



"The financial repression: risks and perspectives?"

28 06 2017

Program

Presentations:

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Panel discussion / Q&A

A macroprudential perspective on the low interest rate environment

Presentation for the Belgian Finance Club

Financial repression: risks and perspectives
28 June 2017



Hans Dewachter
NBB, Prudential policy and financial stability

Disclaimer: the views expressed in this presentation do not necessarily reflect the views of the NBB nor those of the ESCB.



Overview

Macroprudential Report NBB identified a number of risk factors

- ❑ Low interest rate environment against the background of moderate growth and potential search for yield
- ❑ Build-up of risks in the real estate market
- ❑ Cyber risks
- ❑ Point of attention: shadow banking

This presentation focusses on

1. Low interest rate environment: structural versus cyclical views
2. Low interest rate environment: impact on the financial sector
3. Build-up of systemic risks in the real estate market



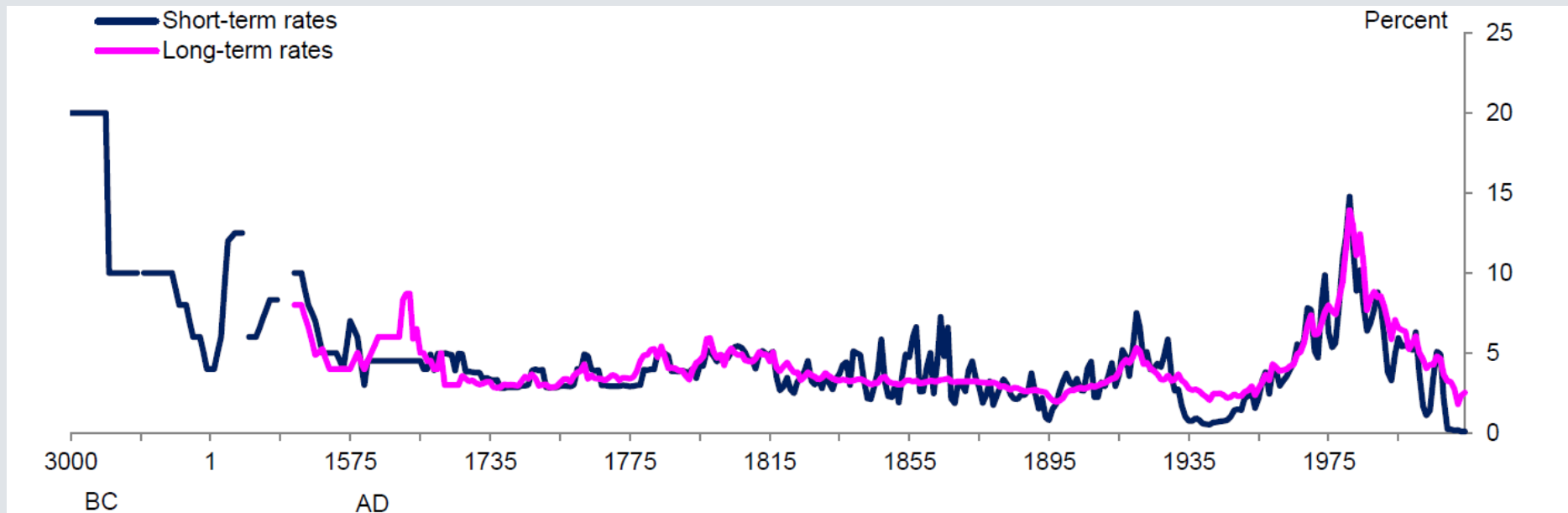
The low interest rate environment: structural versus cyclical views



The low interest rate environment: some perspective

Historical short and long-term interest rates

Interest rates are historically low, literally !



Sources: Homer and Sylla (1991); Heim and Mirowski (1987); Weiller and Mirowski (1990); Hills, Thomas and Dimsdale (2015); Bank of England; Historical Statistics of the United States Millennial Edition, Volume 3; Federal Reserve Economic Database. Notes: the intervals on the x-axis change through time up to 1715. From 1715 onwards the intervals are every twenty years. Prior to the C18th the rates reflect the country with the lowest rate reported for each type of credit: 3000BC to 6th century BC - Babylonian empire; 6th century BC to 2nd century BC - Greece; 2nd century BC to 5th century AD - Roman Empire; 6th century BC to 10th century AD - Byzantium (legal limit); 12th century AD to 13th century AD - Netherlands ;13th century AD to 16th century AD - Italian states. From the C18th the interest rates are of an annual frequency and reflect those of the most dominant money market: 1694 to 1918 this is assumed to be the UK; from 1919-2015 this is assumed to be the US. Rates used are as follows: Short rates: 1694-1717- Bank of England Discount rate;1717-1823 rate on 6 month East India bonds; 1824-1919 rate on 3 month prime or first class bills; 1919-1996 rate on 4-6 month prime US commercial paper ; 1997-2014 rate on 3month AA US commercial paper to non-financials. Long rates: 1702-1919 - rate on long-term government UK annuities and consols; 1919-1953, yield on long-term US government bond yields; 1954-2014 yield on 10 year US treasuries.

As reported by A. G. Haldane in a speech at the Open University Milton Keynes, 30 June 2015

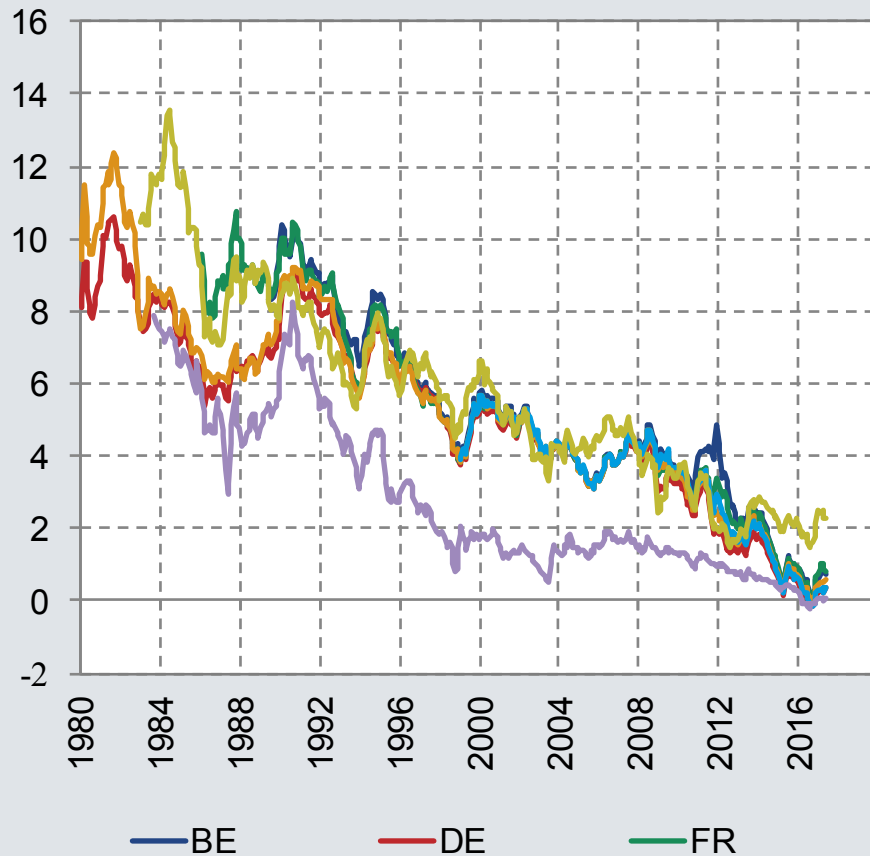


The low interest rate environment: some perspective

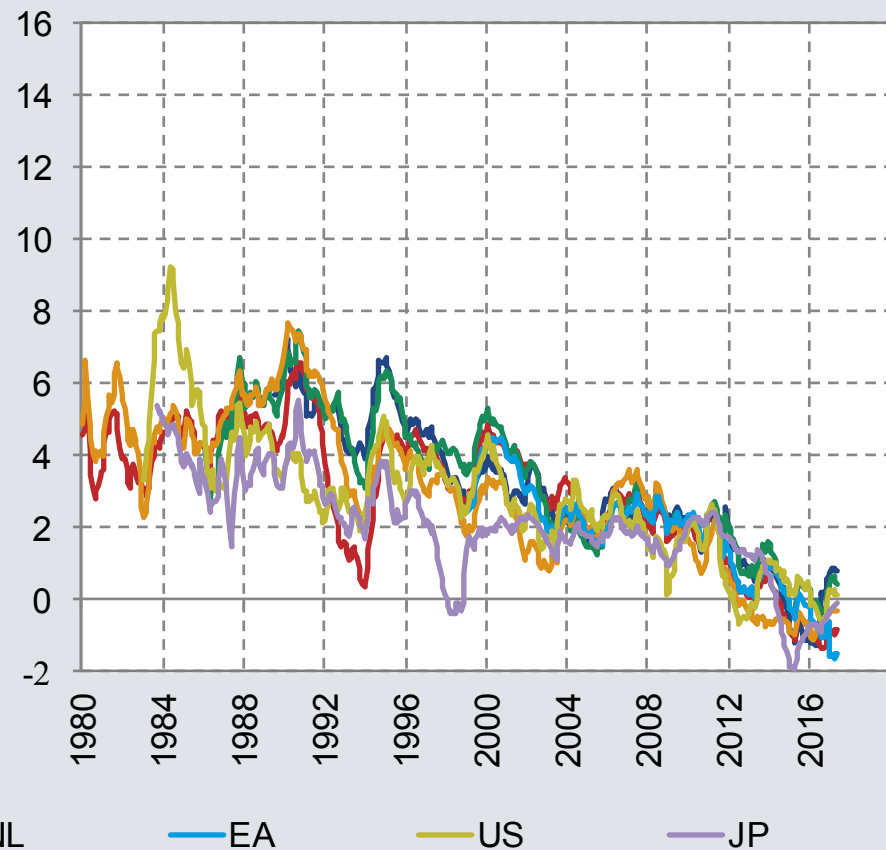
Trend-wise decrease of LT nominal and real yields

Low interest rate environment not fully attributed to financial crisis: last 40 years characterized by decreasing interest rates both in nominal and real terms

Sovereign nominal yields 10 yr. maturity
(percentages, monthly averages Jan 2017)



Sovereign real¹ yields 10 yr. maturity
(percentages, monthly averages Jan 2017)



Sources: OECD, Thomson Reuters Datastream.
¹ Difference between nominal yield and yearly smoothed inflation rate.



The low interest rate environment: some perspective

Structural view

Structural explanations for trendwise decrease in equilibrium real rates: increased savings supply combined with decreased investment demand and lower potential growth

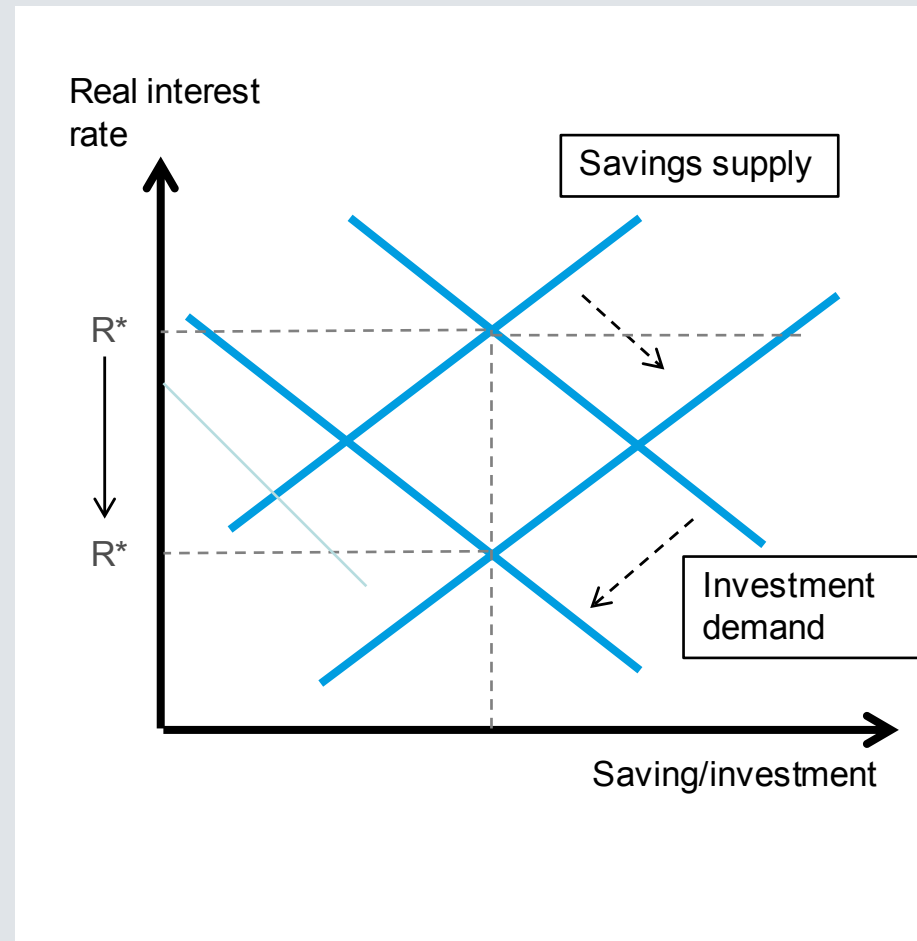
$$R^* = a \cdot g^* + S/I$$

Increased savings supply:

- ▶ Ageing population and increasing post-retirement life expectancy increase need for additional savings
- ▶ Increasing income and wealth inequality shifting resources towards richer households with higher savings ratios
- ▶ Uncertainty: increased precautionary savings

Decreased investment demand:

- ▶ Lower potential growth as a result of lower productivity gains and decreased population growth
- ▶ Decreased public investment
- ▶ Increased economic uncertainty



The low interest rate environment: some perspective

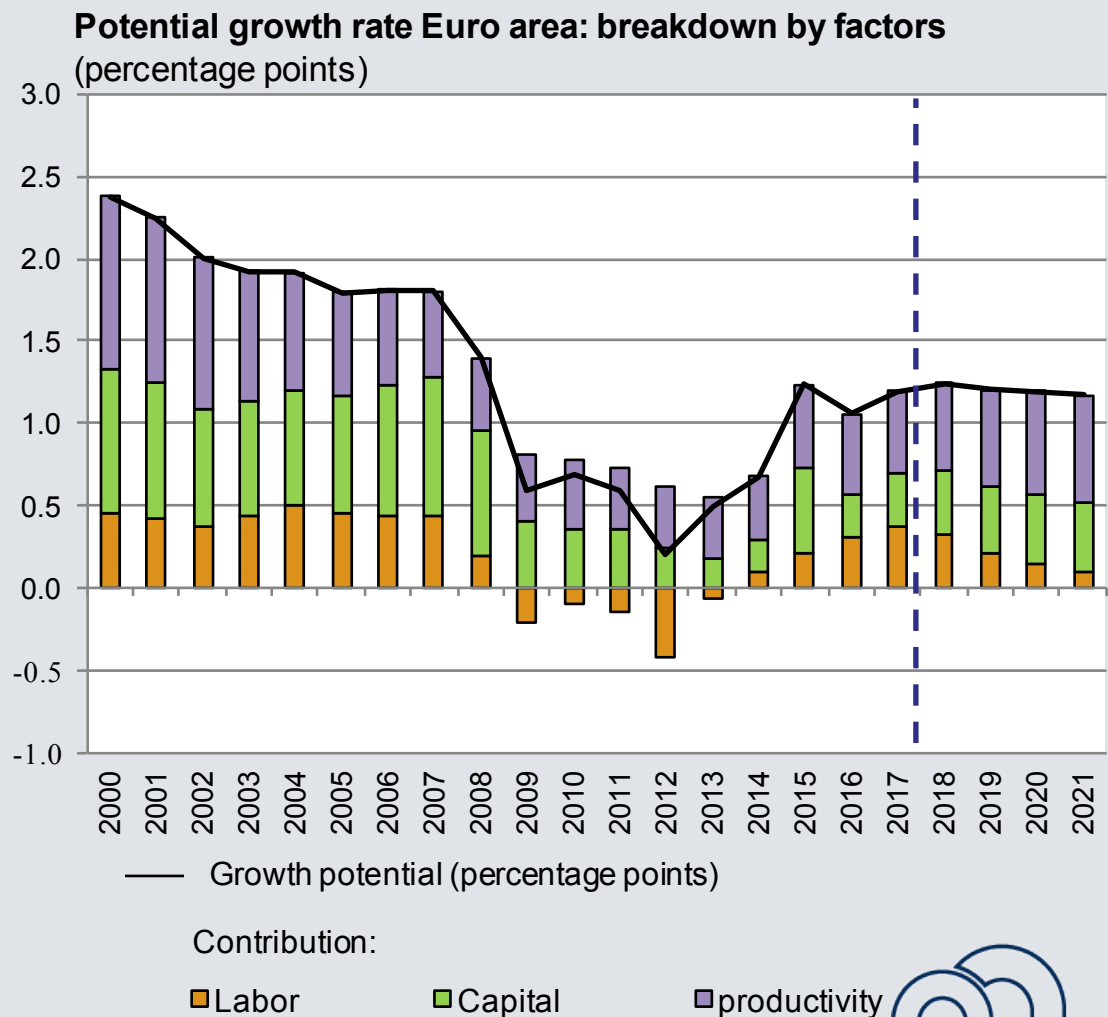
Structural view

Potential output growth has decreased trendwise and is expected to remain moderate for the coming years

Factors explaining the reduced potential output growth:

- ▶ Decreased productivity growth
- ▶ Decreasing contribution of growth in labor force (participation)
- ▶ Decreasing contribution from capital formation

Very similar patterns for different EA members, including Belgium

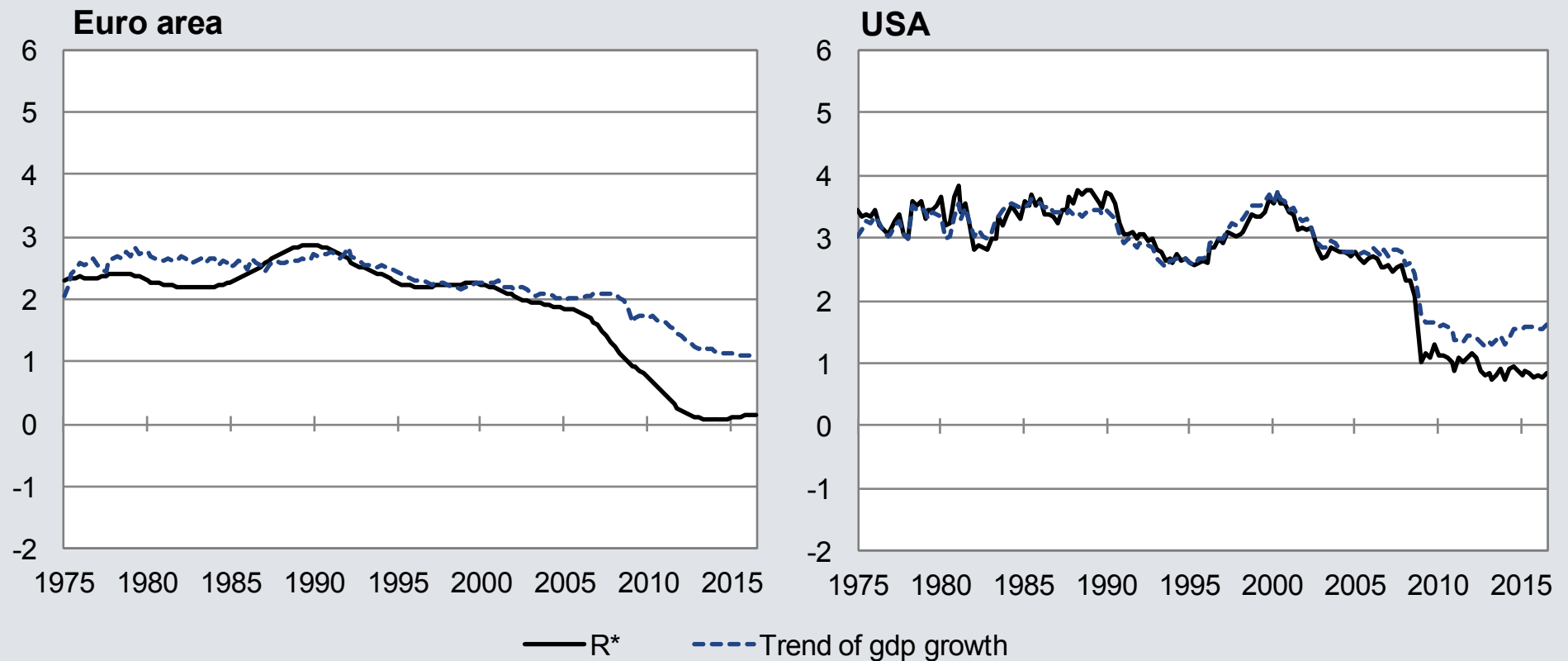


The low interest rate environment: some perspective

Structural view

Estimates of the (structural) equilibrium (real) interest rate are at a historically low level both for the USA and EA....

Holston, Laubach & Williams (2016) estimate of the equilibrium real rate R^*



Bron: NBB based on HLW (2016).



The low interest rate environment: some perspective

Cyclical view

Accommodative conventional and non-conventional monetary policy may help to restore the long-run equilibrium by moving real interest rates *below* the equilibrium real rate

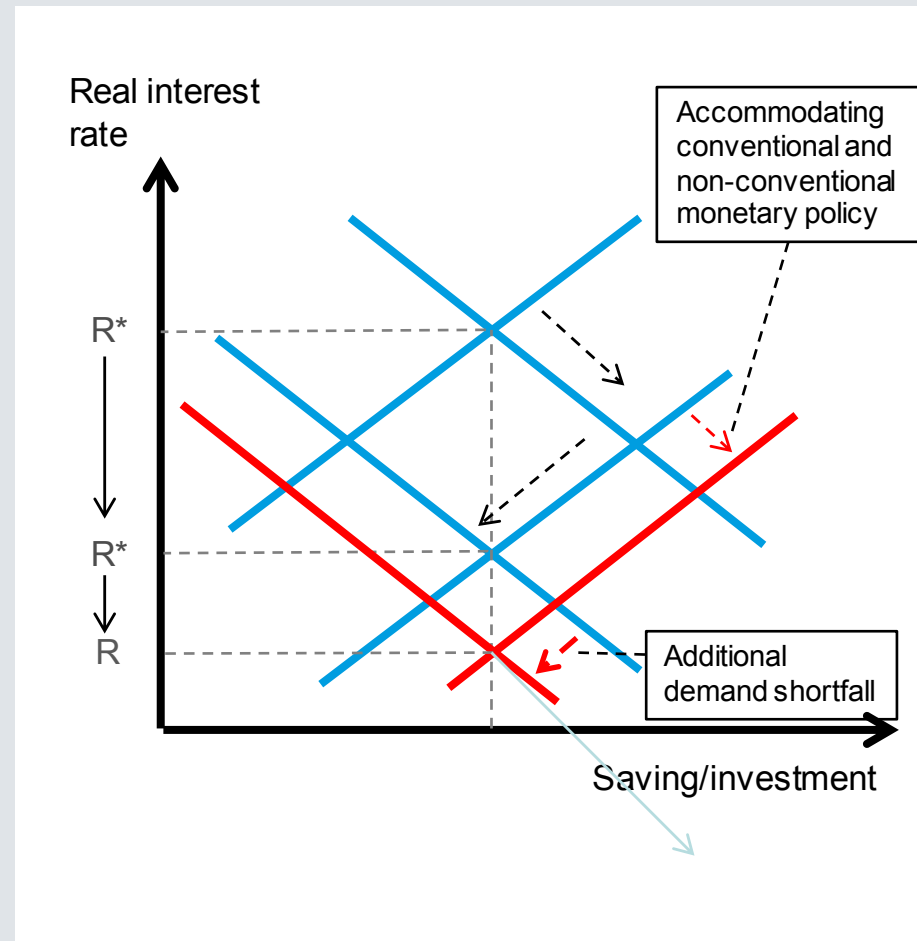
$$R = a \cdot g^* + S/I + R - R^*$$

Fall in equilibrium interest rate following the financial crisis:

- ▶ Fall in potential growth
- ▶ Increased saving supply (precautionary saving, ageing?...)
- ▶ Decreased investment demand

Additional fall in aggregate demand

- ▶ Inflation and output *below* equilibrium values
- ▶ Need for conventional and non-conventional monetary policy responses to set real interest rates *below* the equilibrium rate

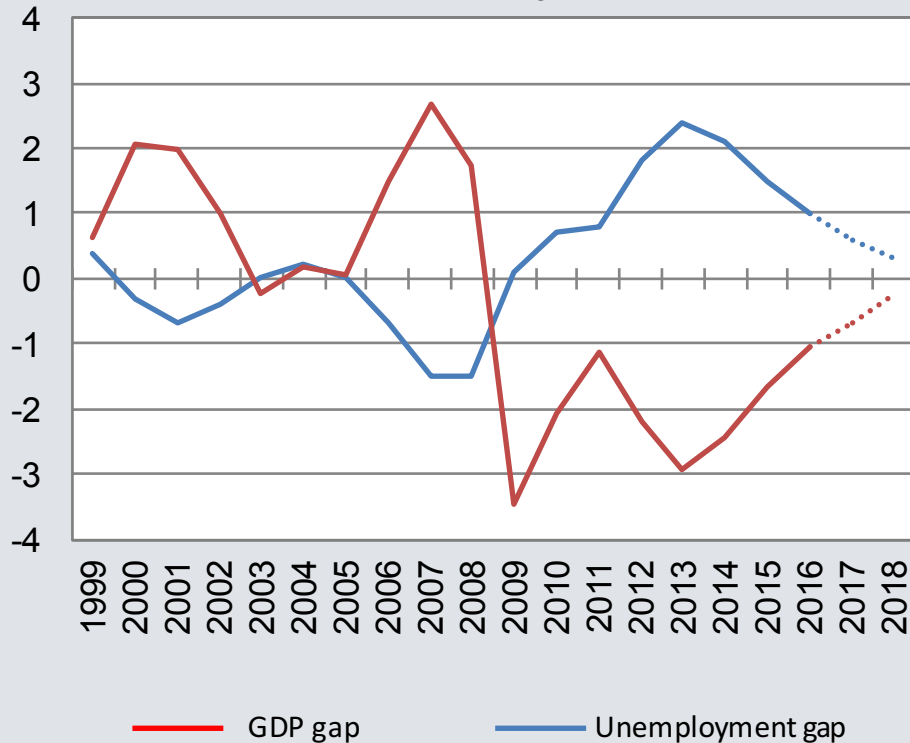


The low interest rate environment: some perspective

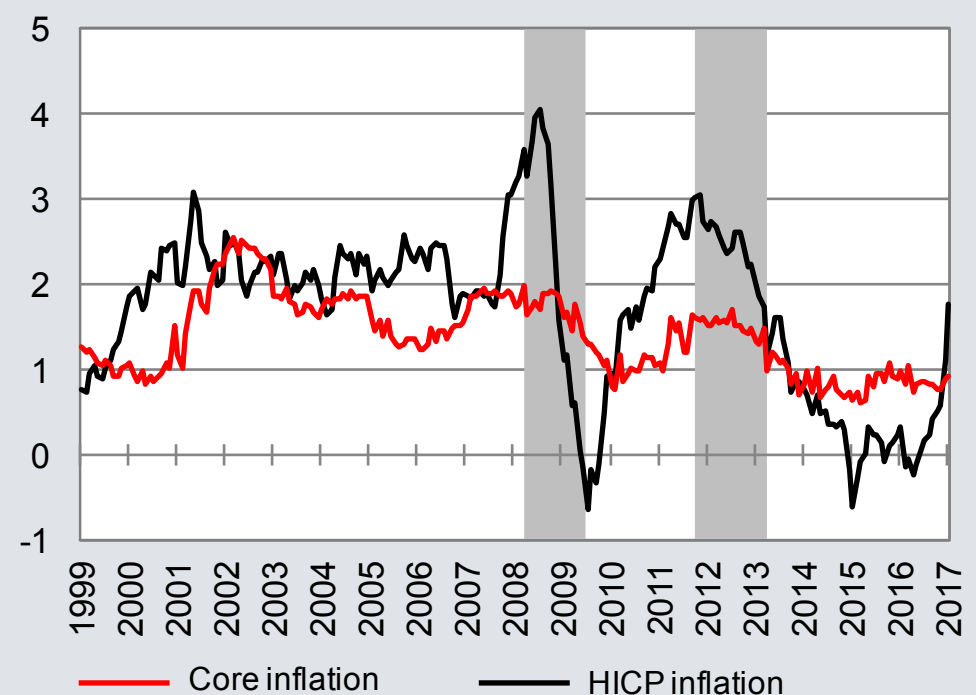
Cyclical view

The financial crisis generated important (and persistent) output and inflation gaps that justified conventional and unconventional monetary policy.

Unemployment and output gaps for EA
(deviation from potential, in percentage point)



Inflation for the euro area
(in percentage points)

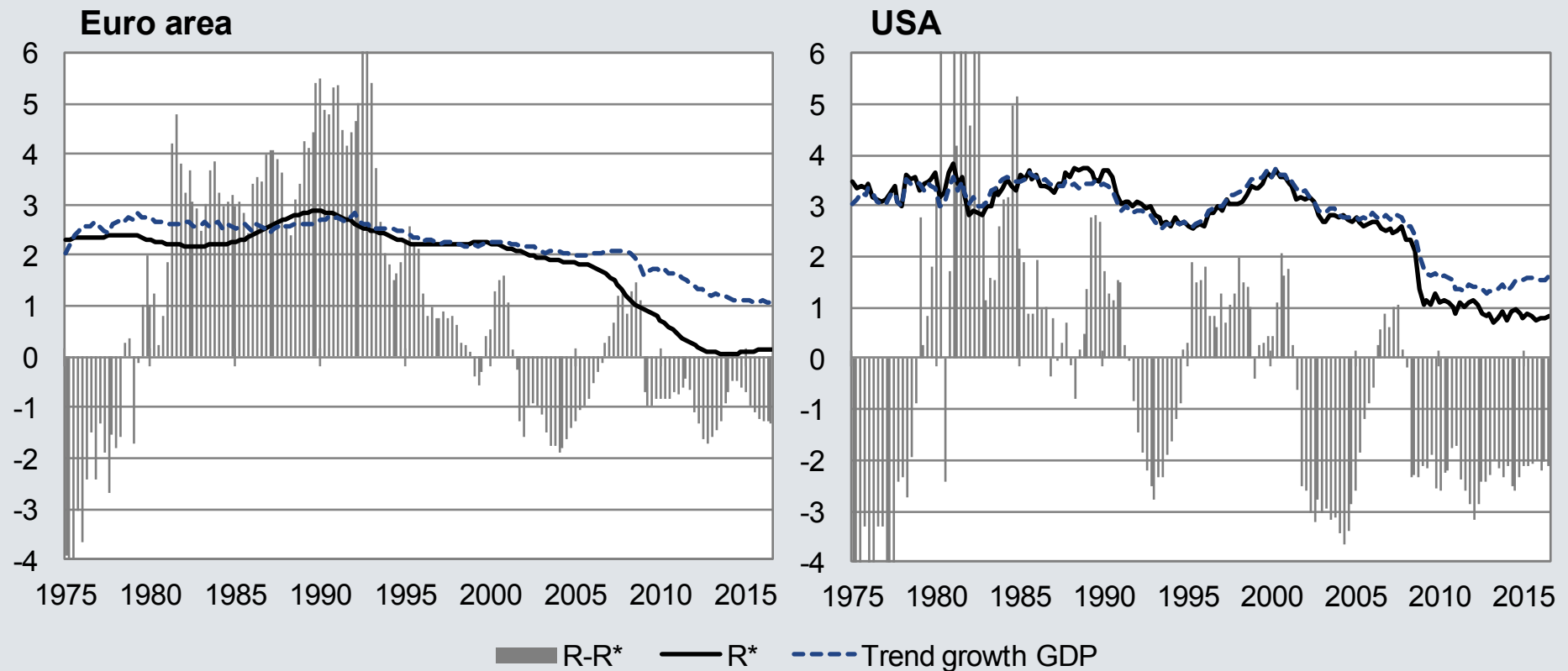


The low interest rate environment: some perspective

Cyclical and structural views combined

Estimates of equilibrium (real) dynamics suggest that structural as well as cyclical factors underly the observed decreased in the (real) interest rates in US and EA

Holston, Laubach & Williams (2016) estimate of the equilibrium rate R^*



Bron: NBB based on HLW (2016).

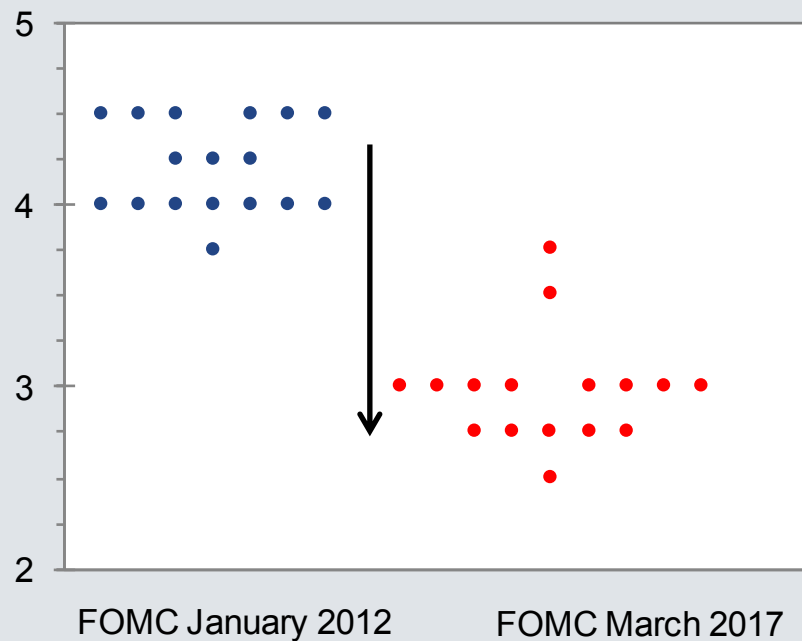


The low interest rate environment: some perspective

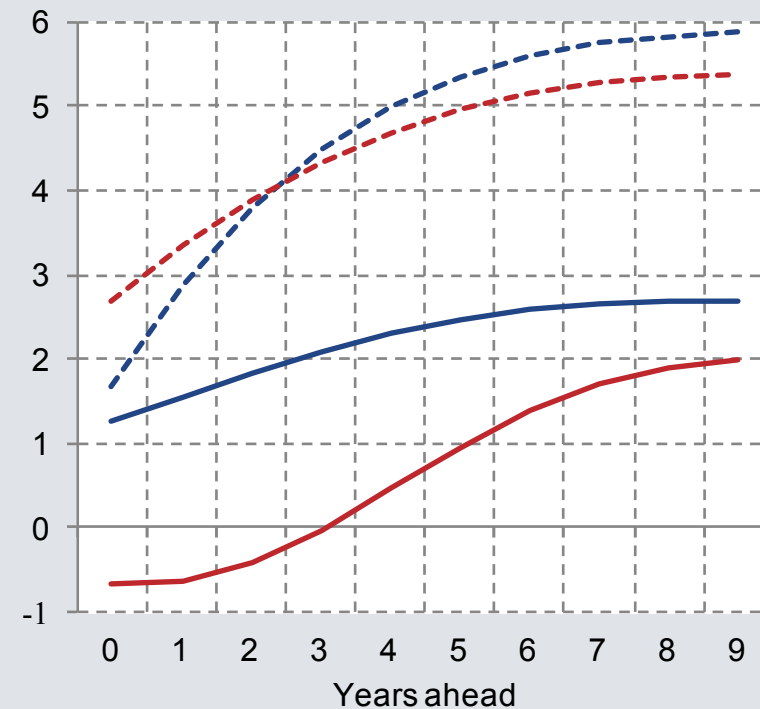
Cyclical and structural views combined

Low for long? Most recent market data suggest yields substantially below average and FOMC central bankers indicate lower rates in the long-run

FOMC “dot chart” “representing members’ long-term expectations on interest rates (in percentage points)



1-year forward yields



US EA1

Average 2002-2004

20 June 2017



Source: Thomson Reuters.
¹ Triple A countries only.lower

The low interest rate environment: impact on the financial sector

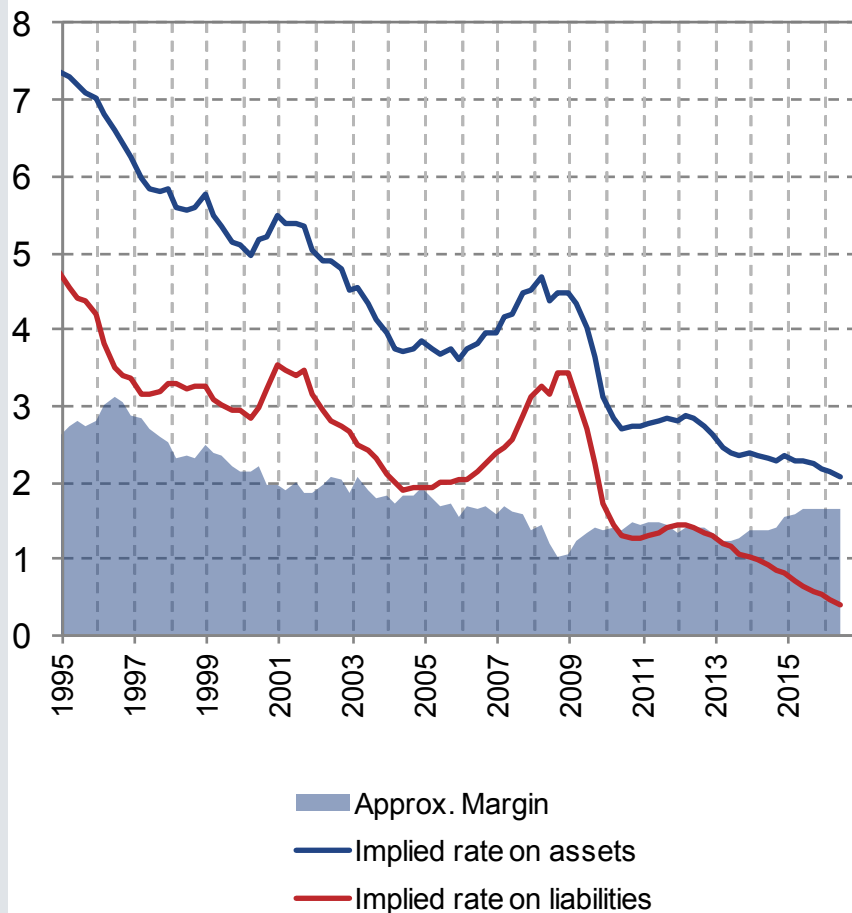


The low interest rate environment: impact on the financial sector

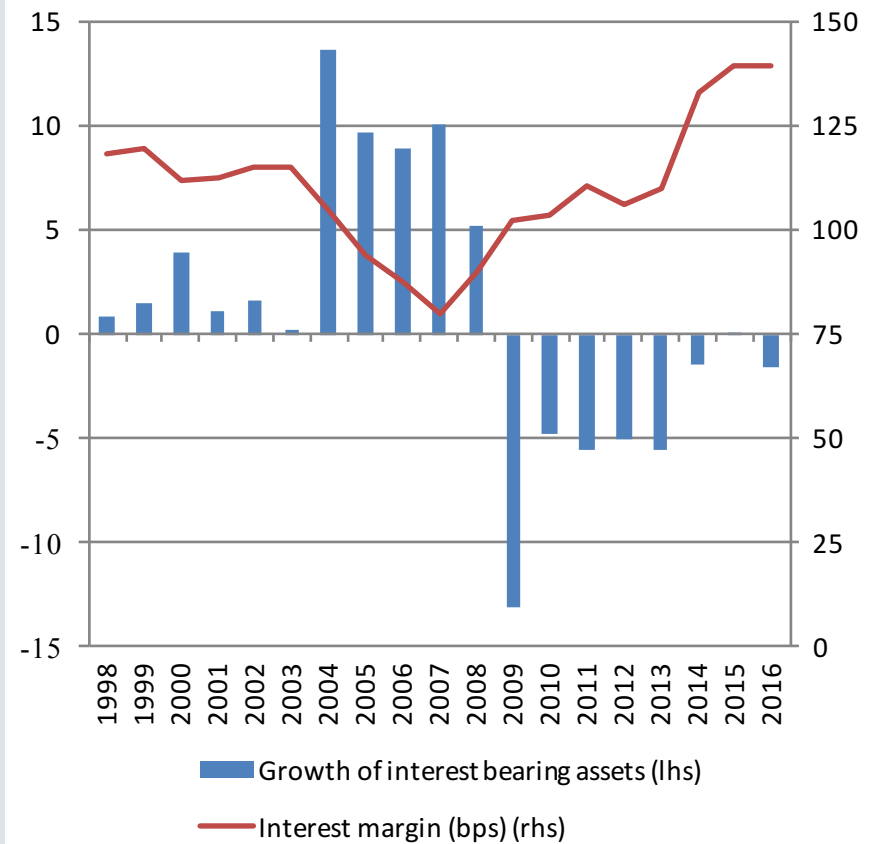
Banking sector

Faster decrease in the funding costs brought the net interest rate margin at very high levels in 2015 and 2016

Implied interest rates on assets and liabilities



Interest margin of banking sector on an unconsolidated basis



The low interest rate environment: impact on the financial sector

Banking sector

IRRBB projections suggest a downward pressure on net interest rate margins, almost independently of the scenario, pointing to important repricing backlog

Preserving future profitability?

Additional risk taking:

- ▶ Search for yield: increasing fraction of high yielding assets (increase in duration, credit risk,...);

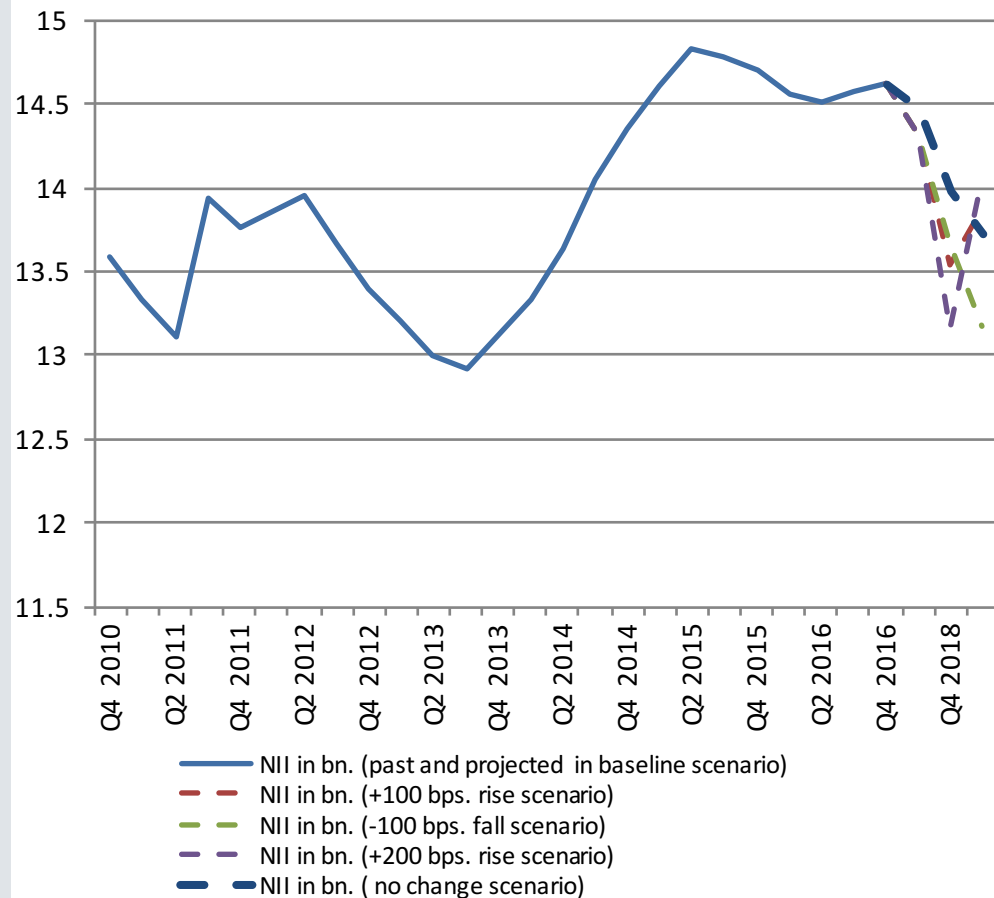
Commercial margins:

- ▶ Counter decreases in commercial margins induced by strong competition

Cost reduction:

- ▶ Additional restructuring of the sector

Net interest rate income and IRRBB projections

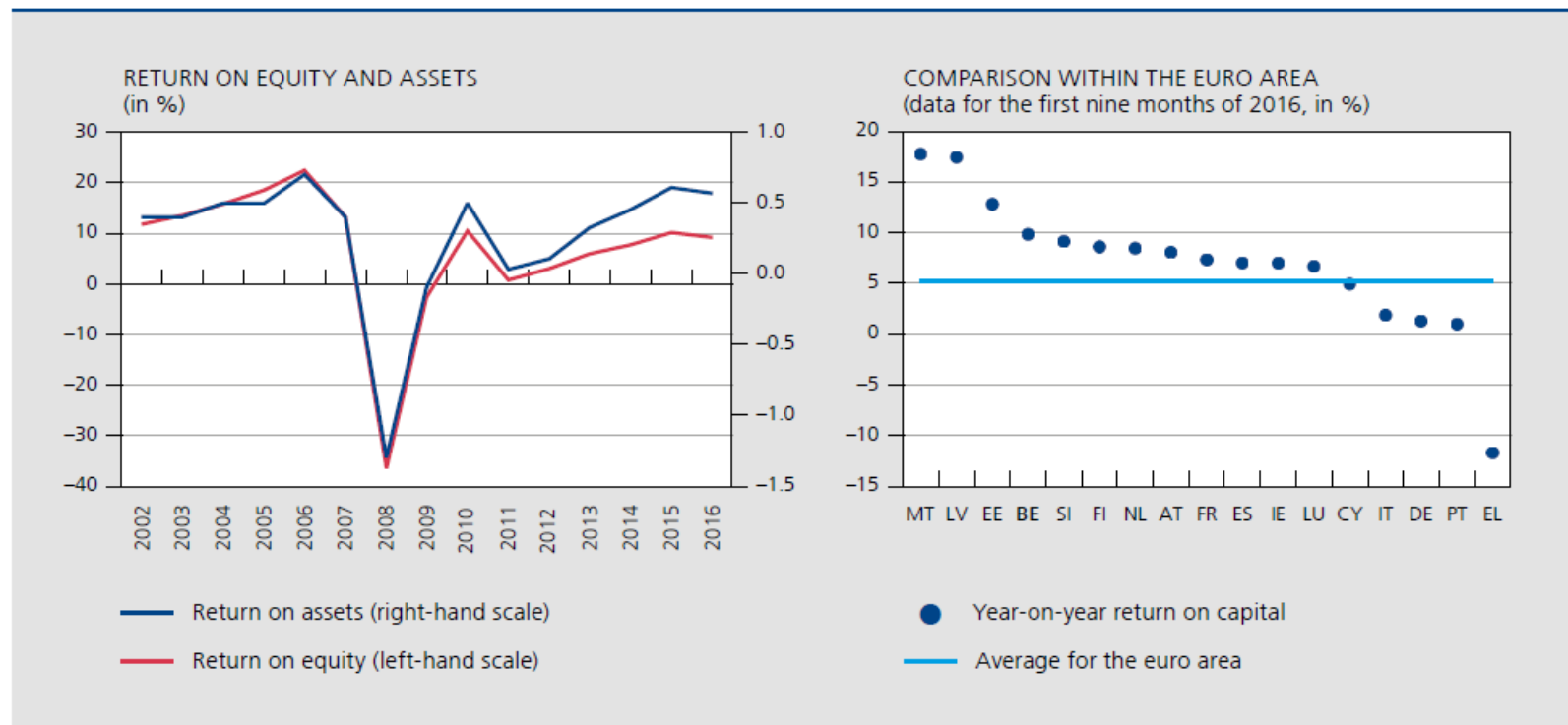


The low interest rate environment: impact on the financial sector

Banking sector

While the economic environment is becoming more challenging, Belgian banks have sufficient capital buffers and start from a sound profitability

CHART 9 PROFITABILITY OF BELGIAN BANKS



Source: NBB.

Build-up of systemic risks in the real estate market



Build-up of systemic risks in the real estate market

Three stretches

Three types of vulnerabilities are currently building up, possibly resulting in increased systemic risk in the medium term (confirmed by ESRB warning November 2016)

► **Household (income) stretch:** captures the implications of household borrowers' debt for their consumption and other behaviour:

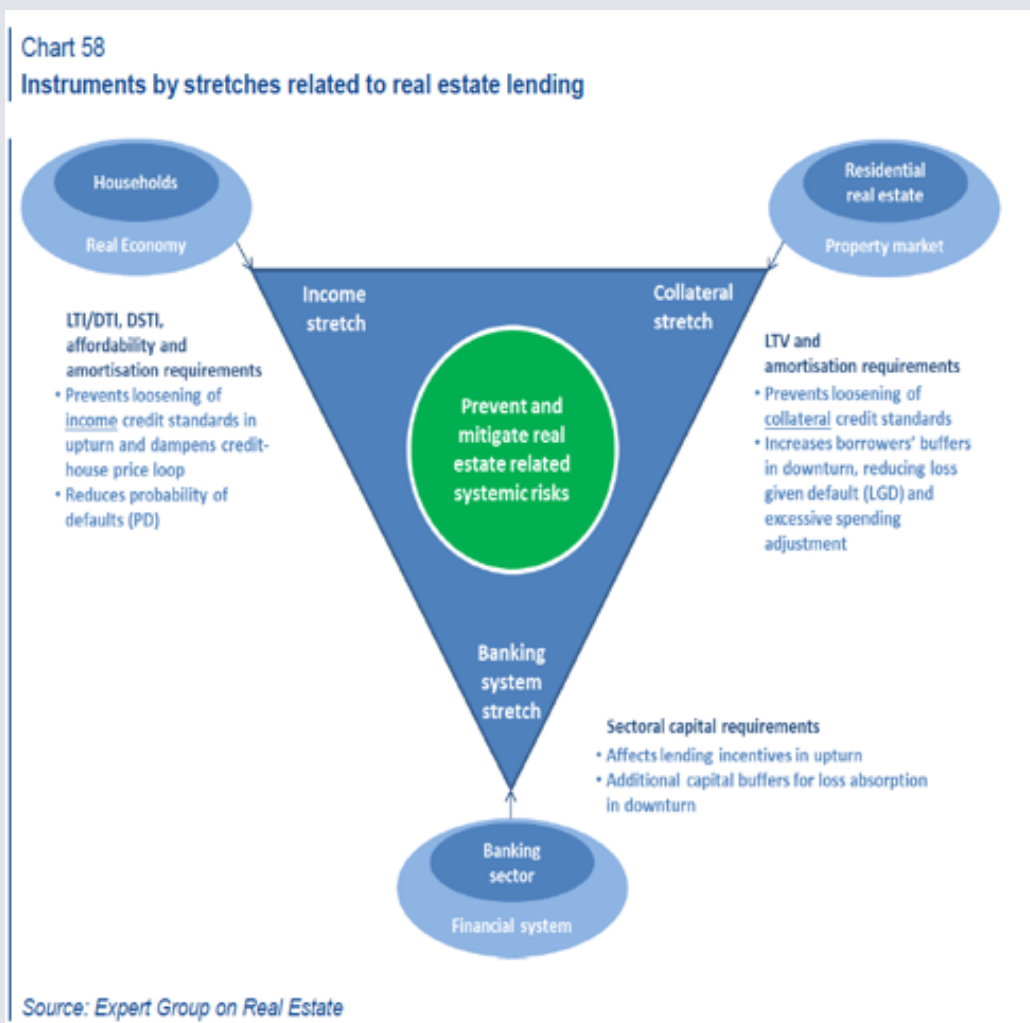
- Trend-wise increase of household leverage : debt-to-gdp ratio increased by more than 50% since 2005 (1.5% gdp per year):

► **Collateral stretch:** captures the price levels and dynamics in RRE markets:

- Overall RRE price indicators have increased and signals of (some) overvaluation appear (albeit subject to substantial uncertainty)

► **Banking system stretch:** captures the potential impact of RRE developments on lenders

- Belgian banks remain exposed to residential real estate risk (low risk weights and loose credit conditions)

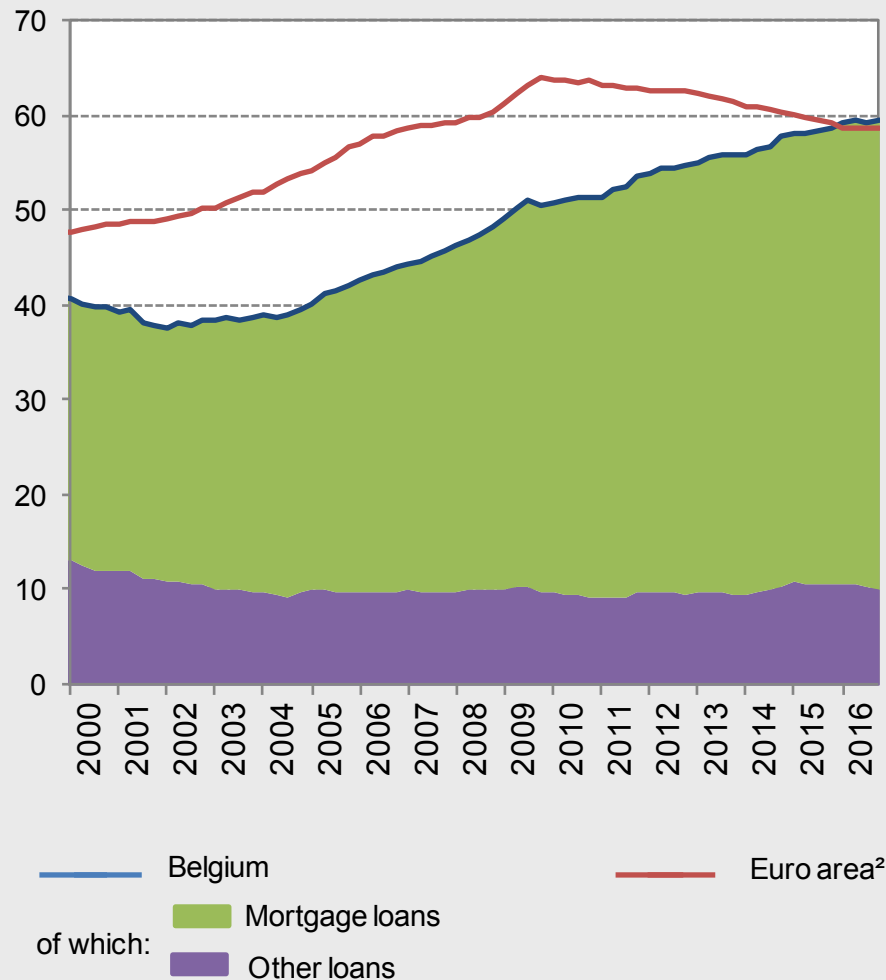


Build-up of systemic risks in the real estate market

Household stretch

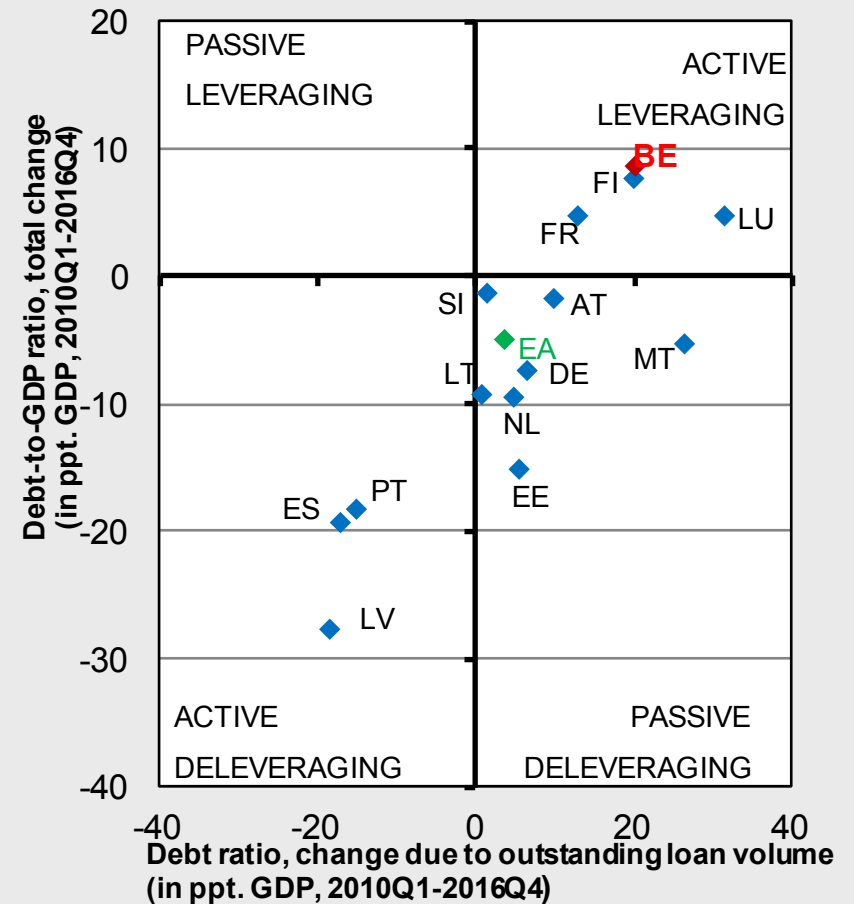
Belgian household debt ratio above EA average and households continue their trend-wise leveraging unlike most EA countries

Household debt : development
(in % GDP, 1999Q1-2016Q4)



Sources: EC, ECB, NBB (National financial accounts).

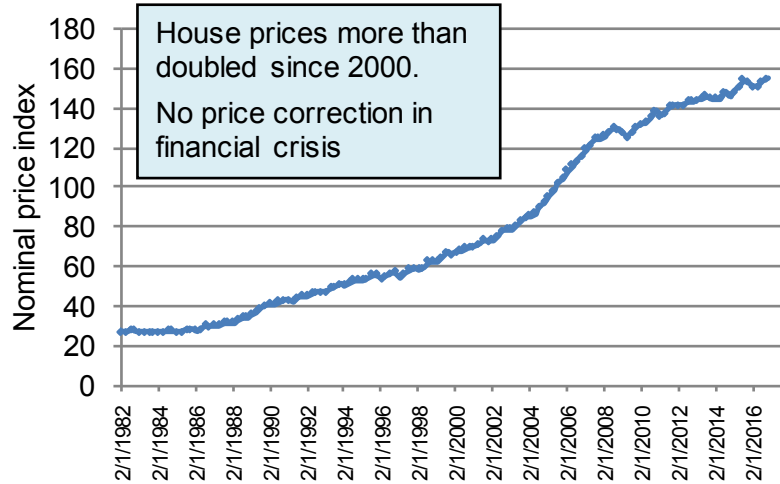
Active vs passive (de)leveraging¹ by households
(in percentage points of GDP, 2010Q1-2016Q4)



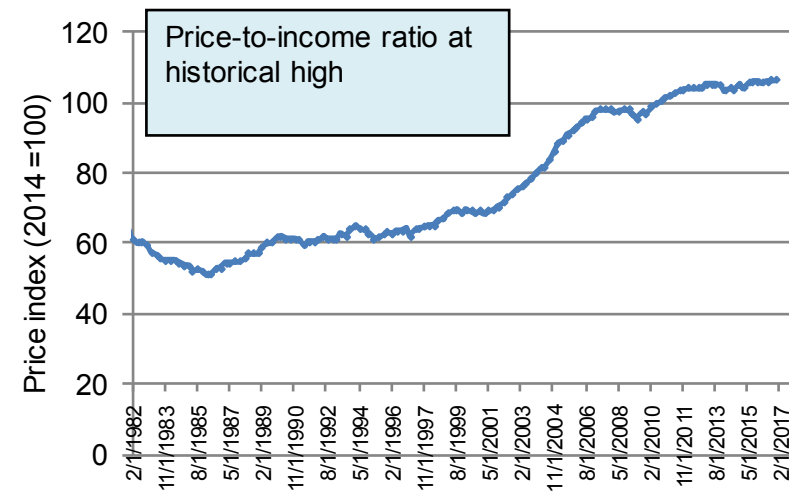
Build-up of systemic risks in the real estate market

Collateral stretch

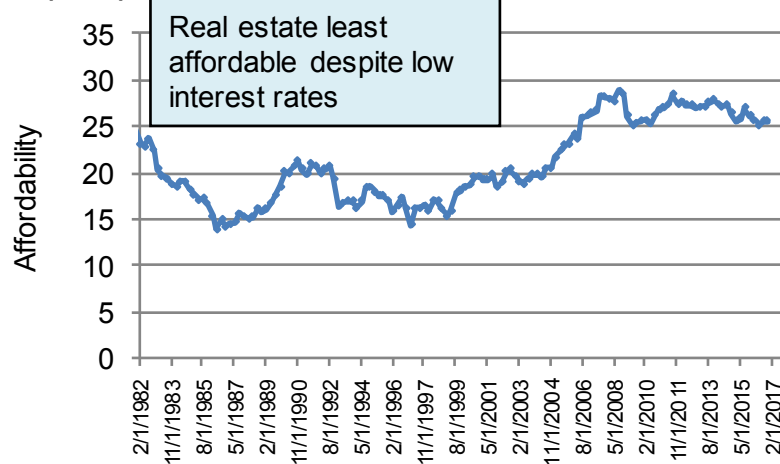
Price (nominal) developments in RRE BE



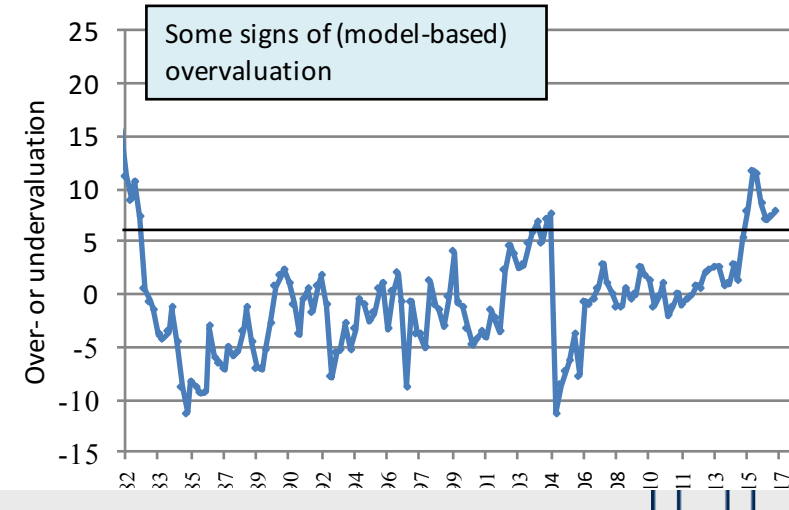
RRE Price-to-income ratio BE



Affordability (interest-adj.) of RRE in BE (in %)



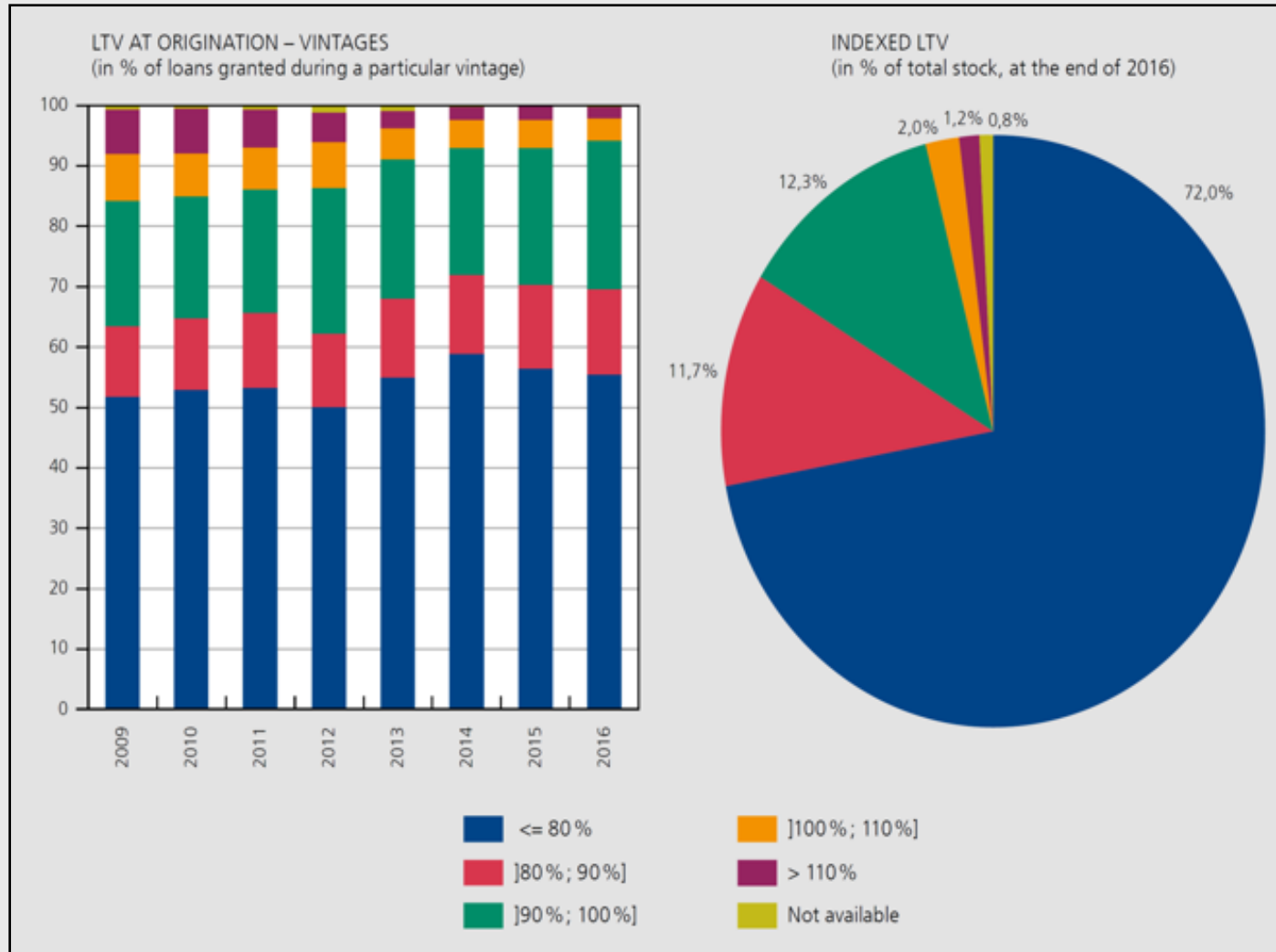
Model-based over (+) and under(-) valuation of RRE in BE (in %)




Build-up of systemic risks in the real estate market

Banking stretch

Sings of loosening credit conditions for mortgage loans, suggesting increased credit risk

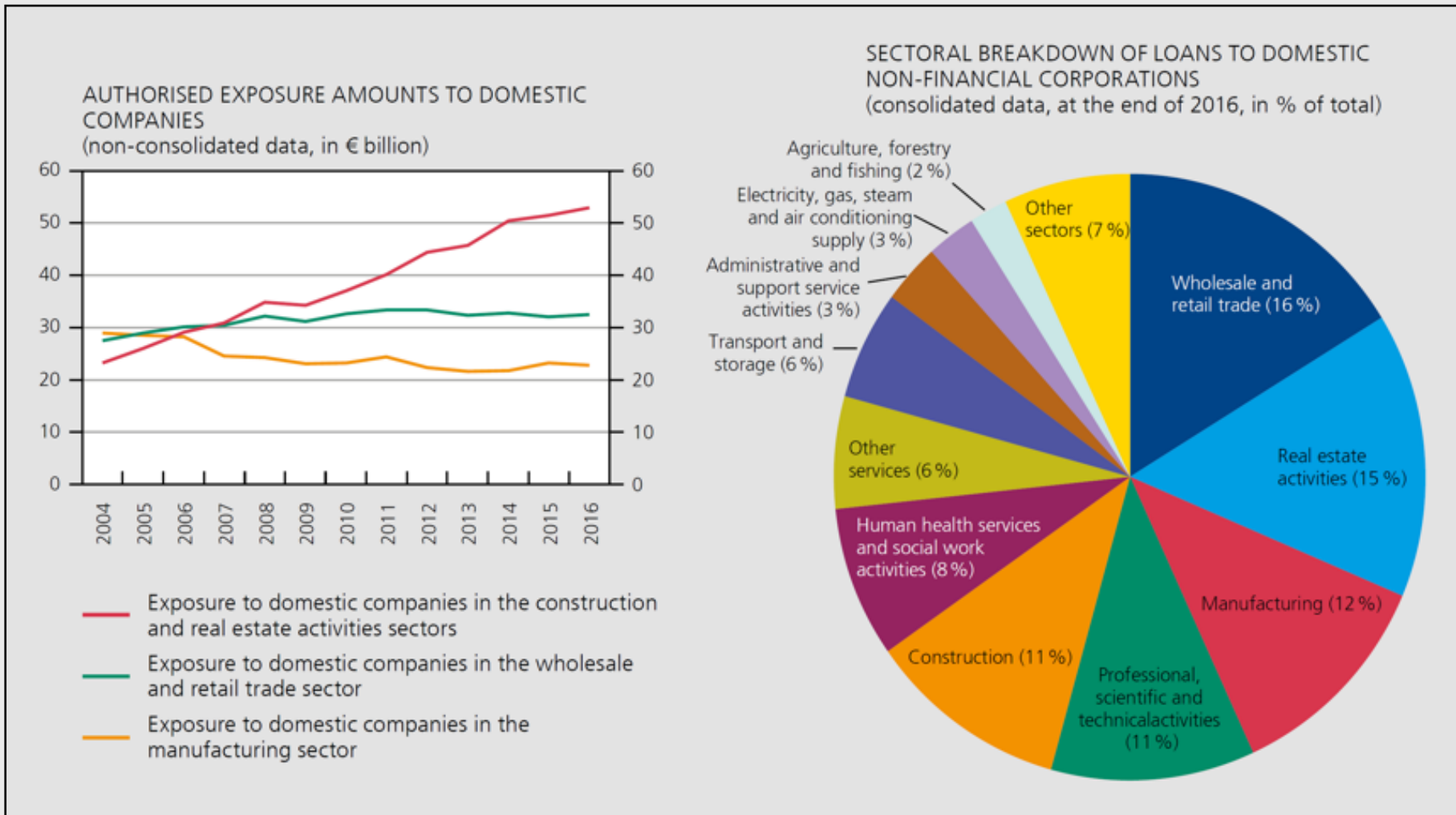


- Bank lending grows at an average of 5%^f
 - Banks extend important volumes of loans with high LTVs (and DSTIs)
 - 30% of loans extended in 2016 (35 % excluding refinancing) have LTVs above 90%
 - 45% of loans extended in 2016 (50 % excluding refinancing) have LTVs above 80%
 - Over 15% of the total loan stock is has an indexed LTVs above 90%
- 

Build-up of systemic risks in the real estate market

Banking stretch

Increasing exposure of banks on commercial real estate



Conclusions

- Interest rates have been historically low and are expected to remain (relatively) low for some time going forward.
- Low interest rates can be explained both by structural factors and by (non-) conventional monetary policies.
- Monetary policy interventions were key in stabilising/supporting the economy during the crisis and have prevented further (deflationary) pressures.
- While overall important and supportive for the economy, low interest rates potentially also generate financial stability risks.
- These financial stability risks arise from the pressure on profitability of banks and insurance companies that may induce a search for yield
- While generalized search for yield is not yet observed in Belgium (Europe), systemic risk is building up in Belgium, reflected in increasing indebtedness of households and the loosening of credit conditions
- Prudential authorities, and specifically macroprudential authorities, should monitor closely these developments and intervene pro-actively





Q & A session



Next meetings

19 September 2017 : Gala Event

Marc Eyskens « Toward a post-economic revoution? »

6 November 2017 :

« Some original proposals to anticipate the expected evolutions in real estate »

