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Europe Needs to Talk About Resilience

By Michael Heise

Ten years have passed since the U.S. subprime crisis spilled over into Europe and beyond. Questions of financial resilience have been hotly debated on the Continent ever since.

For many, the global financial crisis shattered the belief that highly developed financial markets tend to be robust and good for economic growth. Their purported benefits, such as efficient capital allocation and the monitoring and transfer of risk, were nowhere to be seen. Rather, it was the "efficiency" of financial markets, in the shape of ever more complex instruments and cross-border schemes, that tipped the Western world into what has become known as the Great Recession.

Since then, regulators have worked studiously to prevent future liquidity crunches and asset meltdowns. They have ramped up capital and liquidity requirements, restricted certain business activities and revamped remuneration incentives to reduce reckless risk taking. Risk management, especially in systemically important institutions, is now under intense scrutiny by regulators and supervisors.

As a result, financial systems in the large Western economies are now better supervised and more robust. Given the massive scope of the reregulation, however, some inconsistencies have crept in.

One of the most damaging inconsistencies lies in preferential capital requirements for government bonds. Regulators still consider them to be risk-free. As eurozone banks still hold large amounts of their sovereigns' bonds, any doubt about the sustainability of a country's public finances could once again destabilize its banking sector.

Moreover, the zero-capital requirement for government bonds—allowing banks to accumulate government bonds without needing to match higher levels of capital to limit risks, and therefore incentivizing banks to do so—crowds out private bonds and thereby runs counter to central-bank efforts to channel more money into the private economy.

Finally, institutional investors such as insurers need to cover bank bonds with large amounts of capital not only because of default risks, but also because their prices vary substantially in the course of the credit cycle. This makes it difficult for banks to place bail-in capital outside the banking sector. This is inconsistent with the aim of making banks more resilient.

There are also broader questions to ask about financial resilience, and policy makers shouldn't be shy about raising them, even if this leads them straight to the current state of monetary policy—a taboo subject in many political circles. It shouldn't be: Low or negative central-bank rates still represent the biggest risk to long-term financial stability.

Regulators can no longer ignore the financial-stability dangers they created after the crisis.

The prolonged stimulus provided by the European Central Bank, the Bank of Japan and the Bank of England, among others, is supposed to push up asset prices, trigger more lending and eventually rekindle inflation. At the same time, regulators and supervisors have rightly forced banks to deleverage and derisk their portfolios. This process hasn't come to an end in all countries, but it has progressed significantly.

In the U.S., for example, lending to nonfinancial firms and households has been accelerating. In some areas, such as car and student loans, this is happening at a truly disturbing pace. The U.S. Federal Reserve is therefore right to exit its ultraexpansionary policies, and others should stand ready to follow suit in practice, implementing what to date has been only hinted at by the Bank of England and the European Central Bank.

Proponents of pure inflation targeting will, of course, reject the notion that central banks should be responsible for financial stability, arguing that monetary-policy instruments are too blunt to prevent mispricing and excessive leverage. This argument is inconsistent. It is exactly the impact on asset prices—which then increase household and corporate wealth—that monetary policy is aiming at. If monetary policy doesn't affect asset prices, it's hard to see where its impact on the general price level should come from.

Given surging asset prices, declining risk premiums and rising private debt, central banks should figure out how to give more weight to financial stability in their policy strategies. Their policies have successfully stabilized the economies after the financial crisis and insulated markets from various economic and political shocks in the past years. But the resilience of financial markets will be at risk if the balance sheets of banks and investors in the long run again become exposed to overpriced assets and a new surge of debt.

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