BANCO DE ESPAÑA
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EMERGING RISKS IN GLOBAL FINANCIAL MARKETS

KEYNOTE INTRODUCTION

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OUTLINE

1. **Emerging risks in financial markets**

2. **The role of policies:**

    2.1. Monetary policy

    2.2. Prudential policy

3. **A note on liquidity**

1. EMERGING RISKS IN FINANCIAL MARKETS (I)

Almost a consensus that some important risks may be emerging

- **Low interest rates (following a long phase of extremely accommodative monetary policy)**
  - Risks: provoking excessive risk taking and, possibly, asset price misalignments
- **Financial intermediaries under pressure (in a context of low interest rates, weak economic growth and strengthening of prudential regulation)**
  - Risks: making them less able to absorb shocks; incentivising the transfer of risks to the unregulated sector
- **Correction of risk premia potentially aggravated by liquidity problems**
  - Risks: significant instability; vulnerability of some institutional investors

1. EMERGING RISKS IN FINANCIAL MARKETS (II)

- It is naturally difficult to dispute that the above elements are potentially relevant risk factors

- However, the probability and the expected actual impact of each on the real economy are obviously quite uncertain

- Rather than getting into that difficult territory, the rest of this presentation focuses on the role of policy in dealing with the above risks

Has monetary policy gone too far, for too long?

- **A long phase of extremely accommodative monetary policy has undesired effects. It may:**
  - generate search for yield behaviour
  - contribute to the emergence of asset price bubbles
  - delay the deleveraging and clean-up of the balance sheets of over-indebted businesses and households
  - pose challenges for certain specific financial sectors

Has monetary policy gone too far, for too long?

- However, the main factor affecting financial stability is economic stability
- Additionally, the cost of being wrong with the policy stance is asymmetric
- Having said that, financial stability has gained importance as a policy objective
- Financial stability considerations do need to have a role – arguably larger than in the past – in monetary policy making
- Macro-pru policies are not sufficient

Are new requirements putting excessive pressure on financial intermediaries and favouring shadow banks?

Positive effects

- **Stability and soundness of the financial industry**
  - More and better capital:
    - reduced probability of financial crises,
    - and more stable credit developments
  - New resolvability requirements: reduced scope for moral hazard

Challenges

- **Shadow banking**: risk transfer not necessarily bad
- Negative impact on **profitability** of banks

Role of regulators and supervisors

- **No compelling arguments** for a looser prudential policy
- Apply **sufficient gradualism** to permit a **smooth adjustment** of the industry to the new requirements
- In no way aim at preventing the sanitization of the industry, which will most likely involve **further concentration**

3. A NOTE ON LIQUIDITY (I)

Hypothesis: Regulation penalises market making activities (basically via the leverage ratio) → market makers disappear → the price-counterparty search process becomes more cumbersome → liquidity declines → volatility increases → the markets and the economy become more unstable

- **This hypothesis requires careful consideration and clearly illustrates why regulation should always be accompanied by a careful impact assessment**
  - It is regrettable that the confluence of so many new regulatory initiatives has made it almost impossible to conduct, at least so far, a fully comprehensive cost-benefit analysis
- **However, it is, to date, far from proven that regulation has a significant adverse impact on the available liquidity in financial markets**

3. A NOTE ON LIQUIDITY (II)

At present, there seem to be insufficient arguments for amending relevant pieces of the regulation – including the leverage ratio - as a consequence of potential risks related to market liquidity

- **Liquidity seems to be lower in several market segments, but not in all of them**
- **Some indicators, such as bid-ask spreads, generally offer a much less clear picture**
- **Although the flash-crashes observed are quite spectacular, they seem to have self-corrected relatively quickly**
- **The link ‘liquidity – volatility’ and especially the link ‘liquidity – economic performance’ seems, if anything, to be quite weak**