



Resilience and Stability? Setting the course for the banking and financial system during the Corona virus pandemic

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- › Since the global financial crisis of 2008/2009, there has been no challenge to the financial and banking system comparable to that during the Corona crisis.
- › Weak profitability, unresolved regulatory challenges and increasing competition in the digital sector pose further challenges for banks.
- › The stability of the financial system and access to financial markets was not at risk during the pandemic. Through joint efforts and better bank capitalisation, the financial system is now more resilient than during the financial crisis.
- › Provided that grants and loans in the “next generation EU” fund are well targeted for structural reforms and investments in the future, this should boost confidence and growth.
- › However, further improvements in financial stability, such as increased capital requirements, regulation of shadow banks or reforms in financial supervision, are needed.

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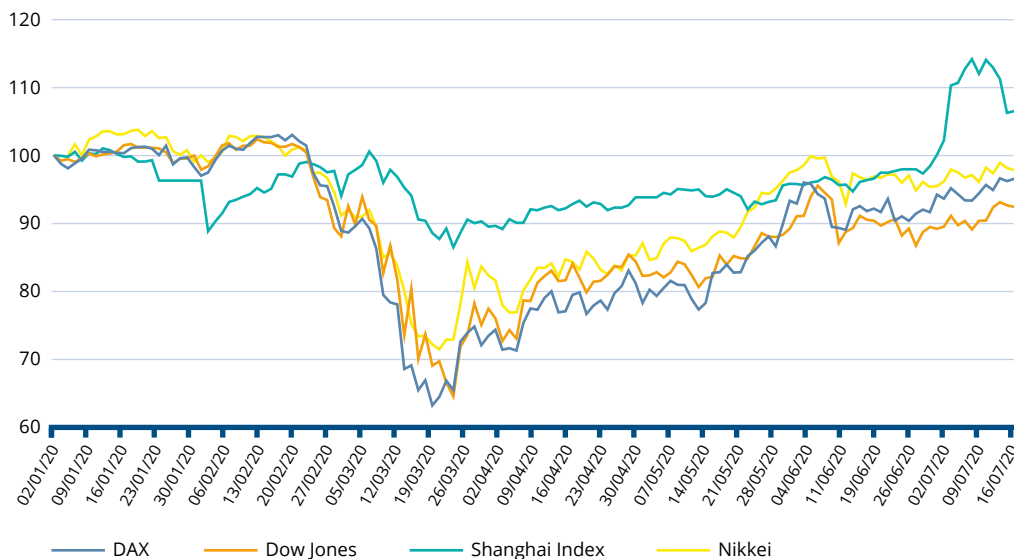
1. Stimulus point

The SARS-CoV-2 pandemic represents the biggest test for the financial and banking system since the global financial market crisis in 2008–2009. The pandemic is causing an extraordinary macroeconomic shock, plunging the global economy into a recession of uncertain size and duration.¹ In this respect, the global financial system faces a double challenge: the flow of credit must be maintained while at the same time financial stability must be safeguarded in the face of increased risks.

The global shock put considerable pressure on the financial system in March and April 2020 (Chart 1). In March, stock markets recorded the fastest decline in financial market history. The DAX, Dow Jones, and Nikkei fell about 20 percent from their highs in just 16 trading days. However, the fall in share prices was only half of the level seen prior to the global financial market crisis. The financial markets were able to recover quickly from the losses, particularly due to proactive monetary and fiscal policy measures.

Despite the fall in share prices, the financial markets recovered quickly thanks to proactive measures.

Figure 1: Development of lead markets



Source: personal calculation.

On the one hand, the increased risk aversion (Figure 3) led to a shift towards short-term and safe assets. On the other hand, credit risks increased (Figure 5) as private and public debt accumulates to new record levels.

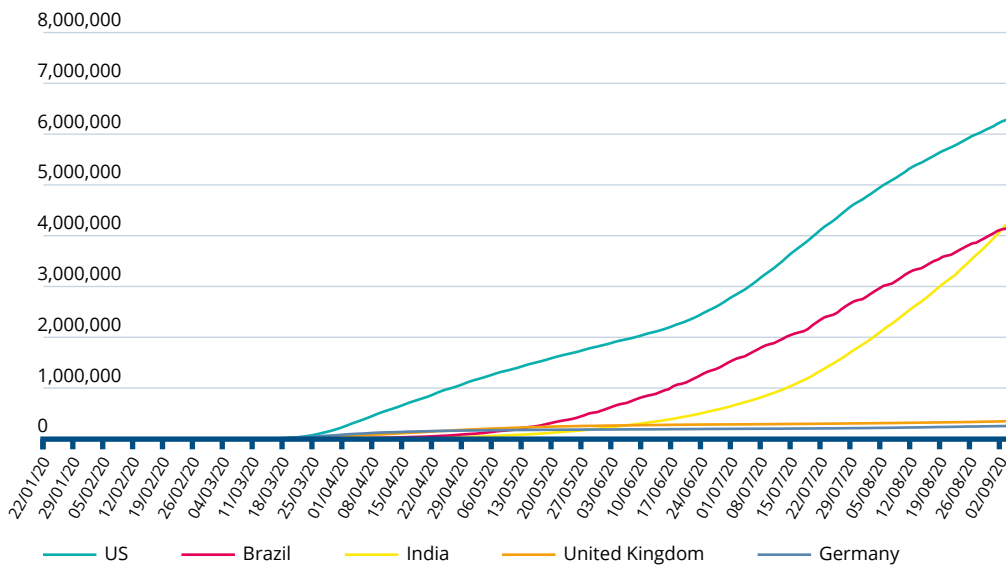
As a result of global efforts, in particular the G20 regulatory reforms, the financial system is now more resilient and better able to sustain the financing of the real economy. In particular, the major banks that are key to the financial system have greater resilience and are largely able to absorb the shock. The core of the global financial market reforms is showing the first positive effects, as there are currently low risks to financial stability despite high uncertainty. The increase in capital requirements for banks (Basel III) and the establishment of central counterparties (CCPs) have contributed to this in particular.² The CCPs ensure that a chain reaction on the derivatives market is minimised despite high uncertainty.

Global efforts have increased the resilience of the financial system.

However, fiscal and monetary policy had to adopt a wide range of measures to ensure the supply of credit to the real economy and financial stability. The measures taken have been resolutely implemented worldwide, including in Europe (Table 1). The large volumes of liquidity provided by the central banks was able to mitigate the initial shock and stabilise the situation with regard to financial markets.

Nevertheless, the extent and duration of the pandemic cannot be estimated at present. The current uncertainty is reflected in the still very dynamic (second) Corona infection rate (Figure 2). The largest increase in COVID-19 cases in August 2020 is lasting proof that we still have a fragile situation in the pandemic and in the real and financial economy. Containing the pandemic remains a top priority, because in medical terms the second wave of a pandemic is ultimately deadlier.³ In international comparison, the German government has so far succeeded in slowing down the pandemic using the slogan “Flatten the Curve”(Figure 2).

Figure 2: COVID-19 case numbers



Source: Data from Johns-Hopkins-Last updated 08/09/2020.

2. Spotlight: Global financial stability

In the short term, the pandemic has led to a re-evaluation on the global financial markets. The expected decline in economic growth and increased uncertainty about future developments contributed to extreme volatility in spring 2020 (Figure 3). During the European lockdown, this financial metric reached an historic level of over 80 points. Since April, a normalisation has been observed. Unlike in 2008, the banking system has so far been resilient.

Figure 3: Volatility index

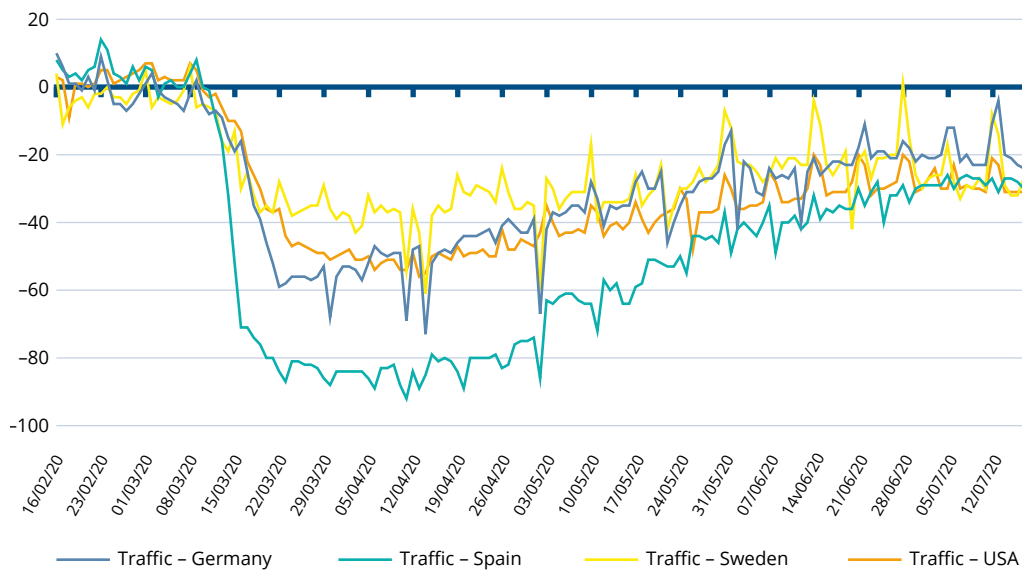


Source: Factset data.

The pandemic is an unprecedented challenge for many sectors of the economy, particularly tourism, transport, the automotive industry and local services. Moreover, the economy has been weakened by the trend towards de-globalisation (protectionism) that has been apparent for some years. The shutdown and fear of contagion have virtually paralysed the networks in the global economy. This is particularly evident in the extraordinary decline in mobility (Figure 4).

The effects of the coronavirus pandemic and the trend towards de-globalisation have weakened mobility.

Figure 4: Mobility data "traffic"(as a percent)

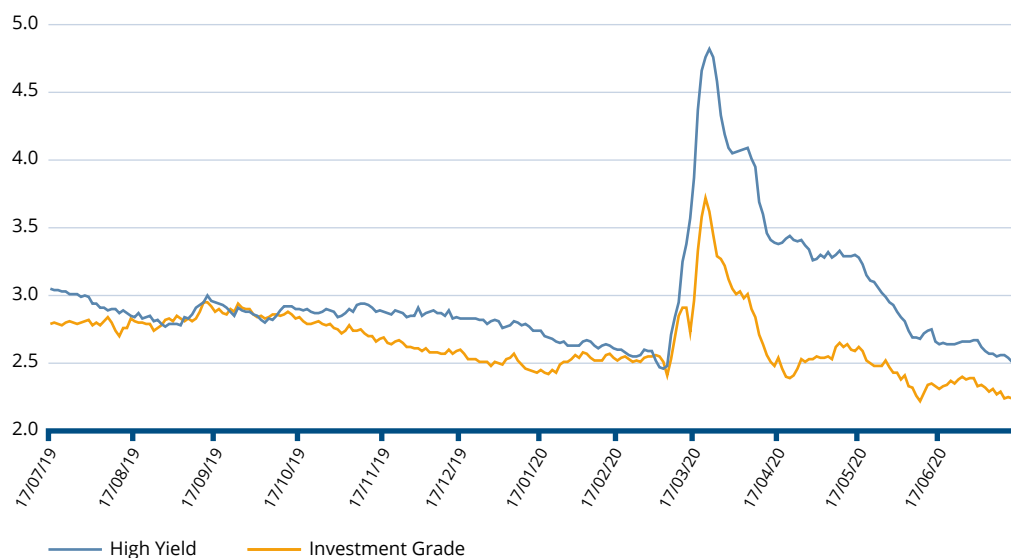


Source: Google data.

While the decline in mobility in Germany and the US was between 40 and 60 percent, mobility in Sweden also declined, despite a pandemic strategy without a lockdown. However, as Sweden did not impose wearing of masks, closing schools and shops, the Swedish mortality rate in relation to the population is high. The strict lockdown in Spain reduced mobility by up to 90 percent.

In this respect, rapid lending to the real economy is essential to stabilise confidence in firms and households (Figure 5). However, one risk of these stabilisation measures is that corporate, household and public sector debt will raise. Although debt has been virtually constant over the past ten years, the data at the current level – even before the outbreak of the pandemic – are already pointing upwards. With the fiscal policy measures to combat the pandemic, public debt is likely to increase significantly and exceed the level after the financial market crisis.

Figure 5: Interest rates for corporate bonds



Source: Factset data.

Fortunately, banks are better capitalised and less indebted than in 2008–2009 during the global financial market crisis. Moreover, the degree of diversification is higher and the risky financial products are much more transparent. However, the concentration in the international banking sector increased after the financial market crisis. The “too-big-to-fail”, or rather “too-big-to-rescue” problem is still virulent, despite global reform efforts.

In addition, financial intermediaries are facing growing challenges. Banks must cope with increasing credit risks as credit quality deteriorates when the global economy enters a prolonged recession. This risk is real, as the US has been the economic engine most affected by the pandemic so far and de-globalisation is gaining momentum worldwide. The latter could trigger a negative credit assessment with rating downgrades of companies and a wave of insolvencies. At the same time, banks have for years been subject to growing pressure on margins with declining profitability due to the zero interest rates, especially in the euro zone.

The weak profitability creates the risk that banks are not truly resilient and develop an excessive risk appetite – known as zombie banks. The banks are trying to compensate for the low revenues through expenditure cuts. One study concludes that bank margins remain under pressure in the post-corona phase.⁴ The future profitability of banks will likely stay low as credit costs and default risks are expected to rise.

Equally unresolved are the regulatory challenges in the area of shadow banks. Increasing competition from digitalised banking, such as Fintech’s, is likely to accelerate the transfer of risk from commercial banks to shadow banks.⁵ Another weakness for financial market stability could be the pandemic-related regulation of distance and short-time work. The implementation of complex contingency plans requires coordination between banks and regulators, which is difficult with a limited and decentralised staff. The risk of cyber attacks is not negligible, as private networks are less secure.

One current estimate of reserves under the Basel III regulation shows that the global liquidity and capital buffers of banks at the end of 2019, the “CET1” share (Common Equity Tier 1), amounted to 14 percent.⁶ The authors come to the conclusion that in the worst case the

The financial system continues to face many challenges. Weak profitability weakens the resilience of banks.

Regulatory challenges still exist and some of them remain unresolved.

share could fall to 6.5 per cent or 270 billion US dollars. This would be insufficient to cushion a deep economic crisis. In short, there is still a threat to financial stability, despite considerable global reform efforts in the last decade.

3. Omnipotence of central banks

In response to the looming recession and the threats to financial stability, central banks have expanded their liquidity programmes and established new unconventional bond purchase programmes. Assessment of these acute measures is still pending, as the impact on the real economy is not foreseeable until the coming months. Monetary policy is always an endogenous catalyst or stabiliser in financial markets.

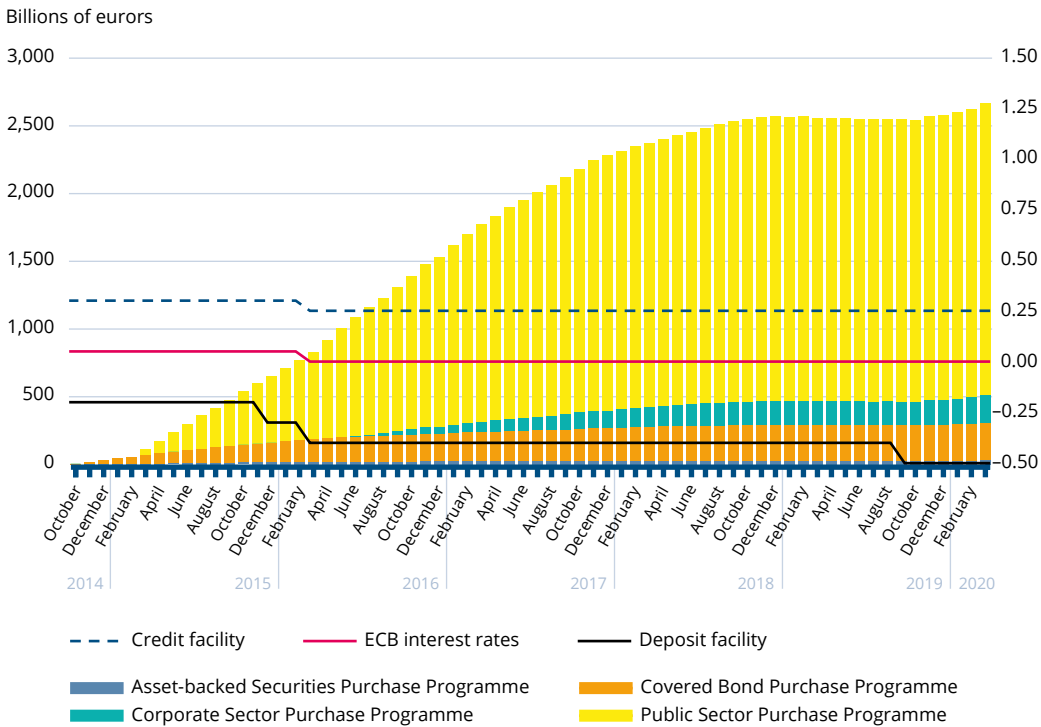
What is certain is that the pandemic will lead to a significant change in economic growth. The global growth forecast for 2020 has been downgraded from +3.3 percent to -3.0 percent. There is even a 5 percent probability that growth will fall below -7.4 percent. This means that the downside risks have become much more significant.

The worldwide action of monetary and fiscal policy was the first line of defence against the initial corona shock. These measures were necessary to ensure that the temporary shutdown would not lead to a permanent damage of the economy. Since 2015, the massive liquidity expansion of the PSPP purchase programme of the European Central Bank (ECB) has cumulated to over 2.7 trillion euros (Figure 6 – left scale). At the same time, the ECB's main refinancing interest rate has been at zero percent for years and the deposit rate is even negative, currently at -0.5 percent (Figure 6 – right scale).

Since the global financial market crisis of 2008–2009, monetary policy has been in an exceptional modus operandi. In the three thousand year history of money, there has never been so much excess liquidity and cheap money in the financial and economic system. Even experts and scholars in monetary theory are currently unable to assess the medium and long-term consequences of this omnipresent and omnipotent central bank policy.

The global and proactive action of monetary and fiscal policy has slowed the first shock wave.

Figure 6: ECB purchasing programmes and key interest rates



Source: ECB data.

Nevertheless, there are worrying signs.⁷ The much-discussed monetary exit from ultra-expansive monetary policy, although urgently needed, is again being delayed by the corona pandemic. How can the ECB succeed in unwinding the European bank-based financial system from the “drug” of cheap money?

Despite the decade of ultra-expansive monetary policy, the ECB adopted further purchase programmes and liquidity measures in March and April 2020. One was the even more flexible bond purchase programme PEPP with a total volume of 1.35 trillion euros. Another example involves the T-LTRO III and PELTRO, which provide high liquidity volumes to commercial banks and the real economy.⁸

The political transgression of the ECB is particularly dangerous.⁹ This can be seen in the implementation of large-volume bond purchase programmes to guarantee the political unity of the euro zone. Moreover, it is apparent in unusual statements by the ECB president that “climate change and environmental protection are central to every institution” and that the ECB must take climate change into account in its work.¹⁰ In doing so, the ECB fails to recognise that its primary objective in Article 127 TFEU is to achieve price stability.

The data show that the purchase programmes and the negative interest rate have economic and fiscal side-effects, including asset bubbles and increasing wealth inequality.¹¹ The consequences of a creeping or disruptive erosion of confidence in our modern monetary system would be the ultimate disaster.

The ECB is in focus with its purchasing programmes and statements on climate change and environmental protection.

Table 1: International comparison

	Eurozone	USA	Japan	China
Monetary Policy				
Rate Cuts	0 Bp.	-150 Bp.	0 Bp.	-30 Bp.
Purchase programmes	Yes	Yes	Yes	Yes
Fiscal Policy				
Stimulus packages	Yes	Yes	Yes	Yes
Public Guarantee for Loans	Yes	No	Yes	Yes
Restructing programmes	Yes	Yes	Yes	Yes
Financial Regulation				
Countercyclical Capital Buffers	Yes	No	No	No
Systemic Capital Buffers	Yes	Yes	Yes	No
Liquidity Buffers	Yes	Yes	Yes	Yes

Quelle: Tabelle 1.1 in IMF-Report (2020). Bp. = basis points.

A comparative assessment of current monetary and fiscal policy instruments shows that the eurozone has been ultra-proactive, as outlined above, although the automatic stabilisers in the eurozone are the most prominent in the world (Table 1). This policy will at best help to end the economic crisis quickly, provided that the pandemic can be controlled in a timely manner with a drug or vaccine. If the latter fails, the courageous policy measures could fizzle out. What would remain would be a historically high level of debt, inflation, unstable banks and unemployment.

Against the background of this gloomy outlook, it was necessary to reach agreement in July on the multiannual EU budget and the "Next Generation EU" fund with first-time European debt. Provided that grants and loans are targeted at structural reforms and investments in the future, this should provide a boost to confidence and growth.¹² However, the Fund does have risks:¹³

1. Economic policy remains in the sovereignty and control of the Member States. In this respect, the Member States are responsible for any developments in the economy or the health system. A new mix of liability and control is likely to further intensify the moral hazard issue that exists today in the eurozone.¹⁴
2. Monetary and fiscal policy have merely a short-term effect. Liquidity can only buy time for political reforms.
3. The stability of the financial system and access to financial markets was not at risk during the pandemic. All the prophecies of doom are not empirically verifiable, as long-term spreads in 2020 are almost unchanged compared to 2011–12.¹⁵ The risk of fragmentation of the eurozone is currently not apparent, especially as the longer-term financing conditions of Italy are at a historically low level (comparable to the US).

Grants and loans must be targeted towards structural reforms and investment in the future.

4. Policy Recommendations

All in all, the financial system is more resilient today than it was ten years ago. The available capital and liquidity buffers have helped to stabilise the economy and financial markets. However, reform efforts in financial and banking regulation need to be further intensified, especially for shadow banks. In particular, it is advisable to increase capital reserves according to current scientific studies.¹⁶ Moreover, the regulatory privilege of government bonds in the European context, which has long been called for by the German Council of Economic Experts, must be abolished.¹⁷ Despite the postponement of the final stage of Basel III until 2023, the implementation of the framework on market risks, in particular the output floor of 72.5 percent and the Pillar 3 disclosure requirements, should take place promptly.

Furthermore, there is a need for action in the area of financial oversight: first, regulatory capital planning and stress testing should be expanded through prolonged periods of liquidity drought. The binding strengthening of business models needs to be closely monitored by regulators. Second, macroprudential regulation must become bolder in good times – i. e. higher countercyclical capital buffers. Third, the supervisory authority must keep an eye on the “too-big-to-fail” problem and pay attention to the competitiveness of banks. Supervisors should remain vigilant to limit excessive accumulation of risk through arbitrage of existing rules.

In addition to the further implementation of Basel III, there is a need for action in financial supervision. The “too-big-to-fail” problem also remains on the agenda.

5. Conclusion

The next banking or financial market crisis is unlikely to occur in the areas highlighted. Rather, macroeconomic factors, including weak economic growth, high debt and low competitiveness, and monetary factors are expected to lead to a loss of confidence in the stability of the monetary and economic systems. In this context, the European Monetary Union and its Member States are per se more vulnerable and at risk.¹⁸ As such, the deepening of the rule-based monetary union with strict conditionality, or a “political union”, is still necessary.

Numerous personalities, including Karl Valentin, Mark Twain, Niels Bohr, Kurt Tucholsky and Winston Churchill, recognised that “forecasts are difficult, especially when they concern the future”. Nevertheless: politicians and business leaders should attribute more importance to the macroeconomic situation – especially in crises that occur at ever shorter and more regular intervals - and establish precautionary strategies for the future now.¹⁹

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Impressum

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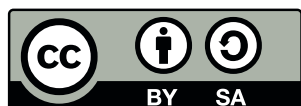
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