Coping with inflationary pressures in a challenging geopolitical and financial environment

*Boštjan Vasle**

Our economies have once again proved more resilient than was generally expected last year. In Slovenia and the euro area, economic growth has slowed markedly over the past year, yet we avoided a decline in the level of activity. In addition to the Russian military aggression and its aftermath, growth slowdown also reflects the high level of economic activity achieved after rapid rebound following the pandemic crisis. The mild winter and diversification of energy sources helped us weather the shortage of energy supply from Russia. While high wholesale prices of energy and raw materials combined with weaker demand for goods brought about a moderation in manufacturing, growth in the services sector remains robust. This activity in the service sector is underpinned by new record-high employment levels and historically low unemployment, which have contributed to the acceleration of wage growth. Although part of the business sector may be able to absorb certain increases in labour and financing costs, not least due to generally higher profit margins in the recent period, some of the burden may be passed on to consumer prices, thereby adding to inflationary pressures if demand remains strong. The confluence of adverse circumstances has had a somewhat more visible impact on global financial markets, where prices have fallen from their late 2021 peaks and remained volatile, as well as on the US and Swiss banking sectors.

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Inflation remains a major concern and bringing it under control is a key policy priority. While the euro area headline inflation receded in recent months due to falling energy prices, the underlying inflation has remained uncomfortably high. Past increases in input costs have probably not yet fully shown in final prices and still motivate upward price pressure. However, with global supply chains largely normalised and energy prices declining to more moderate levels, the price pressure is gradually shifting from external to domestic factors. This increases the need for fiscal policy to help us fight against inflation.

The Eurosystem's response to persistently high inflation has been decisive. Since July, we have raised our key interest rates by a total of 3.75 percentage points at the fastest pace since the euro introduction. After completing net asset purchases in the first half of last year, we initiated a gradual disinvestment in March of this year. Together with the banks' repayment of our longer-term loans, this will gradually reduce surplus liquidity in the economy and decrease our footprints on financial markets. Looking ahead, a few more rate hikes might be needed, given the excessively high core inflation and the tight labour market. We will accelerate the shrinking of our balance sheets soon, albeit with caution and preparedness to address unwarranted reactions from financial markets.

Rising interest rates have so far had a largely positive effect on the overall profitability of banks in Slovenia and elsewhere in Europe. The resulting losses on securities valuations have been manageable, banks' capital and liquidity positions have remained largely sound, and the share of non-performing loans has been historically low at the system level. The US banking sector's turmoil has globally increased depositors and investors' attentiveness to bank health, but the impact on the European banking sector has been limited.

The resilience of our banking systems to recent shocks and interest rate rises reflects, among others, the strengthening of EU banking regulation and supervision over the last decade. It argues in favour of a more conservative European approach in the application of the Basel standards to banks of all sizes. Macroprudential policies have also contributed to limiting risks in banks. Nonetheless, recent developments can serve as a reminder that the challenges of a rapidly changing macro-financial environment should not be neglected and that we all, namely banks, supervisors, regulators and external auditors, must remain vigilant. Banks need to continue working on sound governance and internal controls; this is where the recently troubled banks have failed. As a supervisor, we are increasingly tailoring our oversight processes to bank-specific characteristics and macro-financial circumstances. In the last two years, we have been paying extra attention to banks' exposure to the hospitality and energy-intensive industries, (unrealised) securities losses, a significant gap in the maturity of assets and liabilities, and banks' liquidity profiles. We also strive not to lose sight of longer-term challenges related to banks' prospects in the evolving financial landscape.

Equally important is to avoid any further delays in transposing the final set of Basel III reforms into EU law and to maintain momentum in strengthening of the bank crisis management framework. Extending the scope of depositor protection and the resolution framework to smaller banks will serve as steps in the right direction. In this regard, the right balance between the stability of the banking system and the costs of resolution is needed, and this can be achieved through various resolution tools. Another important outstanding EU issue is the provision of liquidity in the bank resolution process.

Let me conclude with a longer-term challenge: it is true that unprecedented policy support helped us weather the shocks. But to restore the stability and proper functioning of our economies, we should avoid the misleading impression that monetary and fiscal policy can or should step in to address every challenge. It is important that policy support is and will remain available for major shocks and critical periods. However, market participants should strengthen their resilience for major shocks and prepare themselves for unwanted developments as well.