Monetary policy and financial stability in times of persistently high inflation and gloomier economic prospects

*Boštjan Vasle**

The past three years have been challenging in several respects – in terms of health, economics and geopolitics – and the period ahead remains marked with elevated uncertainty. After a strong rebound from the pandemic crisis, economic activity in the euro area continued to expand this year, despite the war raging on the fringes of the EU. Employment in Slovenia and in the euro area has soared to record highs, but so has inflation. Following multi-layered shocks, supply bottlenecks continued and the energy crisis deepened; inflation surged to over 10 percent, and became broad-based and more persistent. In such an environment, the world's major central banks have responded with monetary policy normalisation. Within the Eurosystem, this year we have ended additional (net) asset purchases and, for the first time in eleven years, raised our key interest rates - so far by a total of two percentage points. Additionally, we have aligned the conditions of lending to the banks through the remainder of our targeted longer-term refinancing operations, which might turn out to be a first step towards the reduction of the Eurosystem balance sheet. High core inflation that has not yet started to fall, the pressures that are still in the pipeline and the very tight labour market are, in my view, the arguments for staying the course.

Amidst the energy shock and high inflation, both consumer and business sentiment deteriorated severely this year. The growth momentum in the euro area considerably weakened in the third quarter, with quarterly GDP declines in Slovenia and a few other countries, and the probability of a recession in the region and around the globe has increased. For the next few quarters, it now seems very likely that the euro area and Slovenian economy will face a stagnation or even a temporary decline. However, uncertainty is unusually high, and what will happen next depends largely on geopolitical developments.

The response of financial markets to the historically rapid rise in major central banks' interest rates has so far been smooth. Rising bank borrowing costs have been gradually translating into higher interest rates on bank loans to firms and households, while bank deposit interest rates have been adjusting more slowly, especially in the household segment. Sovereign bond yields have also risen across the board over the last year. In order to prepare for the possibility of different reactions to our policy rate increase campaign in the euro area, we introduced two different lines of defence at the ECB: (a) we started with flexible reinvestments of maturing bonds within the pandemic purchase program, and (b) we preventively launched a new bond purchasing instrument (TPI) that allows us to address any potential unwarranted surges in bond spreads. This helps us in safeguarding the smooth transmission of our policy measures throughout the euro area, which is essential for taming high

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inflation. Regarding the global stock and bond markets, we have this year seen significant but gradual price corrections after a period of buoyant growth. Amidst high market volatility, some segments have felt more stress than others. Overall, the markets remain jittery and asset prices are exposed to further downward corrections, as recently noted by the ESRB in its first general warning of heightened risks to financial stability since 2010.

The euro area and Slovenian banking systems as a whole have so far retained good liquidity, being adequately capitalised and resilient, though both capital and liquidity indicators decreased somewhat in the last year. High uncertainty and a deterioration in macroeconomic prospects have only been reflected to a minor extent in the asset quality indicators. This holds especially true for the Slovenian banking system, where, in addition to the NPL ratio - which has decreased further in the entire euro area - the share of Stage 2 loans also decreased this year. So far, banks have been mostly reaping the positive effects of monetary policy rate hikes, while the negative impact on (potential) borrowers commonly comes with a lag. The still high growth rates of household lending, for example, have started to show the signs of slowing down, in line with the first signs of cooling of the housing market. In response to the growing risks in the housing market, Banka Slovenije introduced a requirement for banks in the spring to maintain sectoral (capital) buffers for systemic risks, which comes into effect in 2023. As bank lending conditions tighten, more indebted households and businesses will come under increasing pressure, also being affected by the rises in energy and other prices. Given the gloomier economic outlook, banks should be (more) proactive in loan-loss provisioning. The pressure on banks' profitability is expected to increase in the coming years, and the question of its sustainability might once a gain come to the fore.

Looking ahead, high inflation and the considerable price pressures that are still in the pipeline call for further increases in our policy rates, possibly into restrictive territory, to bring inflation close to our two-percent target over the coming years. Soon we will set the plans for reducing the Eurosystem's bond holdings, ideally by not replacing all maturing bonds from sometime next year onwards. It is of utmost importance that fiscal policy works hand in hand with monetary policy in the fight against inflation. Otherwise, disinflation process will take longer and would be accompanied by unnecessary costs.