Debt and financial stability: the role of macro-prudential policy

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BANCO DE PORTUGAL
EUROSISTEMA

Growth and Reform in Europe in the Wake of Economic Crisis
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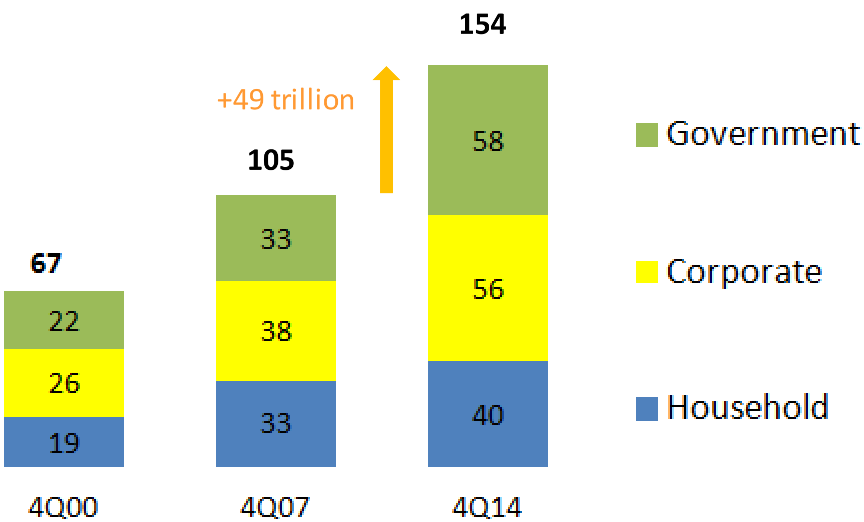
Debt and financial stability: the role of macro-prudential policy

1. High debt and (not much) deleveraging
2. Some facts on high indebtedness
3. The role of macro-prudential policy
4. Conclusions

1. High debt and (not much) deleveraging

Debt still growing…

Global stock of debt outstanding increased by $50 trillion since 2007



Compound annual growth rate (%)

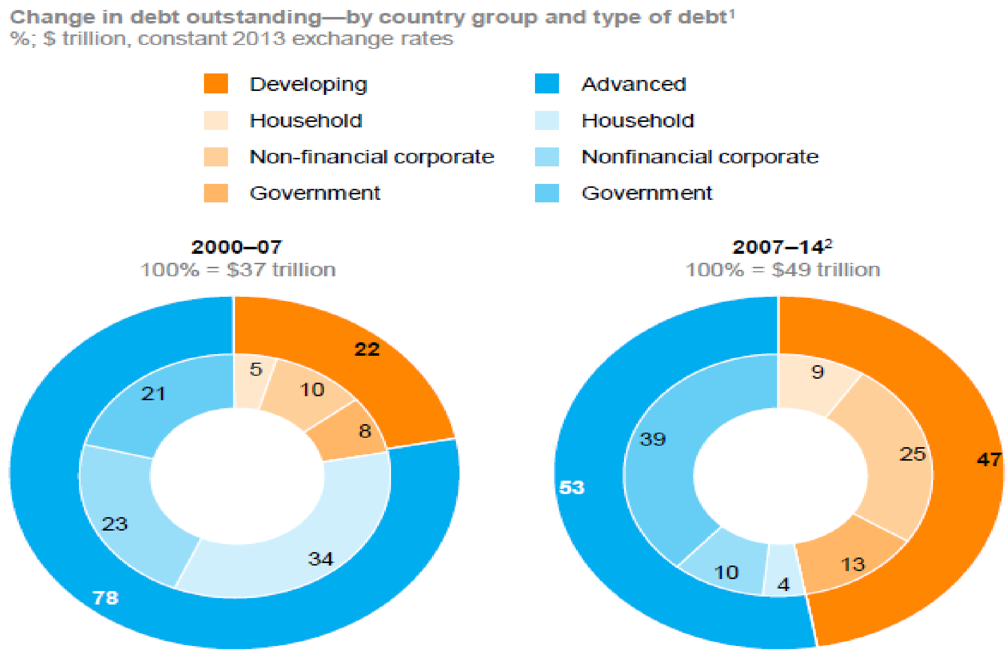
	2000-07	2007-14
Government	5.8	9.3
Corporate	5.7	5.9
Household	8.5	2.8

Source: McKinsey: Debt and (not much) deleveraging; 2Q14 data for advanced economies and China, 4Q13 for developing economies.

1. High debt and (not much) deleveraging

Debt still growing…

2000-2007: Debt increased mostly in advanced economies
2007-2014: Debt increased in developing economies and in the public sector of advanced economies

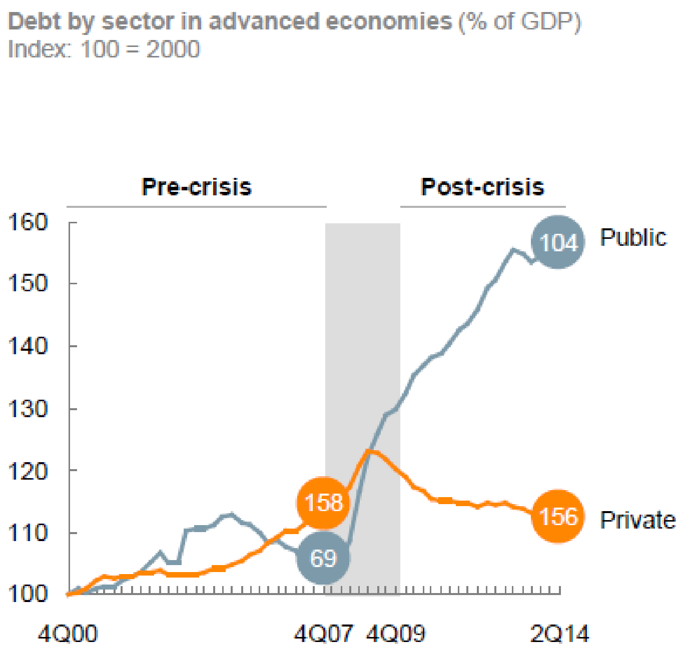


Source: McKinsey: Debt and (not much) deleveraging.

(Not much) deleveraging …

Advanced economies:

- Some progress (for some countries) in reducing private debt (mostly households)
- Public debt continues to grow



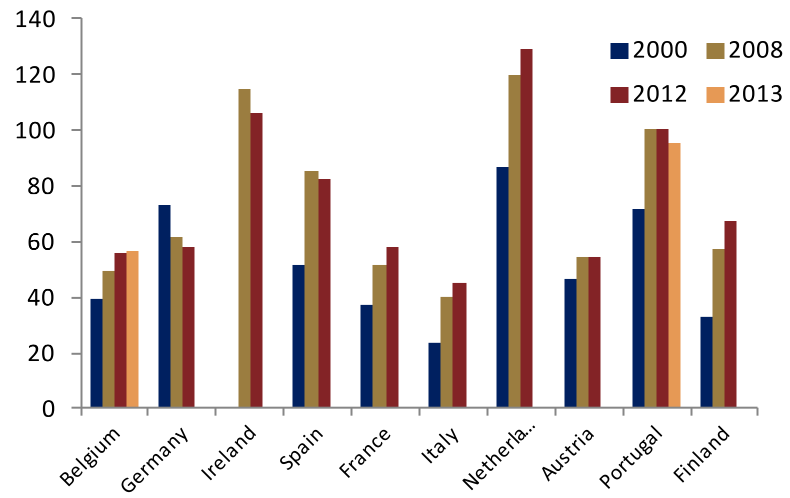
Change in debt-to-GDP ratio
Percentage points

	2000-07	2007-14
Public	3	35
Private	19	-2

Sources : McKinsey: debt and (not much) deleveraging; Eurostat

1. High debt and (not much) deleveraging

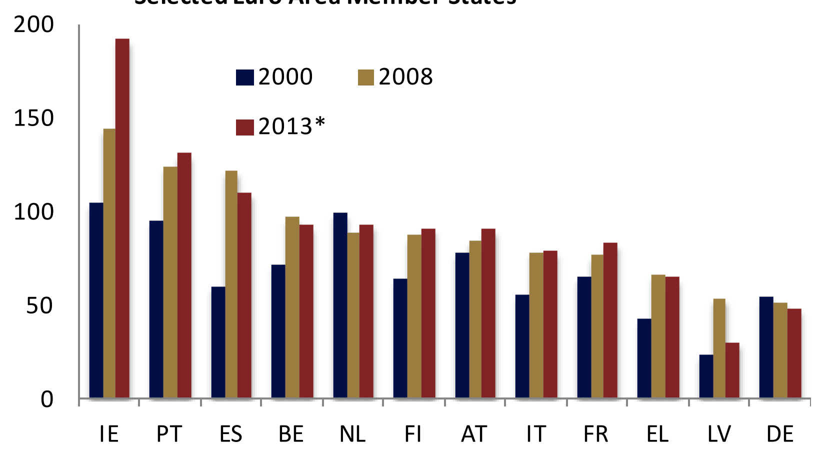
Household Debt (% GDP)
Selected Euro Area Member States



Diversity of situations across the Euro Area...

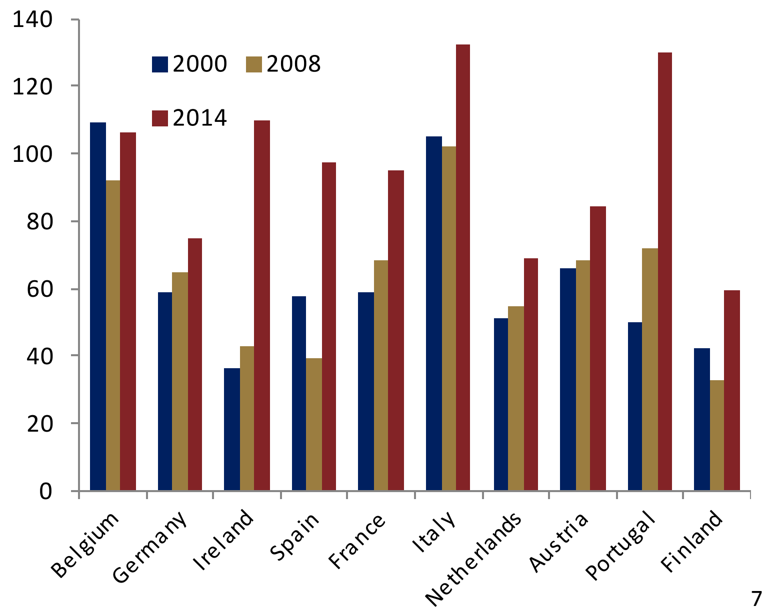
- Household debt increased slightly and it is above 80 per cent for 1/3 of the countries
- Corporate debt also increased slightly and it is above 80 per cent for 1/2 of the countries
- Public debt increased sizably and it is 92 per cent of GDP for the Euro Area

Non-Financial Corporations Debt (% GDP)
Selected Euro Area Member States



Source: Eurostat

Gross Public Debt (% GDP)
Selected Euro Area Member States



2. Some facts on high indebtedness

Conflicting effects of credit…

Many credit booms have been followed by either economic underperformance or by financial crises

Table 3. Credit Booms Gone Wrong

Followed by financial crisis?	Followed by economic underperformance? No: Number	No: Percent of total cases	Yes: Number	Yes: Percent of total cases	Total: Number	Total: Percent of total cases
No	54	31%	64	37%	118	67%
Yes	16	9%	41	23%	57	33%
Total	70	40%	105	60%	175	

Notes: Number and proportion of credit boom episodes are shown. A boom is followed by a financial crisis if a banking crisis happened within the three-year period after the end of the boom and is followed by economic underperformance if real GDP growth was below its trend, calculated by applying a moving-average filter, within the six-year period after the end of the boom.

Source: Dell'Ariccia et. al (2012), IMF

High debt is a drag on growth…

Cecchetti, et al. 2011 (BIS) estimate thresholds after which household, non financial corporation and public debt become a drag on growth.

Current debt levels clearly above those thresholds in many countries

Cecchetti's estimates are merely indicative, as other factors are important to determine the level after which debt becomes a drag on growth:

- ✓ Degree of financial deepening
- ✓ Net financial position of households and NFC
- ✓ Other structural characteristics

'Fiscal space' matters…

- In advanced economies financial stability risks have come mostly from private sector credit booms and not from the expansion of public debt

However:

- High levels of public debt have tended to exacerbate the effects of private sector deleveraging after crises, leading to more prolonged periods of economic underperformance (Jordá & Schularick, 2013)

Why:

- If there is no 'fiscal space' there is less capacity to provide counter-cyclical stimulus to the economy
- Feedback loop between sovereign risk and banks

3. The role of macro-prudential policy

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Goal: aimed at smoothing financial cycles and at increasing the resilience of financial market participants

Smoothing the financial cycle:

- Reduce credit growth in the upswing
- Allow financing the economy in the downturn in order to facilitate the recovery, but in a way that is compatible with the deleveraging of highly indebted economic agents

Macro-prudential instruments

Instruments activated as a function of the cycle or structural characteristics as a whole - and not according to the specific risk profile of a given institution - aiming at reinforcing the resilience of the financial sector.

How is macro-prudential policy conducted?

First Pillar: Surveillance of the possible risks that could threaten financial stability. Past experience clearly indicates that increasing valuation pressures, rising leverage, and widening maturity mismatches provide important warning signals.

Surveillance identifies emerging risks; it is then required to take preventive actions to build resilience of banks and markets.

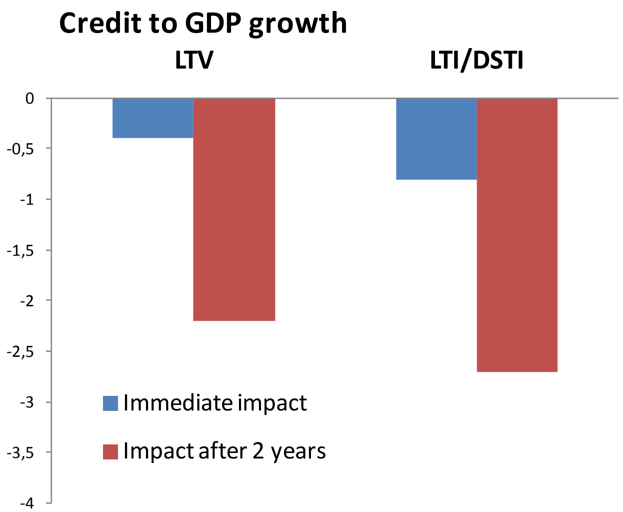
Second Pillar: Policy tools

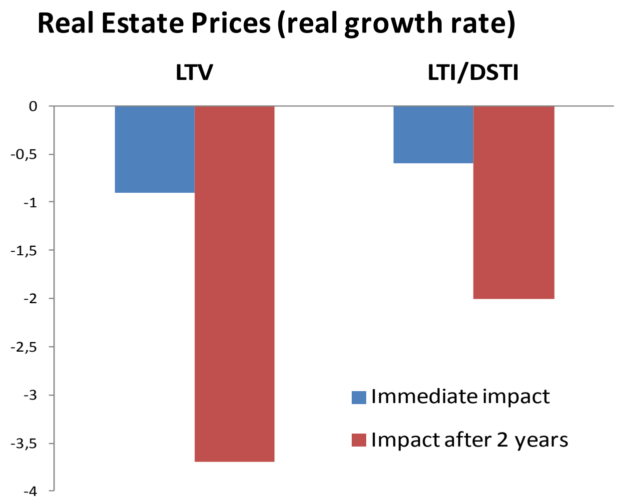
- Time-varying broad macro-prudential tools
- Time-varying sector specific tools
- Stress tests

To mitigate the risk of excessive credit during the upswing…

- Capital buffers
- Restriction on lending: limits on LTV, LTI/DSTI

Some evidence: LTV and LTI/DSTI are (somewhat) effective in reducing credit growth and house price growth during the upswing





Source: Crowe, Dell' Ariccia; Igan, Rabanal (2011) IMF

Macro-prudential policy is much more difficult to conduct when indebtedness levels are very high and growth is low…

- Countercyclical macro-prudential policy is severely constrained given that **capital buffers were not built during good times**
- Very **high indebtedness levels in the private sector**, in a situation in which **nominal disposable income and GDP grow at very low growth rates and inflation is very low**
- **Public indebtedness** is extremely **high** in many countries and in many cases **exposure to the domestic sovereign by the banking sector increased**
- **Profitability of the banking sector is clearly under strong pressure** and the business model of most of the banks will have to be adapted to the new circumstances

in addition

- It is not clear **how private savings will behave in a situation characterized by very low nominal and real interest rates**
- A context of very low interest rates and **large-scale liquidity injections may feed asset price bubbles** and magnify the potential for systemic risk

What is then the adequate reaction in the current situation?

- **More loss-capital absorption** capacity
- **Broader approach** to the definition of **adequate capital levels**
- **Close monitoring of different segments of economic agents** (banks, households or firms), as distributional aspects matter a lot
- **Specific action to deal with over-indebtedness**

Complemented by:

- **Greater attention to the role of the shadow banking** and the exposure of the banking-sector to the shadow-banking sector
- Greater **attention to the misconduct risk**

As well as:

- **Breaking the vicious 'public debt-banking sector' cycle**
- Maintaining or to **increase the fiscal space**
- Developing **appropriate resolution tools**

4. Conclusions

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- The current crisis has been mainly driven by debt
- High debt is a drag on growth
- Fiscal space is limited
- Macro-prudential policy faces new challenges
- Focus on increasing the resilience of the financial system
- Promoting deleveraging without endangering the economic recovery
- Coordination is needed between different authorities

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