EUROPEAN CENTRAL BANK

EUROSYSTEM

The Toolkit of Policies in the Brave New World of Debt

Boston Fed 65th Economic Conference

10 November 2021

Luc Laeven (ECB and CEPR)

The views expressed are my own and not those of the ECB or the Eurosystem

Main messages

Corporate leverage, macroprudential policy and monetary policy

Increase in **corporate leverage** is not widespread but concentrated in high-yield and specific sectors, and supported by favourable financing conditions, strong earnings and a transfer of risk to the government sector. Vulnerabilities from growing stretch in financial markets, risk-taking by non-banks and elevated sovereign and high-yield corporate debt, in environment of growing interest rate risk.

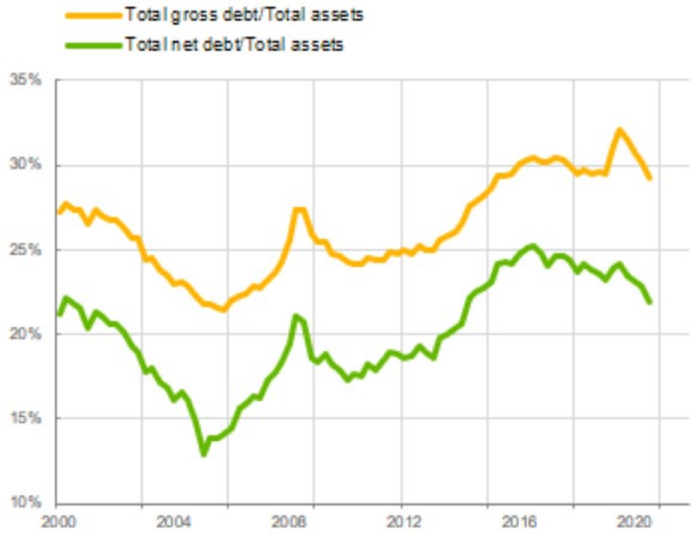
Existing **macroprudential policy** frameworks ill equipped to deal with these risks. Need to strengthening the regulatory framework for non-banks. Implications for other policies (fiscal, monetary) that will have to do their part. Historically debt overhang managed through combination of growth, inflation and debt restructuring.

Monetary and macroprudential policies interact and mostly tend to be complementary. Expansive monetary policy boosts lending more in accommodative macroprudential environments. This complementary effect is present for both bank-based and borrower-based macroprudential measures. Lack of macroprudential policy puts pressure on monetary policy to play a macroprudential role.

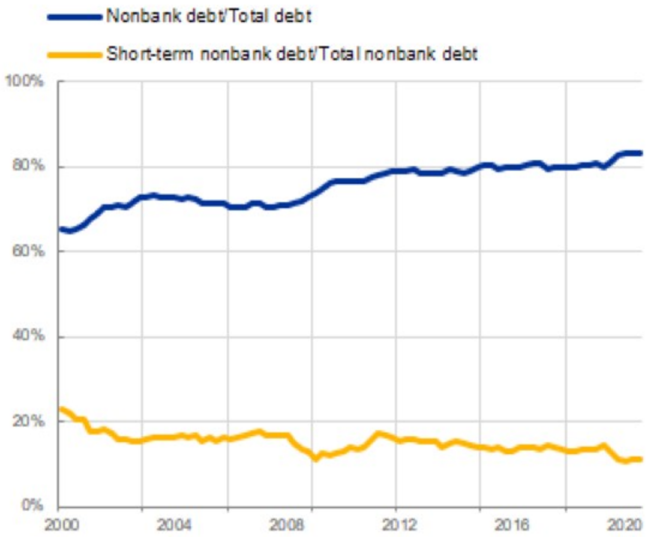
Financial leverage of US corporate sector has not materially increased

- On the whole, financial leverage of US corporate sector has not increased, both on gross and net terms
- But leverage has increased for certain sectors (affected), segments (high yield), and markets (nonbanks)

Financial leverage of US manufacturing sector
Q4 2000 – Q2 2021, percentages



Nonbank debt of US manufacturing firms
Q4 2000 – Q2 2021, percentages

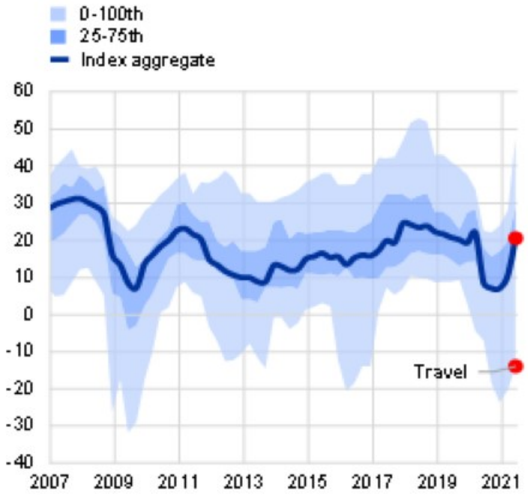


Sources: Quarterly Financial Report, US Census Bureau.

Corporate solvency risks lower than feared previously and sector-specific

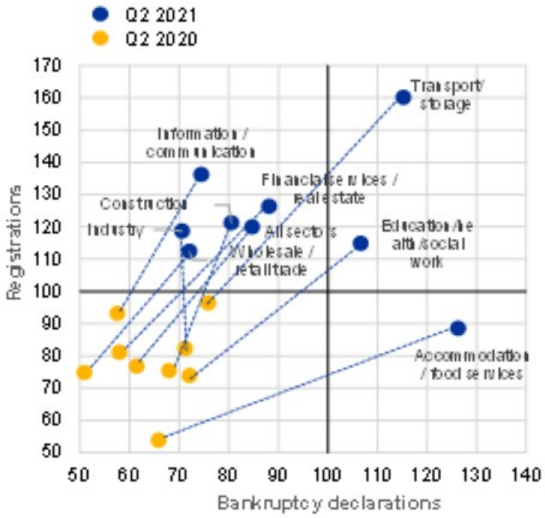
- Strong corporate earnings combined with support from favourable government guarantees, grants, debt forgiveness, and job retention schemes helps alleviate solvency concerns
- Some signs of net increase in insolvency in most pandemic-affected sectors

Earnings per share across EURO STOXX sectors
Q1 2007 – Q2 2021, per share



Sources: Bloomberg Finance L.P.

Bankruptcy declarations and new business registrations
Q2 2020, Q2 2021, indices: 2015 = 100

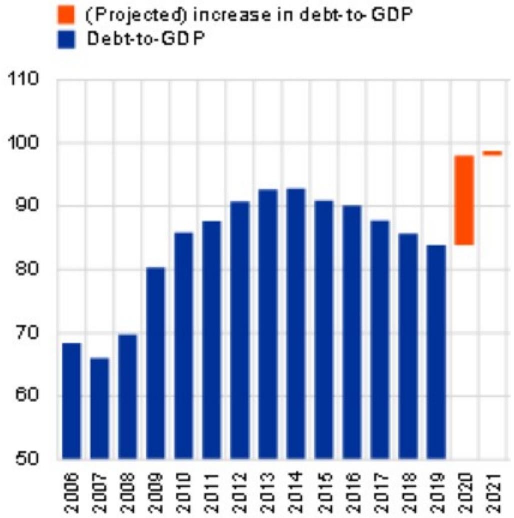


Sources: Eurostat and ECB calculations.

Sovereign debt sustainability concerns are alleviated by low funding costs for now

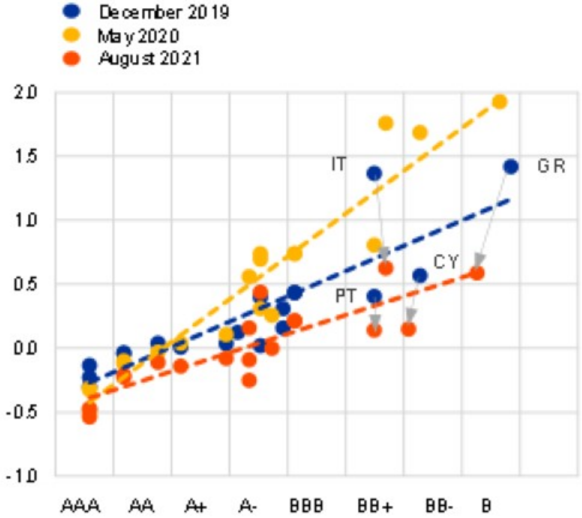
- Sovereign debt levels have increased markedly during the pandemic
- Benign financing conditions and the ongoing economic recovery underpin sovereign debt sustainability

General government debt-to-GDP ratios of euro area sovereigns
2006 – 2021, percentages of GDP



Sources: ECB and ECB staff calculations.

Ten-year government bond yields and credit ratings of euro area sovereigns
Percentages per annum, rating category

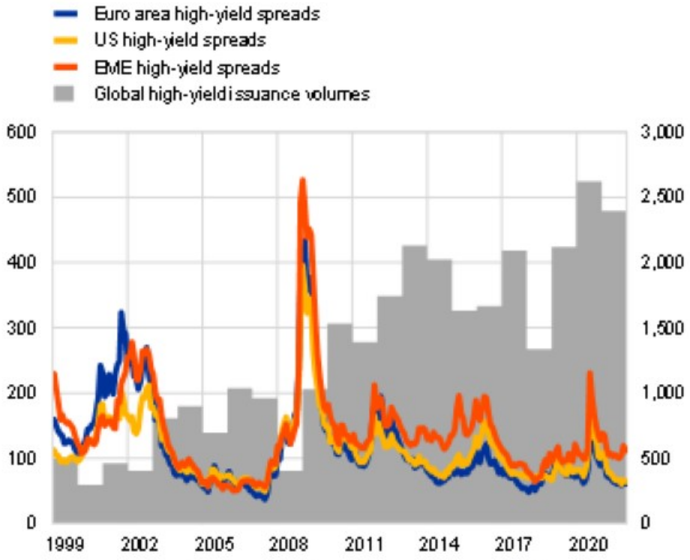


Sources: Bloomberg Finance L.P., S&P, Moody's, Fitch.

Vulnerabilities are on the rise in specific asset markets

- Search for yield continues in credit markets, as high-yield borrowers negotiate record level of deals
- Non-banks absorbing the bulk of the record-high issuance in high-yield

Global high-yield corporate bond issuance and high-yield bond spreads
Basis points; USD billions

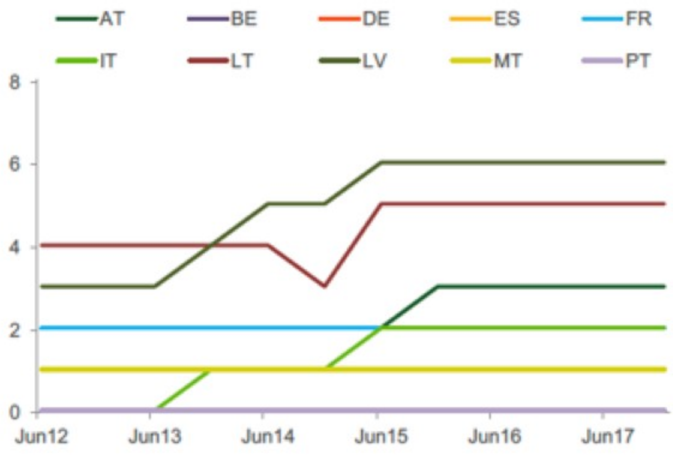


Sources: Dealogic and Bloomberg Finance L.P.

Macroprudential policy to the rescue?

- Macroprudential policy should in principle be first line of defense
- But tendency to do too little too late, and ill equipped to deal with risks stemming from non-banks
- Puts pressure on other policies (fiscal and monetary) to do their part
- Historically debt overhang managed through combination of growth, inflation and debt restructuring

Macroprudential index euro area countries
Number of macroprudential measures in place, 2012-2018



Sources: ECB Macroprudential Database; Altavilla, Laeven and Peydro (2021).

Complementarity of macroprudential and monetary policies

- Empirical evidence using loan-level credit register data from Europe suggests strong complementarities between macroprudential and monetary policies, for both household and firm loans
- A softening of monetary policy augments lending especially in a softer macroprudential policy environment
- Effects are stronger for less capitalized banks (bank lending channel), especially when these banks lend to riskier borrowers (risk-taking channel)

Impact of macroprudential and monetary policies on credit growth
Regression analysis using loan level data, 2012-2017

	(1)	(2)	(3)	(4)	(5)	(6)
	Households			Firms		
	Capital-based measures	Bank-based measures	Borrower-based measures	Capital-based measures	Bank-based measures	Borrower-based measures
MAP^{soft}	0.421***	0.182***	0.295***	0.0535***	0.0238***	0.0473***
	(0.00304)	(0.0243)	(0.0342)	(0.00250)	(0.000684)	(0.0171)
MP^{soft} x MAP^{soft}	0.0174***	0.0251***	0.0430***	0.00234***	0.00166***	0.00764***
	(0.000113)	(0.00485)	(0.000292)	(0.000175)	(0.000124)	(0.000494)
N	95,633,434	88,412,340	88,412,340	67,396,286	67,396,286	67,396,286
R^2	0.849	0.852	0.852	0.717	0.716	0.764

Source: Altavilla, Laeven and Peydro (2021).

Main messages

Corporate leverage, macroprudential policy and monetary policy

Increase in **corporate leverage** is not widespread but concentrated in high-yield and specific sectors, and supported by favourable financing conditions, strong earnings and a transfer of risk to the government sector. Vulnerabilities from growing stretch in financial markets, risk-taking by non-banks and elevated sovereign and high-yield corporate debt, in environment of growing interest rate risk.

Existing **macroprudential policy** frameworks ill equipped to deal with these risks. Need to strengthening the regulatory framework for non-banks. Implications for other policies (fiscal, monetary) that will have to do their part. Historically debt overhang managed through combination of growth, inflation and debt restructuring.

Monetary and macroprudential policies interact and mostly tend to be complementary. Expansive monetary policy boosts lending more in accommodative macroprudential environments. This complementary effect is present for both bank-based and borrower-based macroprudential measures. Lack of macroprudential policy puts pressure on monetary policy to play a macroprudential role.