EUROFI VIEWS MAGAZINE - BERLIN SEPTEMBER 2020

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After the Covid shock, treading carefully and drawing the necessary lessons

Several months into the pandemic, we are still grappling with its consequences: speaking of a "post-Covid" world is premature. The public health dimension is and will remain front and center in the near term. As for the economic outlook, the worst may be over but the speed and extent of the recovery remain uncertain and the economic and social consequences of the pandemic will remain with us for quite some time (when they have already surfaced yet).

So far, potential threats to global and European financial stability remain under control. Two factors proved decisive so far for navigating this stormy sea. First, the banking sector held up, providing a clear vindication of the reforms introduced in response to the global financial crisis, and allowing it to contribute to the support of the real economy. Second, swift, simultaneous and massive measures taken by economic and financial policy makers have helped dampen the shock to the real economy and maintain the stability of the financial system as a whole.

Yet, we are not out of rough waters. The current circumstances call for remaining cautious in the near term, executing a balanced exit strategy over the medium term and addressing longer term challenges.

In the near term, the strong improvement in sentiment and associated markets rally call for caution. While a positive development in itself, it raises the probability of a disconnection between asset prices and underlying economic conditions. Managing market sentiment is elusive, especially in such uncertain times. But reining in excessive risk-taking and being prepared for the possibility of a market correction will be key to ensure financial stability.

Current geopolitical risks only compound these concerns. Now that uncertainty around the Brexit timeline has been lifted, all stakeholders must finalize their preparation to smoothly get past the end of the transition period or collectively face a renewed risk of market stress in an environment already weakened by the Covid.

Massive public support has provided essential protection to households and firms. A decisive and most welcome step forward has also been taken at the EU level with the European Commission's Next Generation EU proposal, which should strengthen the EU's economic stability by introducing a mechanism for fiscal solidarity between State members critically lacking until now. Both –public support and fiscal solidarity- were and are still necessary but should not give way to complacency vis à vis the need to tame –in due time- fiscal spending to ensure fiscal sustainability.

Public support needs indeed to be carefully managed and eventually phased out in order to avoid backfiring to the real economy through worsening financial conditions. At a later stage (but sooner rather than later), refilling the buffers that helped cushion the shock in the banking sector will be necessary to ensure that the banking system remains part of the solution to ensure the recovery of our economies.

Finally, "pre-Covid" longer term developments and associated risks need more than ever to be addressed.

At the top of the list lies high levels of debt, and leverage, which exacerbate risks. Despite public support, an upturn in corporate insolvency risk and bankruptcies could weaken banks' balance sheets and weigh on the credit supply the recovery depends upon. Accordingly, negative shocks to households' income would increase the weight of debt service, resulting in slacker consumption and, in more extreme scenarios, greater credit risk. The "post-Covid" recovery will have to avoid overreliance on debt fueled growth and the associated build up in vulnerabilities.

In addition, the stress in a number of core markets in March laid bare the vulnerabilities of market based financial intermediation. It only receded thanks to massive central banks' interventions and highlighted tensions between individually legitimate actions (e.g. MMF seeking to strengthen their own liquidity position) and their destabilizing consequences (exacerbated liquidity stress for other stakeholders, including banks and corporates). A much more comprehensive macroprudential framework is long overdue to effectively underpin financial stability.

Finally, the massive scaling up of remote working brought about by the pandemic heralds an acceleration in the digital transformation of the overall economy. For the financial sector, it entails major challenges to business models' , exacerbates cyber-risks and requires major investments going forward. Similarly, the pandemic shock is a foretaste of what is just around the corner if climate change is left unchecked.

Not only banks and other financial institutions should proactively adjust to the low carbon transition and brace for adverse physical risks likely to materialize even in a 2°C world but, just as they did in this crisis, they should aim for being a decisive part of the solution. ●