Financial stress in euro area: implications for real economy, monetary policy, and financial integration

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Abstract

The problem of financial stress has been largely underestimated prior to the global financial crisis. The post-crisis years, on the other hand, saw high interest in the financial stress as important determinant of macroeconomic situation and monetary policy stance. Financial stress during the global financial crisis and the European debt crisis might have also affected negatively the financial integration in the euro area which is crucial for the effective transmission of the ECB monetary policy stance. Further, the impact of the stress might also change depending on the stress level: being highest in high-stress environment, gradually building-up to the crisis, and extending strong impact even after the stress levels go down. Thus, this paper employs time-varying parameter VAR (TVP-VAR) model to analyse the changes in an impact of the financial stress on the macroeconomic variables, monetary policy stance, and financial integration in the euro area over the time. Comparison of the influence at pre-crisis, financial crisis, debt crisis, and post-crisis time reveals that financial stress indeed extends higher impact during the high-stress crisis periods, and that for output this heightened impact does not disappear even when the financial stress already subsides after a high-stress experience. Monetary policy stance eases after increase in the financial stress, with the highest response at the time of the crisis. In case of the measures affecting size of the central bank balance sheet, the increased sensitivity lasts even after the stress diminishes. Finally, the financial integration does indeed fall due to increase in the financial stress and for some measures the impact stays high even in the lower-stress post-crisis environment. On the whole, the results confirm the need for risk monitoring and institutional framework to prevent episodes of extremely high stress that are being implemented in the euro area at the moment.