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Opening Remarks

Ladies and Gentlemen,
I welcome you all to the first session on *Restarting Growth: Perspectives for the Euro Area*. Let me, as a financial supervisor, take the opportunity to raise some issues which are of importance in this context for financial stability reasons.

A long-term perspective on economic growth has to consider that too much debt can be a drag on economic growth. Already in the early 2000s, some economists stressed that financial deepening is only positive for economic growth up to a certain threshold – dependent on the time-horizon, the countries' institutional and economic development (e. g. Loayza and Rancière, 2006; Wachtel, 2003). This raises the question of "how much debt is right". For example, the IMF analysed a global sample of countries from 1970 to 2010 with a wide range of estimation techniques and came up with an easy rule of thumb: a threshold of about 80% of credit to the private sector as a share of GDP creates a maximum value-added for GDP growth (Arcand et al., 2012). Another example is Cechetti and Kharroubi (2015). They show for a panel of 15 OECD countries that an exogenous increase in finance reduces total factor productivity growth as financial sector growth disproportionately benefits high collateral/low productivity projects.

At the beginning of the crisis in autumn 2008, bank loans to the private sector stood at about 115% of GDP in the euro area (total banking assets were at about 343% of GDP in 2008/10). They were thus well above the mentioned threshold calibrated by the IMF – although these figures only include bank lending and not even securities outstanding. No wonder that a deleveraging process within the banking and private sector was observed during the last years and the issues of indebtedness of sovereigns, the financial sector and the private sector were pushed in the global spotlight. It has raised a major concern with many stakeholders: less financing – no growth.

But, one can also perceive these developments from a different angle. Deleveraging, defined as a reduction in leverage (capital/total assets), also means that banks and corporates have boosted their capital ratios. But more needs to be done, because the market and creditors ask for it (as highly levered institutions are granted no credit – or only at very high cost) and regulatory requirements are tightened for banks.

Often it is claimed that this process of deleveraging in the financial sector causes a reduction in the supply of credit to the real economy. However, this is contradicted by empirical evidence in Europe, where banks increased their capital significantly since

the peak of the financial crisis (plus 40% from October 2008 to end of 2014). Loans, instead, were not reduced nearly in that dimension. In the euro area, loans to the real economy (households and nonfinancial corporations) were only reduced by 2% from October 2008 to end of 2014. But most of this reduction is due to write-offs, reclassifications and exchange rate adjustments. The balance sheet reduction was instead mainly caused by a reduction in interbank loans (–22%) and external assets (–19%). In some countries even an increase in credit to the private sector is observed (e. g. in Austria).

Besides this often raised importance of the "quantity of credit", the "quality of credit" is crucial for individual institutions – from a microeconomic perspective – and also for the stability of the financial system as a whole – from a macroprudential perspective. Hence, credit growth at interest rates that do not cover the costs of capital and liquidity is neither desirable from a macroprudential nor an economic perspective. Adequate risk pricing in credit business is necessary to avoid unsustainable levels of indebtedness as mispricing of credit risk has long-term negative consequences in terms of high crisis cost. Underpricing of credit risk in the run-up to the recent economic and financial crisis contributed to global over-indebtedness and weighs on credit cost in the post-crisis period, which is referred to as the so-called "back-book effect".

In particular, in the current environment of ultra-low interest rates, the issue of adequate pricing is critical. Ultra-low interest rates are a double-edged sword: Monetary policy aims at fostering economic growth, while financial stability is set at risk. One major risk is embedded in rising "search for yield" as it manifests an increase in risk tolerance in a variety of different products across sectors. A global survey of supervisors, firms in the banking securities and insurance sectors found that this is the case e.g. for auto loans, increasingly risky assets in the investment portfolio for life insurers and the syndicated leveraged loan market (Joint Forum, 2015). In such an environment, capital adequacy is important to further strengthen the resilience of the banking sector against systemic risks. As the crisis has shown, higher capital buffers simply pay off in uncertain times.

Overall, debt is indispensable, but long-term economic prosperity will largely depend on "credit quality" rather than its mere quantity.

References

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