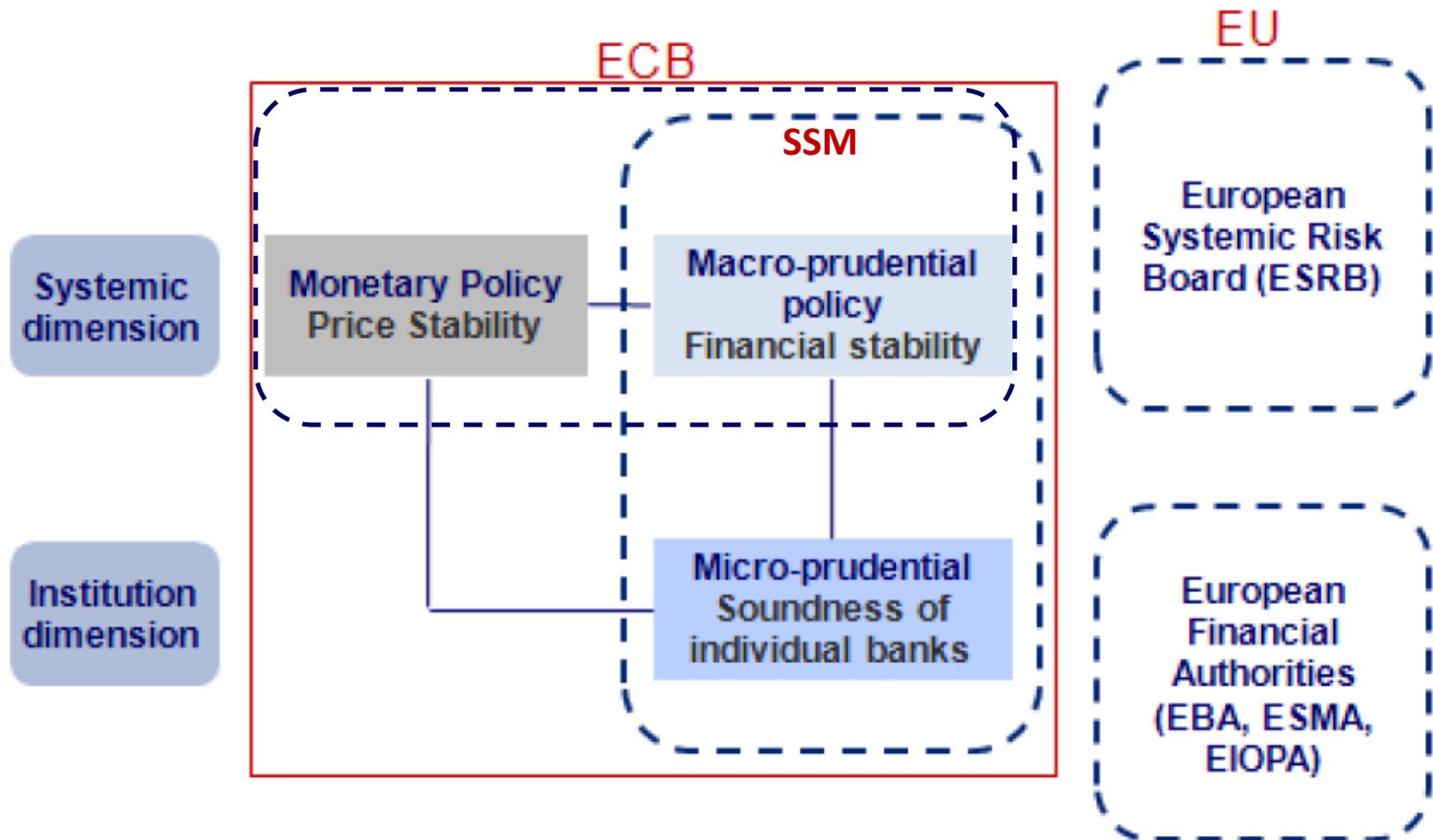**Frank Smets**
European Central Bank

Financial stability and monetary policy: How closely interlinked?

Policy panel: Looking beyond narrow mandates for price stability in central banks
Annual Research Conference of the National Bank of Ukraine
18-19 May 2017

Financial stability and monetary policy: Institutional set-up in the euro area

Three views on fin stability and mon policy

Source: Smets (2014)

	Modified Jackson Hole consensus
Monet. Policy	Framework largely unchanged Limited effects on credit and risk taking Blunt instrument to deal with imbalances
Macro Pru	Granular and effective
Inter-action	Limited interaction and easy separation of objectives, instruments, …
Issues	Coordination? Lender of last resort?
Models	Svensson; Collard, Dellas, Diba and Loisel (2012)

Three views on fin stability and mon policy

Source: Smets (2014)

	Modified Jackson Hole consensus	Leaning against the wind vindicated
Monet. Policy	Framework largely unchanged Limited effects on credit and risk taking Blunt instrument to deal with imbalances	Financial stability as secondary objective; lengthening of horizon Affects risk-taking "Gets in all of the cracks"
Macro Pru	Granular and effective	Cannot fully address financial cycle; arbitrage
Inter-action	Limited interaction and easy separation of objectives, instruments, …	Financial fragility affects monetary transmission and price stability
Issues	Coordination? Lender of last resort?	Coordination? Overburden mon. policy?
Models	Svensson; Collard, Dellas, Diba and Loisel (2012)	Borio; Woodford (2012)

Three views on fin stability and mon policy

	Modified Jackson Hole consensus	Leaning against the wind vindicated	Financial stability is price stability
Monet. Policy	Framework largely unchanged Limited effects on credit and risk taking Blunt instrument to deal with imbalances	Financial stability as secondary objective; lengthening of horizon Affects risk-taking "Gets in all of the cracks"	Twin objectives on equal footing Unblocks balance sheet impairments; avoids financial imbalances in upturns
Macro Pru	Granular and effective	Cannot fully address financial cycle; arbitrage	Indistinguishable from monetary policy
Inter-action	Limited interaction and easy separation of objectives, instruments, …	Financial fragility affects monetary transmission and price stability	Financial stability and price stability are intimately interlinked
Issues	Coordination? Lender of last resort?	Coordination? Overburden mon. policy?	Time inconsistency problems?
Models	Svensson; Collard, Dellas, Diba and Loisel (2012)	Borio; Woodford (2012)	Brunnermeier and Sannikov (2012)

Three questions

- How effective is the new macroprudential framework in maintaining financial stability?

- What is the impact of monetary policy on financial stability (e.g. through the risk-taking channel)?

- What is the risk of financial dominance, i.e. the risk that financial stability considerations undermine the credibility of the central bank's price stability mandate?

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Preliminary conclusions

- Some of the lessons from the financial crisis are clear:
  - Both macro and microprudential policies need to be strengthened in order to increase the resilience of the financial sector and reduce its procyclicality.
  - Macroprudential policy should be the first line of defence in taming the financial cycle.

- Less clear whether the monetary policy framework should be amended to include financial stability.
  - If prudential policies are effective, not an issue.

Preliminary conclusions

- But prudence probably argues for a middle ground:
    - Lexicographic ordering:
        - Price stability primary objective;
        - Financial stability secondary objective.

- Recognizes that:
    - The new macroprudential policy framework is still very much under construction and its effectiveness largely unproven.
    - Just cleaning up is no longer an option: The costs of systemic financial crises are too large

Preliminary conclusions

- – Monetary policy rates intimately interact with important drivers of financial imbalances such as credit, liquidity and risk taking.
- – Non-standard monetary policy instruments are difficult to distinguish from macroprudential tools

- But alleviates important risks:
  - – In particular, maintaining price stability as the primary, overriding objective reduces the risk of financial dominance.

Household loan dynamics and house prices

Real household loans around starting period of house price booms
*(indices, normalised to 100 at T=trough; T=2013Q4)*

Real house prices around starting period of house price booms
(indices, normalised to 100 at T=trough; T=2013Q4)
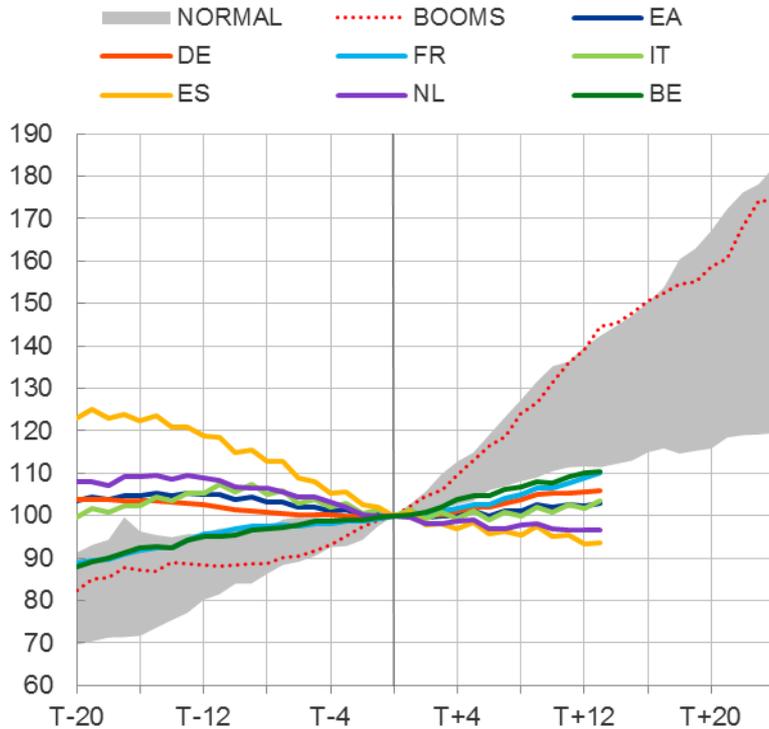
Sources: BIS, ECB and ECB calculations.
Notes: Based on data from 1975Q1 to 2017Q1 for euro area countries. All indicators are deflated by HICP. Trough (starting point of house price normal increases or booms) identified via quarterly version of Bry-Boschan algorithm by Harding and Pagan, 2002. Dotted line refers to median during house price booms. Grey range refers to interquartile range during normal house price increases.
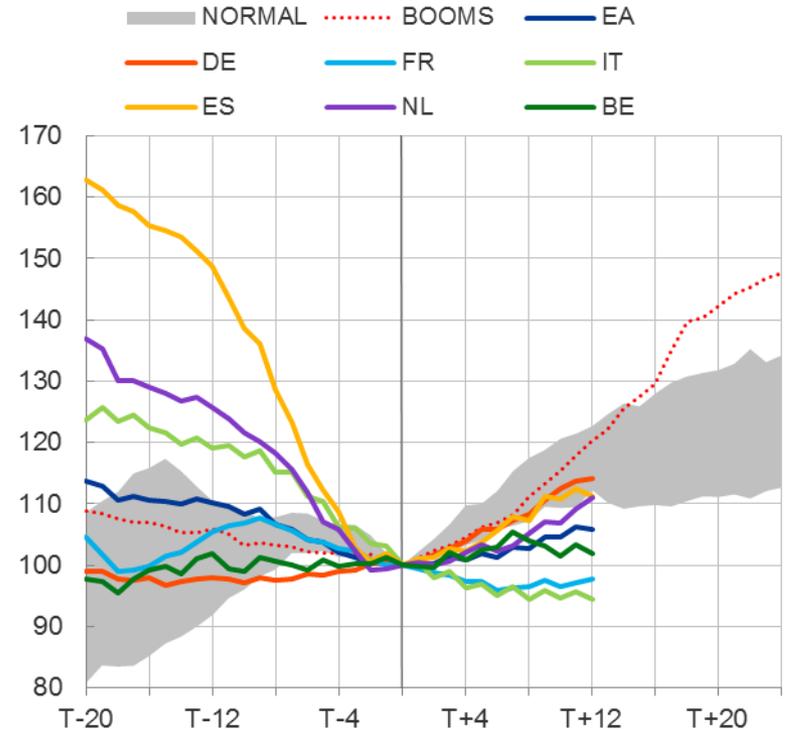
Sources: BIS, ECB , Fed Dallas, OECD and ECB calculations.
Notes: Based on data from 1975Q1 to 2016Q4 for euro area countries. All indicators are deflated by HICP. Trough (starting point of house price normal increases or booms) identified via quarterly version of Bry-Boschan algorithm by Harding and Pagan, 2002. Dotted line refers to median during house price booms. Grey range refers to interquartile range during normal house price increases.

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Macroprudential policy in the EU
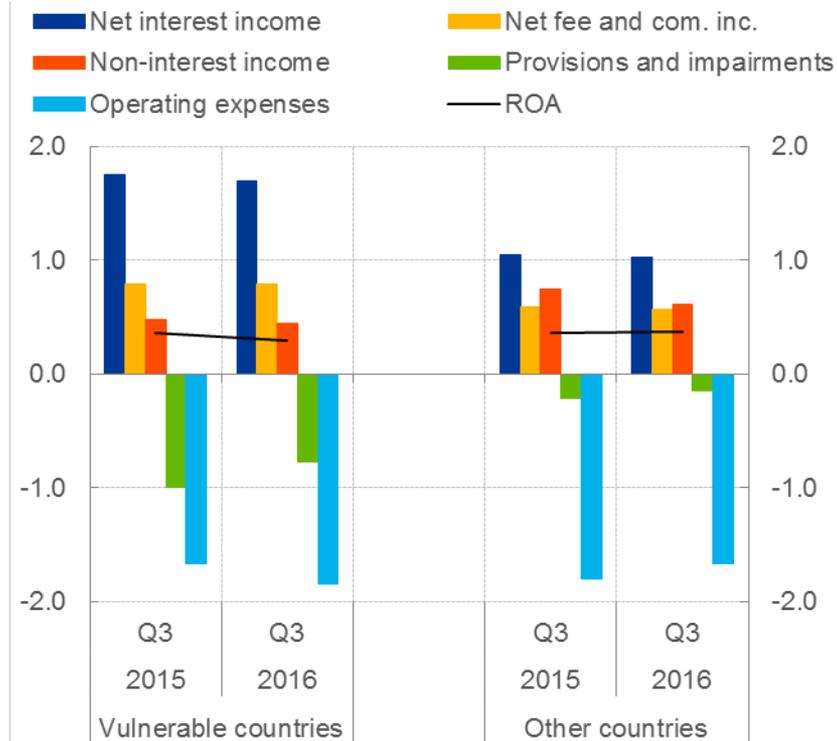
Measures in place related to the residential real estate sector

Under CRD/CRR	
Risk weights	BE, IE[15], LU[13], MT[9], SE, UK, (NO)
LGD floors (indirectly risk weights)	(NO)
Outside CRD/CRR	
Loan-to-value	CZ[19], DK[7], EE[21], IE, CY[8], LV[23], LT[4], LU[13], HU[1], MT[9], NL, PL, RO[5], SK, FI[20], SE[3], (NO)
Loan-to-income / Debt-to-income	DK[24], IE, UK
Debt-service-to-income[1]/Payment-to-income[1]	EE[21], CY[11], LT[4], HU, PL[14], SK[21]
Stress test / sensitivity test	DK[24], IE[16], CY[11], LT[18], LU[6], SK, UK, PL[10], (NO)
Loan maturity	CZ[19], EE[21], LT[4], NL, PL[22], SK[1]
Loan amortisation[2]	DK[17], NL, SK[1], SE[12], CZ[19], (NO)

Source: ESRB

Bank profitability and low interest rates
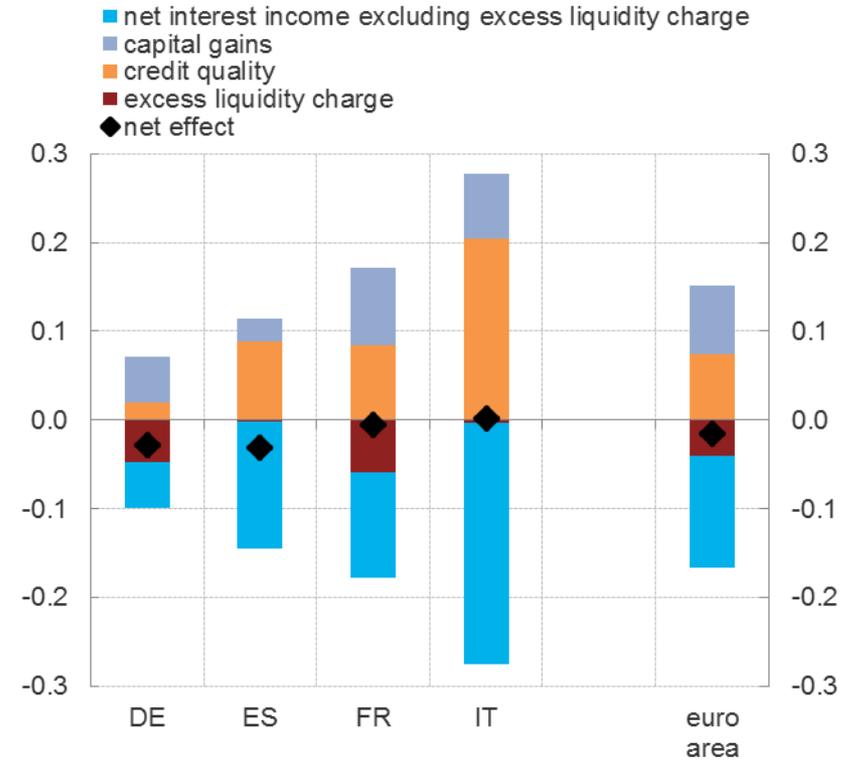
Bank profitability and contributing factors
(percentages of total assets)

Bank profitability and APP/Negative DFR: 2014-2017

Legend (left chart):
- Net interest income
- Non-interest income
- Operating expenses
- Net fee and com. inc.
- Provisions and impairments
- ROA

Legend (right chart):
- net interest income excluding excess liquidity charge
- capital gains
- credit quality
- excess liquidity charge
- net effect

Source: ECB and ECB calculations.
Notes: Based the Consolidated Banking Data (CBD) database, it includes Domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches whose reporting scheme is FINREP (IFRS and GAAP).

Source: EBA, ECB and ECB estimates.
Notes: Deviation from no policy action scenario. Capital gains based on data on a consolidated basis for 68 euro area banking groups under direct ECB supervision and included in the 2014 EU-wide stress test. Euro area figures calculated as the weighted average for the countries included in the sample using Consolidated Banking Data (CBD) information on the weight of each country's banking system on the euro area aggregate. Effect on net interest income based on aggregate BSI data and obtained by simulation of the interest income and interest expenses based on estimates of the effect of APP on bond yields, lending and deposit rates, excess liquidity and economic growth taking into account BMPE projections for interest rates and credit aggregates. Effect on credit quality based on the median of estimates obtained from a suite of empirical studies.

**Euro area and US valuation metrics
in a historical context**
(Distributions since 1985)
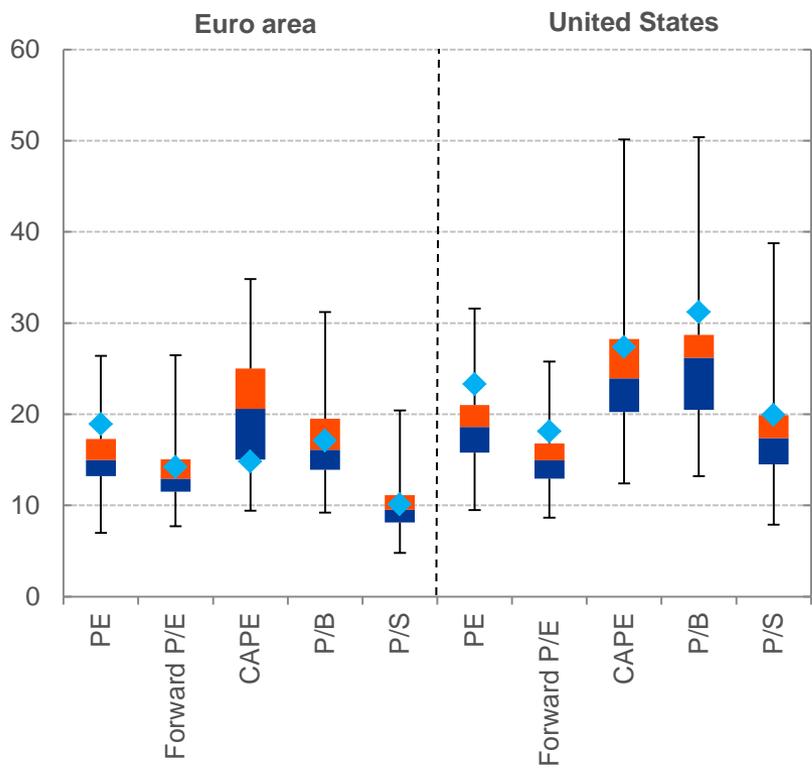
Sources: Thomson Reuters Datastream, Bloomberg and ECB calculations. Valuation metrics are recorded monthly since 1985, except for the forward looking P/E ratio for the EA, which is available since 1989. The price to book and price to sales ratios have been multiplied by a factor of 10. The horizontal line between the blue and red area represents the median of the distribution, the upper and lower borders the 75th and 25th percentiles, and the whiskers the min and max of the distribution. Blue diamonds show the current level.
Last observation: May 2017

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Thank you