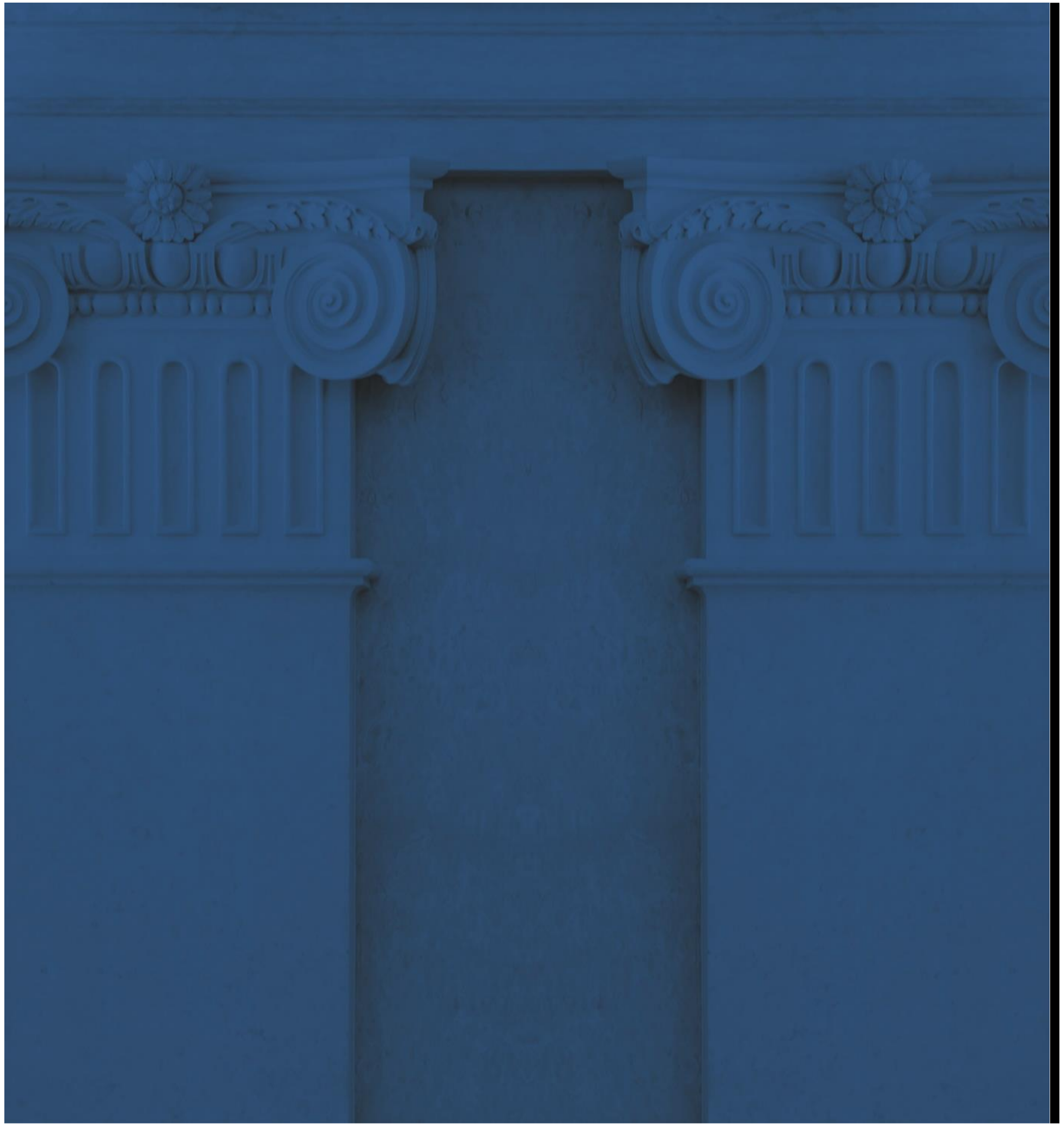


BANCO DE PORTUGAL:

MONETARY POLICY, SUPERVISION AND REGULATION

MÁRIO CENTENO, GOVERNOR

NOVEMBER 2024 | NovaSBE

BANCO DE PORTUGAL
EUROSISTEMA

ROLE IN THE ECONOMY AND SOCIETY

The banking system has a central role in the economy and society:

- Financial intermediation;
- Management and redistribution of risk;
- Facilitation/execution of payments.

Necessary to take into account:

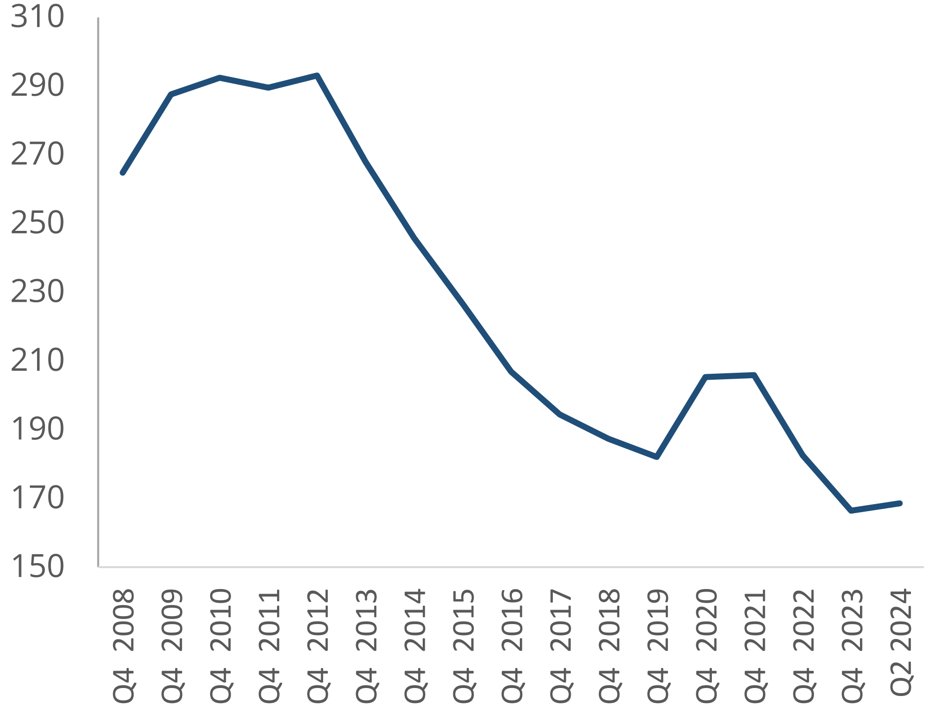
- Liabilities (vg. deposits) with a maturity lower than the assets (vg. credit);
- High interdependence between agents;
- Strong dependence on public trust;
- The existence of market failures and risks to financial stability;
- The need for consumer/borrower protection.

THE VULNERABILITY OF THE BANKING SECTOR TO RISKS AND THE HIGH CAPACITY OF CONTAGION IT CAN PRODUCE REQUIRES IT TO BE SUBJECT TO STRICT **REGULATION** AND CONTINUOUS **SUPERVISION.**

RELEVANCE OF THE SECTOR IN PORTUGAL

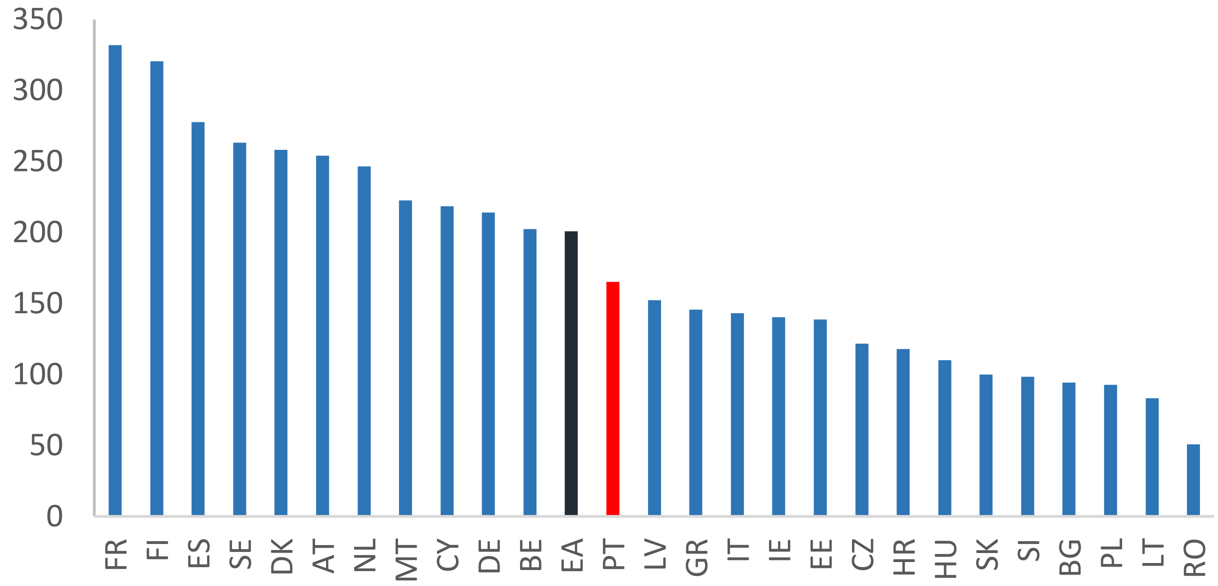
The banking sector has a relevant weight in both the Portuguese and European economies.

Evolution of Portuguese banking system assets as a percentage of GDP



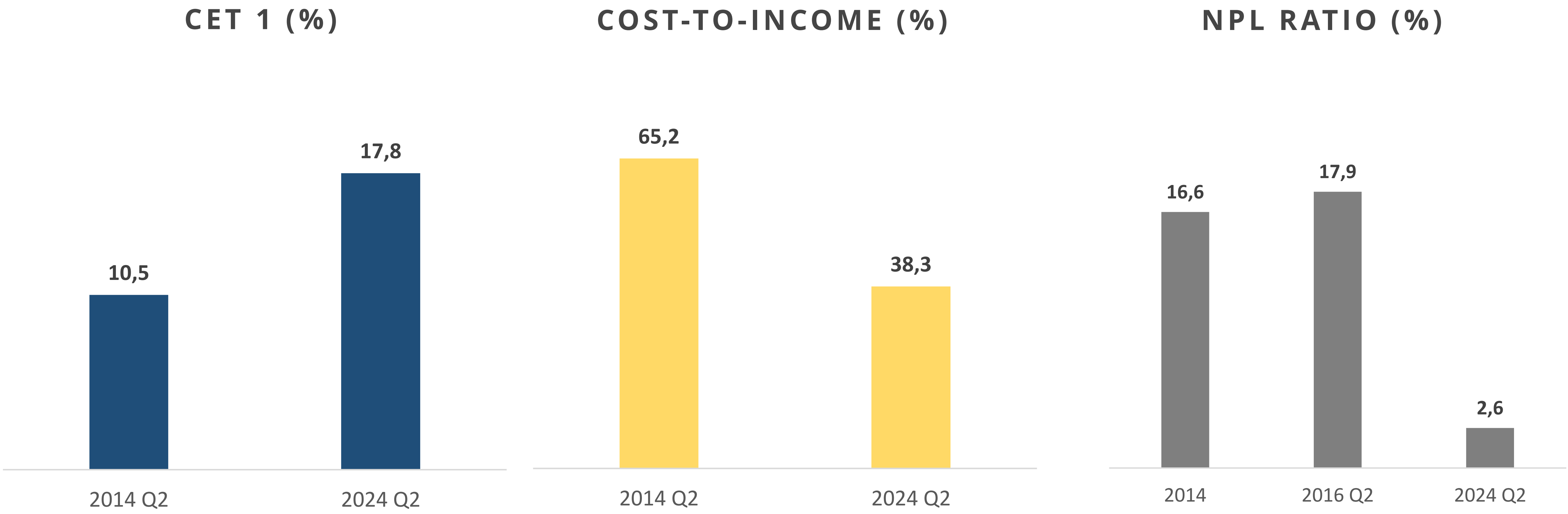
Source: Banco de Portugal

Weight of banking system assets as a percentage of GDP in 2023 (international comparison)



Source: ECB

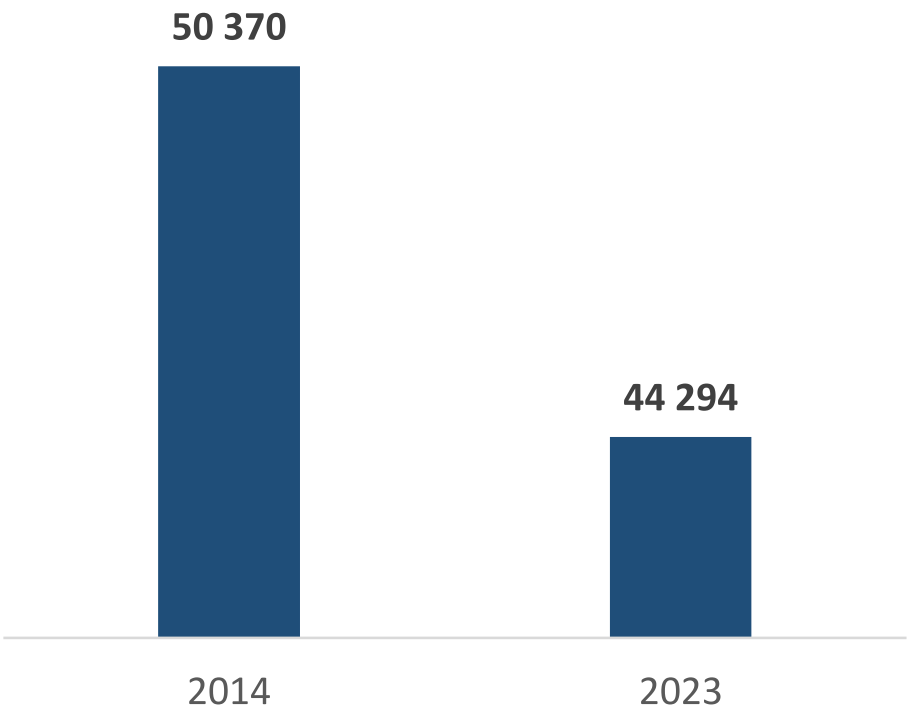
STRUCTURAL TRANSFORMATION OF THE PORTUGUESE BANKING SECTOR



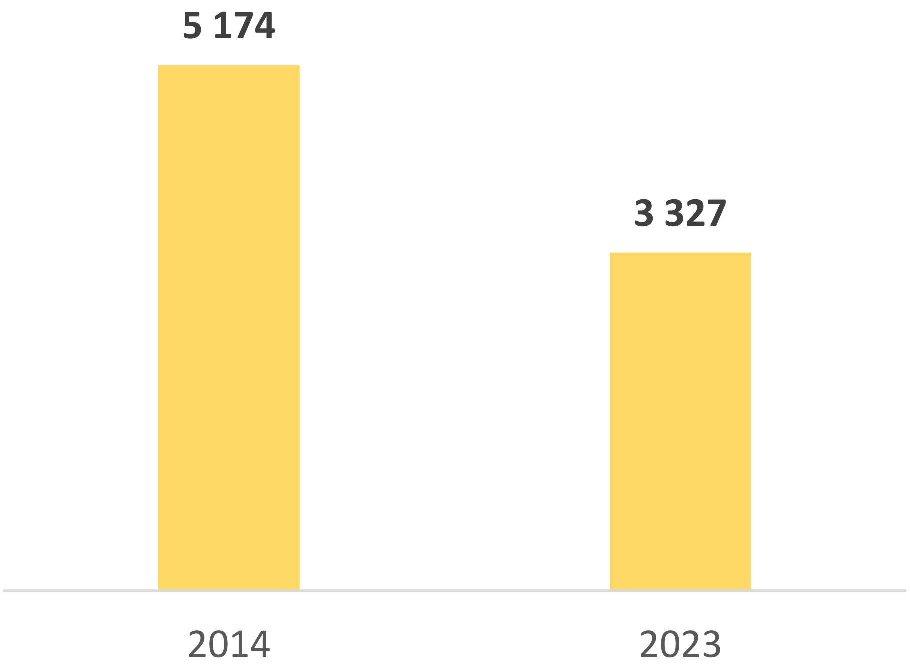
Source: Banco de Portugal

STRUCTURAL TRANSFORMATION OF THE PORTUGUESE BANKING SECTOR

TRABALHADORES

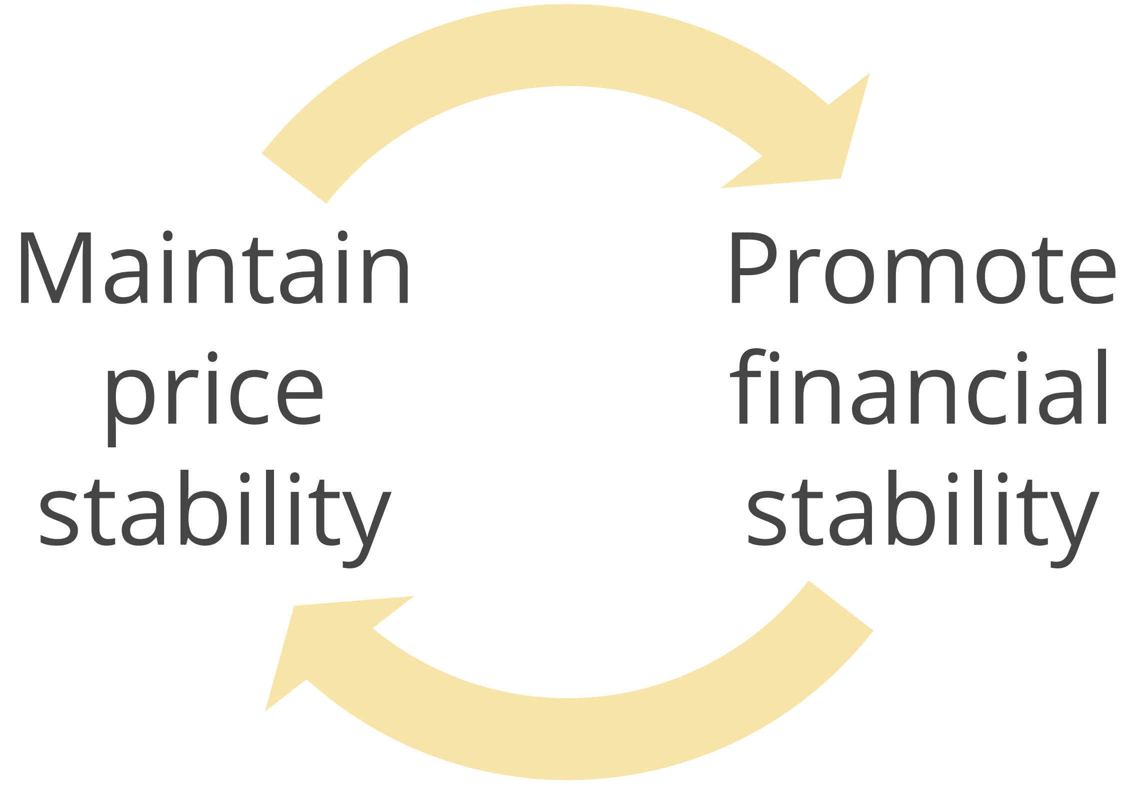


AGÊNCIAS



Source: Banco de Portugal

TWO CORE MISSIONS OF BANCO DE PORTUGAL



MONETARY POLICY PRIMARY OBJECTIVE: PRICE STABILITY

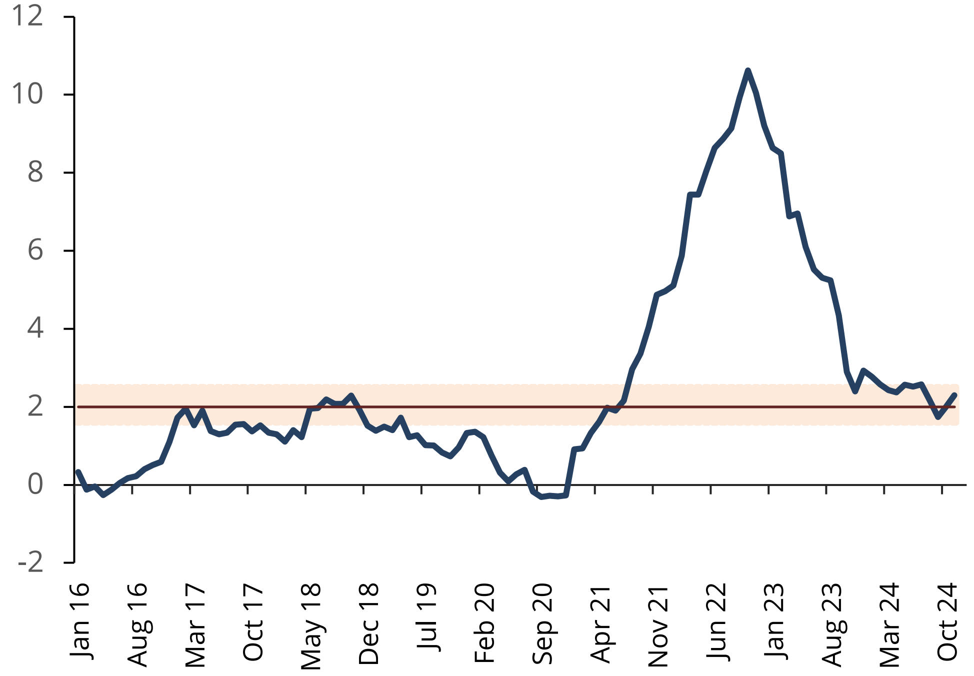
- The Governing Council considers that **price stability is best maintained by aiming for 2% inflation over the medium term**.
- The commitment to the target is symmetric
- Secondary objectives of monetary policy: support the general economic policies in the Union with a view to contributing to the achievement of its objectives
- **Revised Monetary Policy strategy (2021):**
  - Recognition that financial stability is a precondition for price stability
  - Commitment to take into account the implications of climate change and the carbon transition for monetary policy and central banking
  - Communication and interaction with the public

INFLATION HAS CONVERGED

A tall mathematician and a short statistician, both shy, meet in a pub…

- Inflation hit exactly 2% just 18 times in the euro area's 310-month history.
- Hovered within "1.5% - 2.4%" about 42% of the time.
- Now, inflation has settled back into this desirable territory.

HICP – EURO AREA



Source: Eurostat.

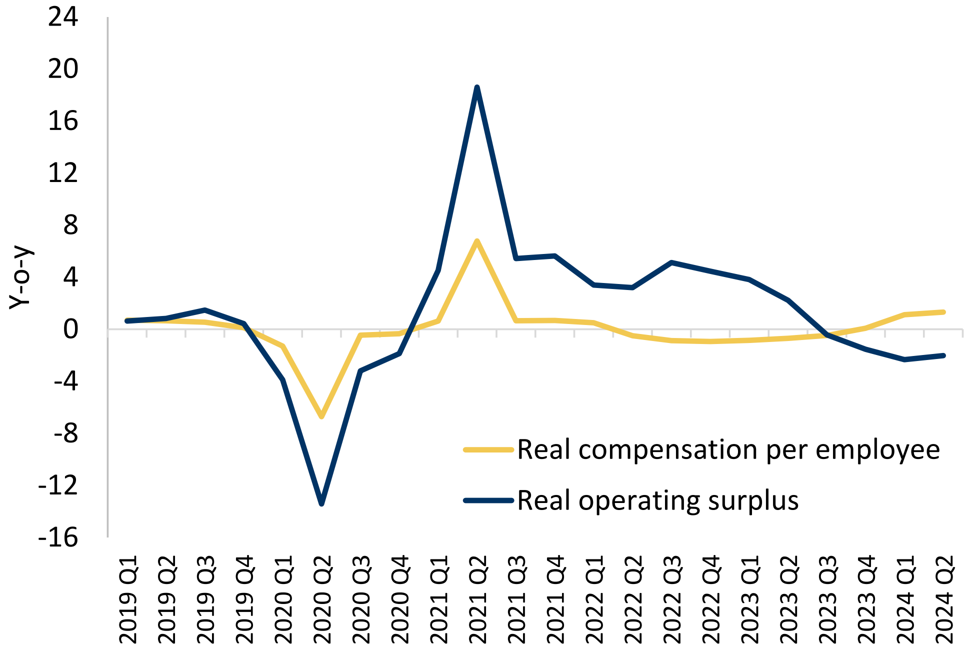
WHY DID INFLATION CONVERGE?

1. MARKETS WORKED EFFICIENTLY, NOTABLY THE LABOR MARKET

Wages and profits: price stabilizers

- Initially, profit margins rose in response to the sharp drop during the pandemic.
- More recently, profit margins have been absorbing the recovery in real wages acting as:
    - a price stabilizer;
    - **a market-based risk-sharing mechanism between employees and employers**.

EURO AREA WAGE AND PROFITS DEVELOPMENTS



Sources: Eurostat and Banco de Portugal calculations.
Note: Data deflated using the GDP deflator.

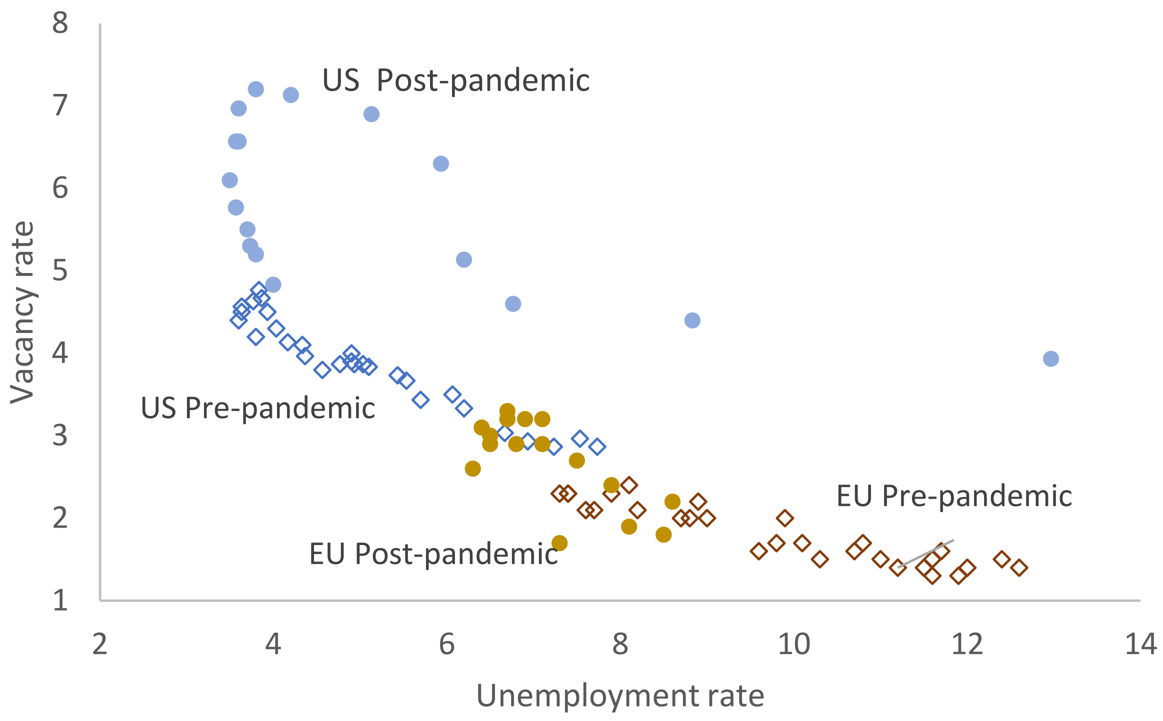
WHY DID INFLATION CONVERGE?

1. MARKETS WORKED EFFICIENTLY, NOTABLY THE LABOR MARKET

Efficient adjustment of the labor market

- Shift in the *composition of employment*:
    - skills, labor market churn, migration, and mobility.
- Shift in the *composition of unemployment*:
    - shorter durations and reduced subsidized spells.
- Increased flexibility in *working hours*

BEVERIDGE CURVE



Source: Eurostat and BLS.

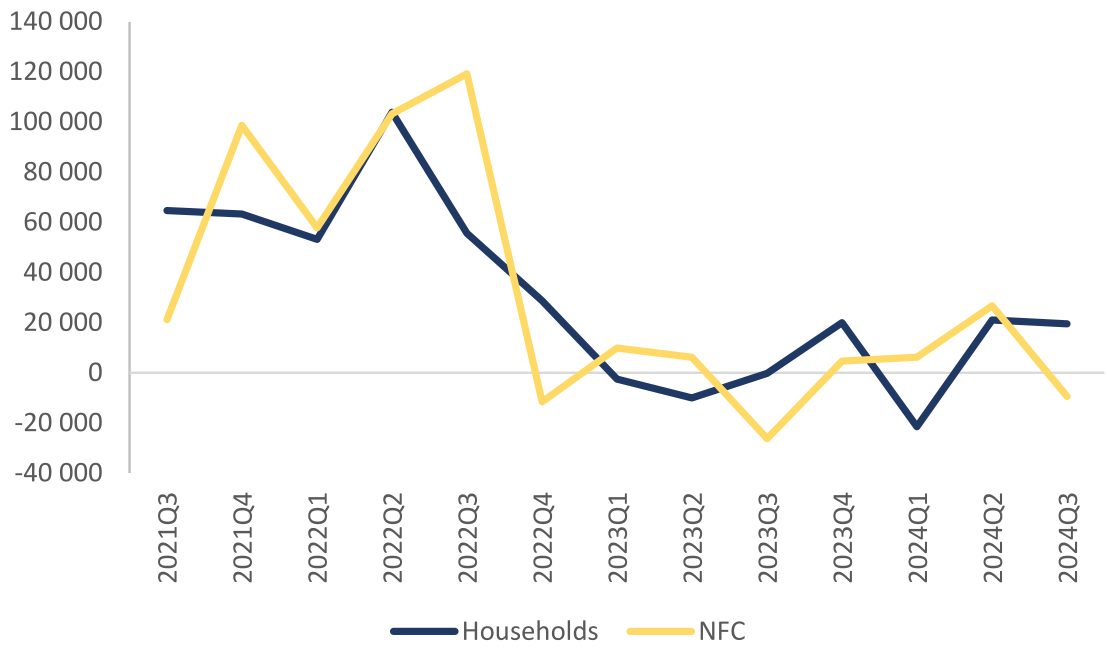
WHY DID INFLATION CONVERGE?

2. MONETARY POLICY TRANSMISSION WAS EFFECTIVE AND FAST

Despite 450 bps hike, no fragmentation

- Credit flows declined (net reductions as early as 2022 Q4).
- Transmission Protection Instrument (July 2022):
  - prevented market fragmentation;
  - preserved financial stability.

CREDIT FLOWS TO HOUSEHOLDS AND NFC



Sources: Eurostat and ECB.

WHY DID INFLATION CONVERGE?

3. FISCAL AND MONETARY POLICIES WERE COORDINATED

- **EA:** Fiscal support contained price pressures and EU programs revitalized the economy
- **US:** Fiscal profligacy
  - 2015 to 2019: -17.3% (EA -5.4%);
  - 2020 to 2023: -38.4% (EA -19.5%);
  - 2015-2023: **30.8 pp difference**
- Government bond markets avoided stress
  - testament to risk reduction observed up until 2019 and first **common debt issuance**

4. SUPPLY-SIDE PRESSURES EASED, AS MARKETS ADJUSTED

- Large manufacturing slack; Low PMIs
  - China industrial base: huge overcapacity, with spillover effects on the world (prospects).

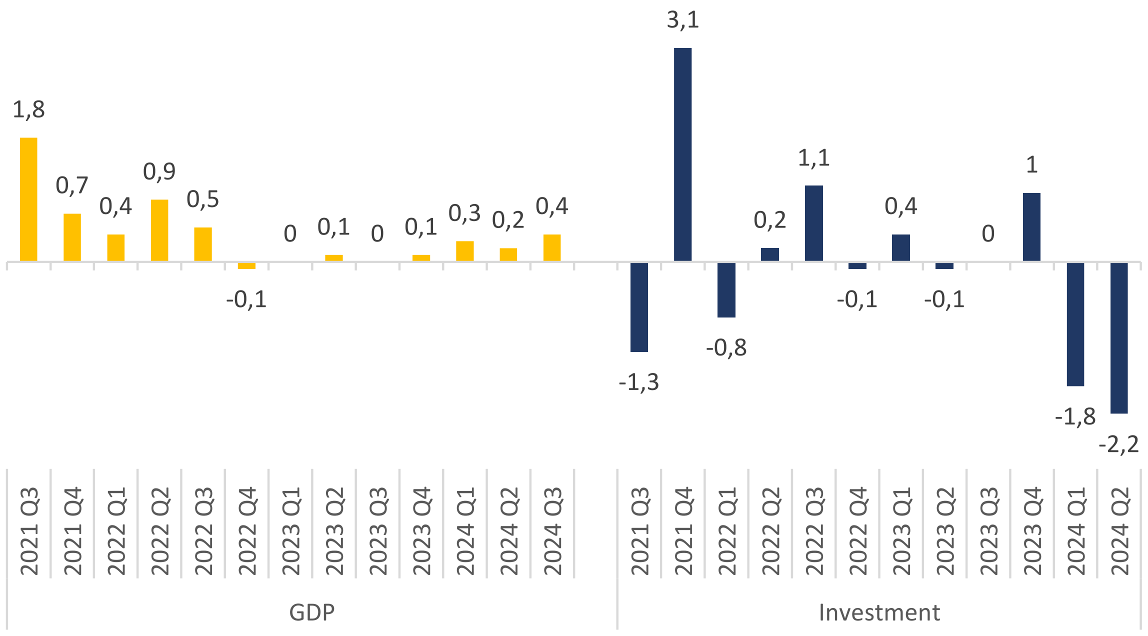
THE EUROPEAN ECONOMY IS NOT INVESTING…

…AND, THEREFORE, NOT GROWING

The sacrifices made by EA economic agents to reduce inflation are evident

- Since the ECB first raised interest rates, EA economy only grew 0.7%.
- **US difference widen** in the post-pandemic
    - 2015-2019: the EA grew 0.6 pp annually below the U.S.
    - 2020-2023: divergence widened to 1.2 pp
    - 2015-2023: cumulative -10.3 pp

GDP AND INVESTMENT | Q-Q %



Source: Eurostat. Note: 2024 Q3 Flash estimate.

RISKS AHEAD

UNDERSHOOTING TARGET INFLATION COULD STIFLE ECONOMIC GROWTH

Endogenous sources of risks to projections:

- Stronger monetary policy transmission;
- Consumers: low confidence and high savings

Labor market resilience faltering since 2022 Q2:

- Recent job starters fell 10,7%;
- Job vacancies declined 21%;

China and global trade could once again exert deflationary pressures

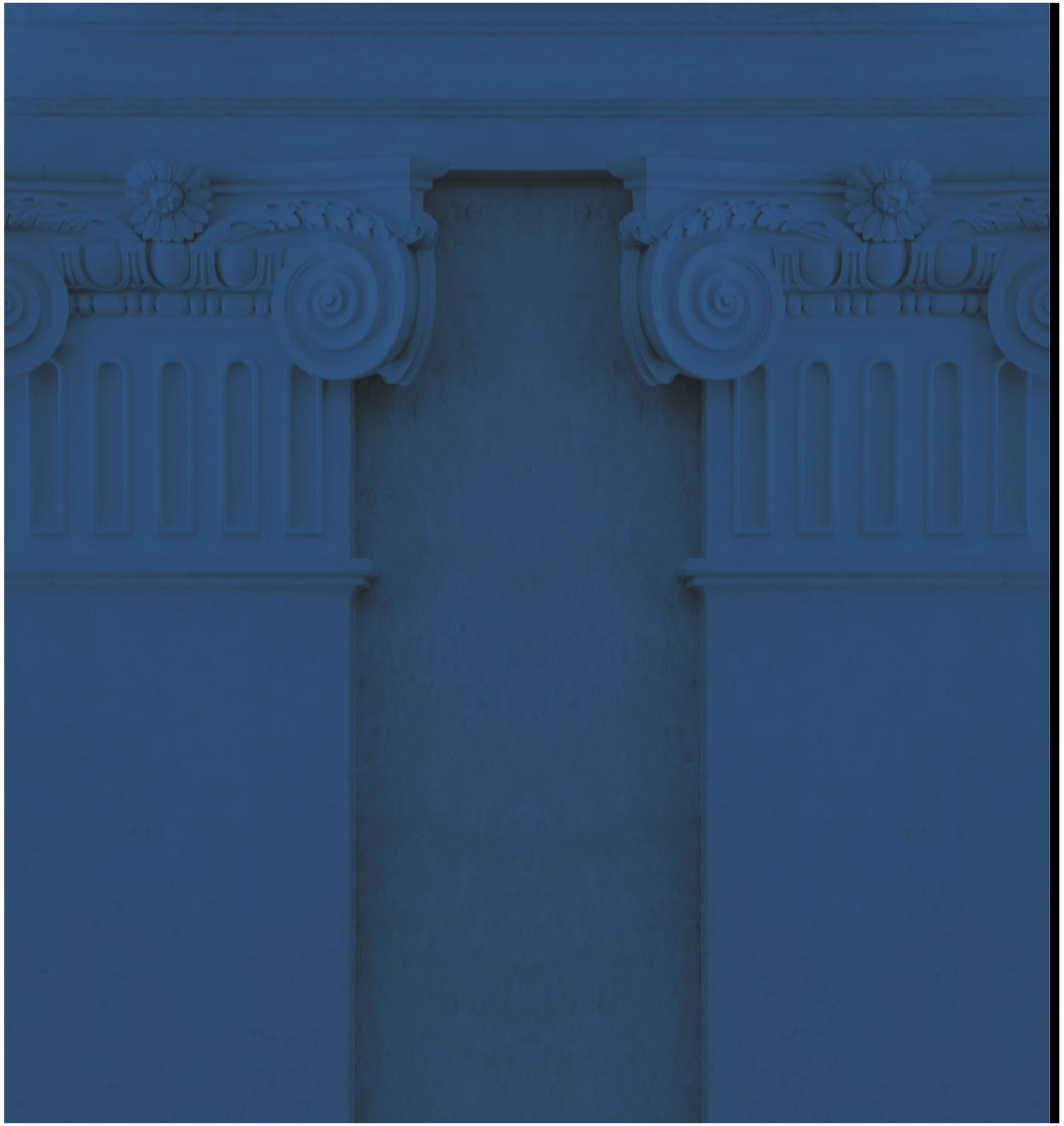
Without growth, employment or wages will have to adjust; vicious cycle.

It's on us, policy makers!

THE POLICY RESPONSE

TO FOSTER CONFIDENCE AMONG INVESTORS AND CONSUMERS

- Continue to **generate fiscal space** for the future; countercyclical
    - 2015-2023: **US public debt** +20.2 pp; EA -4.9 pp
        - Euro: window of opportunity as a currency of reference
- **Tackle trade disruptions and protectionism**
- **Improve the institutional landscape**
    - Banking Union and Capital Markets Union, to channel EU savings into investments in climate and digital transition; common debt
- Redevelop a **culture of risk taking**, lost during the financial and sovereign debt crisis
- Monetary policy:
    - gradual, steady, and predictable **reduction in interest rates to their neutral level**



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