KEY FINANCIAL SECTOR VULNERABILITIES

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Financial stability implications of Covid-19 support measures

During the first phase of the pandemic a liquidity crisis was avoided, and the financial system continued to function. Up to one-third of new bank lending to companies has been subject to crisis-related fiscal measures, and the prompt action taken by governments has been essential to mitigate the impact of the crisis on households and firms. The financial system has benefited from fiscal support programmes as well as from monetary policy. Moreover, a flexible approach within the existing regulatory frameworks has supported these measures, also by temporarily relaxing some bank balance sheets constraints. Overall, spillovers from the real economy to the financial system have so far been contained.

Differences in fiscal measures reflect, to a large extent, different exposures to the pandemic. Countries hit harder by the pandemic tend to have larger programmes with greater uptake, while countries with a higher share of employment in vulnerable sectors rely more on direct grants. The uptake of moratoria is positively correlated with the pre-crisis debt levels of non-financial corporations and households. Macroprudential authorities reported fiscal support packages related to the COVID-19 pandemic of around 14% of member countries' combined GDP (more than €2,400 billion) to the European Systemic Risk Board (ESRB).

The packages include public guarantees on loans, public loans, direct grants and tax measures. By September 2020, the reported uptake of these programmes was roughly 4% of member countries' combined GDP. In addition, around 5% of banks' total loans were subject to moratoria.

Authorities need to carefully manage the trade-offs related to the duration of the support measures.

The longer the crisis lasts and the weaker the economic recovery, the greater the risk that liquidity problems turn into solvency issues and losses in the non-financial sector spill over into the financial sector. During this phase of the pandemic, authorities should focus on (i) targeting fiscal measures to the most affected sectors, (ii) monitoring private debt sustainability, given that some of the measures increase the indebtedness of borrowers, (iii) preparing for a scenario of increased distress in the corporate sector by promptly addressing potential administrative constraints with regard to dealing with non-performing loans and restructuring and insolvency processes, (iv) enhancing financial institutions' balance sheet transparency and upgrading reporting, and (v) coordinating policies across policy areas and countries.

Authorities need to carefully manage the trade-offs related to the duration of the support measures. The scale of potential future solvency problems depends on the evolution of the pandemic, the performance of the different sectors and the appropriateness of policy responses. Withdrawing fiscal support too soon could exacerbate the effects of the economic crisis and put financial stability at risk. Maintaining fiscal support for too long would increase budgetary pressures and could delay structural change and subsequent recovery. Managing this trade-off effectively requires access to timely and reliable information on the state of the economy and the effects of policy measures.

To provide authorities with accurate information, the European Systemic Risk Board is continuously monitoring COVID-19 related fiscal measures and their financial stability implications.[1] It has a broad mandate, which includes the monitoring and prevention of all risks affecting all types of financial intermediaries, markets and infrastructure. It is in this context that the ESRB considers the overall implications – and in particular the cross-border and cross-sectoral implications – of the COVID-19 crisis.

The ESRB is monitoring the measures that are implemented directly through the financial system, such as moratoria, public guarantees on loans and credit insurance, as well as measures of a fiscal nature that could have an impact on the creditworthiness of borrowers, issuers and investors. These include loans by public entities, direct grants, tax measures and public equity participation.

1. See Financial stability implications of support measures to protect the real economy from the COVID-19 pandemic, ESRB, February 2021; and Recommendation of the ESRB on monitoring the financial stability implications of measures of a fiscal nature taken to protect the real economy in response to the COVID-19 pandemic (ESRB/2020/8).

BORIS VUJČIĆ
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Escaping the paradox of thrift in the liquidity trap

The Covid-19 pandemic induced an unpreceded shock to European economies at a time when Europe was already concerned about secular stagnation issues. When the pandemic hit, the conventional monetary policy transmission mechanism was out of order and the monetary policy framework focus was already shifted to unconventional policy measures which expanded the ECB's balance sheet.

While the efficacy of these measures is still being debated, many empirical studies found evidence that reliance on non-standard instruments helped to escape the liquidity trap in the past. It is therefore not surprising that the initial phase of the current crisis was characterized by a massive expansion of the ECB's balance sheet, which helped stabilize financial markets. This, in combination with a strong fiscal response, saved labour markets and businesses from crashing down.

Still, the ECB's success during the first wave of the pandemic confirmed the side effect of extensive reliance on QE and low interest rates during a prolonged period: much of the monetary policy space was spent without facilitating significant growth in productive investments.

As the Covid-19 pandemic continues to drag down European economies, growing hopes that the recovery is around the corner pose challenges to policymakers.

First, inflation has remained below the medium-term target despite the accommodative monetary policy. Since low inflation may signal lower growth in the future, the pandemic shock has amplified secular stagnation concerns as it pushed core inflation further below the target. Therefore, unresolved low inflation-related issues and QE-related asset price inflation will continue to occupy policymakers in the post-crisis's era.

Countercyclical policies going beyond the short run should not distract investment-enhancing reforms.

Second, lasting ultra-low interest rates have encouraged the growth of public and private indebtedness and the holding of cash without promoting productive investment. Long-run implications of mounting Covid-19 related public debt, which in some countries has accumulated on top of already high indebtedness, are still uncertain. On the one hand, low interest rates support and make high indebtedness less of a concern, while on the other, each in its own right, they pose a risk to financial stability and long-run growth. Sustainability of the QE-indebtedness nexus comes on top of these concerns.

Third, Covid-19 has triggered an unprecedented increase in the savings rate in the EU. This raises worries related to Keynes' paradox of thrift. In such a situation, monetary policy should focus on mitigating precautionary saving motives and fostering investment by reducing uncertainty. While trying to escape the paradox of thrift, it is important to ensure that investment activity is not constrained by banks' tight credit standards.

Not only that investments drive the demand side of the economy, but they also determine the supply side of the economy. The fact that we still cannot be sure about the extent of damage inflicted by Covid-19 on the potential output and growth amplifies the need to foster productive investment.

Finally, although it is hard to answer the old "appropriate policy mix" question which the current crisis has put in front of policymakers, post-crisis recovery calls for a clear commitment to countercyclical policies to mitigate uncertainty and adverse effects of precautionary savings. As some empirical evidence points out that there are limitations to what monetary policy can do on its own in promoting recovery, the fiscal expansion will become an indispensable tool to support demand and to reduce the costs of the pandemic.

Limitations of monetary policy and public indebtedness concerns, which will inevitably emerge when the crisis is over, will make targeted and efficient use of the NextGenerationEU's Recovery and Resilience Facility funds a key instrument to crowd-in investments.

While countercyclical policies may be needed beyond the very short term, they should not divert attention from regulatory and institutional factors which drag on private investments in some countries. In these countries, the priority is not to "let a good crisis go to waste" by implementing investment-enhancing reforms. Without them, the reach of macro policies will likely be very limited.

ROLF STRAUCH
Chief Economist and Member of the Management Board, European Stability Mechanism (ESM)

The corporate-sovereign-bank nexus and future policy space

While strong national and European policy responses have contained the economic impact of the pandemic, there are spill-over risks from corporates to banks and to sovereigns. Any exit strategy must consider both corporate revenues and debt dynamics.

The pandemic severely affected the corporate sector; many firms saw their revenues collapse while they still needed to pay their bills. This caused severe liquidity shortages with risks of corporate insolvencies, voluntary closures and defaults. While precise estimates are difficult, economic studies suggest a large increase of bankruptcies due to the economic restrictions that were imposed to contain the pandemic.

In response to these challenges, governments supported firms' liquidity through direct subsidies, tax deferrals, debt moratoria and state loan guarantees. Short-term work schemes enabled workers to keep their jobs while others were supported with unemployment benefits.

EU monetary and fiscal policies complemented these government actions. Together, they considerably reduced the depth of the recession: there has been a high uptake of credit lines by firms to continue operations, default rates have been limited so far and unemployment has been substantially contained.

However, these strong policy responses resulted in a growing corporate and bank dependence on public policy support. This interconnectedness will carry risks when the temporary policy support is phased out.

The pandemic has exhausted firms' own reserves and capital, and the necessary bank lending has resulted in higher levels of indebtedness - backed by explicit and implicit state support. We will likely see corporate defaults and non-performing loans (NPLs) increase with more firms facing solvency problems when the budgetary and regulatory support is phased out.

While a certain increase seems unavoidable, the question is how high it will be and whether viable firms, that would survive without the temporary impact of the pandemic, will also face these challenges.

Any exit strategy must consider both corporate revenues and debt dynamics.

So far, the impact on banks has been limited. Banks entered the pandemic crisis with larger capital buffers than during the financial crisis, and they have also been in a better position to absorb NPLs. Moreover, prudential and monetary policy as well as budgetary measures facilitate the extension of credit to firms during the pandemic crisis. But the expected increase in NPL rates will likely take a toll on banks' profitability and their ability to lend. The challenge is to sustain and phase out support measures in a manner that minimises the impact on viable firms, bank balance sheets and their ability to lend.

These developments in the corporate and banking sectors are occurring against a backdrop of a significant increase in sovereign debt due to the large fiscal expansion. While the government guarantee schemes have not significantly affected fiscal balances so far, the impact will become more sizeable in the coming years as guarantees are called. This will reduce fiscal space, particularly for hard-hit, highly indebted countries. Going forward, this government support, including the guarantee schemes, will therefore have to become more targeted.

Besides the fiscal implications, there is the crucial challenge of ensuring that viable firms as well as new firms have access to additional, new financing as we emerge from the crisis. A comprehensive, gradual and well-sequenced promotion of post-pandemic bank and capital market financing is critical for a strong and sustained recovery. This includes the narrowing of public support schemes to viable firms, restoring transparency, removing forbearance in bank operations and accounting, and remedying any capital shortfalls that may have emerged.

This will not only help protect public finances from further - potentially unsustainable - pressure but will also reinstate the right incentives in the corporate and financial sectors which are essential for private-sector-led growth. In this context, the progress being made towards banking and capital markets union is also very relevant, as this will encourage risk-sharing and financing flows throughout the euro area.

JORDI GUAL
Chairman, CaixaBank

Should the euro area worry about the US overheating?

One of the lessons of 2020 is that problems which many in the world had stopped worrying about can rear up with sudden force. There is a real risk that the overheating of the U.S. economy becomes one of them.

In pre-pandemic times, a low growth – low inflation scenario had led the mainstream circles of economic policymaking to focus on subdued demand problems, anchoring an environment of low interest rate expectations. The initial policy response to the economic crisis of the Covid-19 reinforced these expectations.

Against an unprecedented shock, there was a pressing need for central banks to anchor accommodative financial conditions with major liquidity injections and low interest rates. Economies steadied and most recently they have even managed to adapt to the restrictions that are still needed to contain the pandemic. A sustained recovery is now in sight as the vaccination campaign gathers speed.

China's case aside, the US is set to be one of the first countries to regain pre-pandemic levels of economic activity. Supported by a comparatively fast vaccination campaign, the Fed's accommodative monetary stance, a major fiscal push and a boost from pent-up demand (real disposable personal income managed to grow by an astonishing 6% in 2020), this could happen as soon as mid-2021.

In this context, the fiscal packages approved at end-2020 and in March 2021 (which together amount to ca. 15% of GDP) have led many to warn about a significant risk of overheating in the US. This alarm has been raised before and proved wrong. The scars of a balance sheet recession and a low money multiplier hampered the inflationary pressures on goods and services of the massive monetary expansion in the Great Recession – while price pressures were more visible among real estate and financial assets.

But this time really could be different: the huge fiscal stimulus has shifted much of the potential impact from the private sector balance sheet onto the public sector and a lot of the cash that the Fed has injected has gone directly into people's pockets through fiscal transfers. While there was no doubt that a locked-down economy needed income support, many voices across the political spectrum are warning that doubling down on a stimulus that will be implemented with a recovery well underway poses significant overheating risks in the US.

If a US overheating materializes, global and European financial conditions could be set for a bumpy ride.

A few steps behind, Europe's recovery could benefit from a booming US economy thanks to the positive spillovers on external demand – raising euro area growth and, possibly, nudging up Europe's inflation. The euro depreciation against the dollar would also provide support to European exporters.

At the same time, an overheating US economy could also imply higher interest rates not only in the US but also abroad. Changes in US rates tend to spill over to other economies in a highly synchronous manner. As a matter of fact, Europe has recently imported a bit of the increase in US yields. Overall, positive spillovers from stronger US demand and a weaker euro may outweigh the drag from higher interest rates – more so because the ECB has the firepower and the commitment to keep financial conditions anchored in an accommodative region.

But there are also risks. If a US overheating materializes and inflationary pressures become more persistent, US monetary policy could face an uncomfortable dilemma: stick to the 'low interest rates for long' narrative that has supported markets in the past decade – risking higher inflation and future financial instability – or tighten the policy stance and risk an abrupt readjustment of expectations in financial markets. In any event, no matter the response, global and European financial conditions could be set for a bumpy ride.

ALASTAIR WILSON

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Enormous policy challenges, but the financial sector is holding firm – for now

Even at the darkest times, there are silver linings. As Europe weathers a humanitarian and economic crisis unprecedented in recent times, policymakers can reflect with relief on the absence – for now at least – of signs of financial instability. And take some credit for that.

The financial system sat at the heart of the global financial crisis – in some cases the proximate source of instability, in others the channel by which it propagated, in all cases an impediment to recovery. The financial system's woes drove and magnified the impact across multiple sectors.

So far, this crisis has been a different story. The European banking sector entered it from a position of relative strength. Capital has been built to levels, and is generally of a quality, well exceeding that prevailing ahead of the last crisis. Liquidity is similarly strong.
More broadly, the sound banking system has been accompanied by (and its resilience to some extent reflects) a prompt, proportionate, concerted response from policymakers acting individually and (reasonably) collectively.

Central banks' actions have ensured that banking sectors and sovereigns have retained access to affordable funding. Regulators have taken steps to encourage the flow of credit. National policymakers have launched unprecedented fiscal support. EU agreement on initiatives such as the NGEU will support the recovery and help sustain investor confidence in Europe.

Taken together, the first order impact on the financial sector should be in stark contrast to the global financial crisis. In Moody's view, corporate defaults will remain high through 2021, but the European spec grade default rate is projected to have already peaked at around 5%, well under half that in the prior crisis. And while nonperforming loans will continue to rise through 2022, we do not expect material pressure on bank balance sheets.

> **The future is unusuallyuncertain, and risks are to the downside.**

The intuition behind this view is strong. Unlike prior crises, this crisis was not the result of longstanding imbalances; it was not at all 'cyclical'. It resulted from an exogenous 'black swan' event. Policymakers have spared little expense to try to contain the resultant economic scarring and to allow economies to return to something approaching normality as quickly as possible.

The inevitable consequence of those actions – higher debt – has fallen largely on the public sector. While household and corporate debt has risen somewhat over the crisis, the largest increase has been in public-sector debt. But with interest rates very low, governments can carry higher debt for longer.

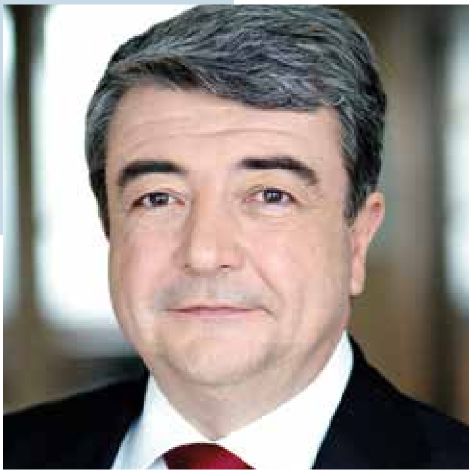
But the future is unusually uncertain and risks are to the downside. The return of growth is dependent on successful rollout of vaccines and avoiding new strains which lead to further lockdowns. A return to pre-pandemic growth levels assumes minimal scarring (e.g., rises in long-term unemployment) and the smooth reallocation of resources from damaged to more productive sectors. Neither is assured.

Europe remains overbanked and the low-rate environment – so essential to managing public debt loads – exacerbates structurally weak profitability. Weak profits and fear of losses may once again hamper banks' ability to support the economic recovery.

Relatively low default forecasts are predicated on a rapid return to health of parts of the economy – for example the SME sector – currently on life support. Even a relatively small increase in defaults in those sectors could undermine weaker banking systems.

And most fundamentally, so much rests on confidence. Confidence that vaccines will work – and be rolled out effectively. That policymakers will (individually and collectively) calibrate the removal of extraordinary monetary and fiscal policy measures without either stoking inflation or choking off recovery. That economies will respond. And, looking ahead, that the crisis will revitalise the fiscal and economic reform effort that had been fast running out of steam as the last decade neared its close.

Because a less rosy narrative is easy to construct, in which lack of confidence impedes the flow of credit to vulnerable sectors, and the flow of capital to more vulnerable sovereigns. That way lies a credit crunch and a debt crisis. And we've been there before.



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The combined risk of ultra-low interest rates and too restrictive (future) regulation for life insurers: the economy needs a balanced Solvency 2 review

Life insurers manage their balance sheet over the long term with savings and retirement products representing several trillions of commitments in euros on a European scale. Consumers have shown interest in these offers, especially with the growing aging of the population in Europe. Insurers are therefore committed and continue this management to meet the needs of European citizens over several decades. Based on this time horizon, very low rates are still recent for insurers.

This paradigm shift occurred with the Quantitative Easing of the ECB in 2015 and now the Covid19 crisis reinforces the scenario of low interest rates for long. It seems likely that an accommodative monetary policy will be necessary to overcome this unprecedented crisis further while at the same time it is a challenge for the insurance industry. Ultra low or even negative rates weaken insurers and medium-term profitability as of now solvency is undermined. The 2020 results showed substantial declines in solvency for life insurers, until several dozen points lost over the year due to the decrease in interest rates.

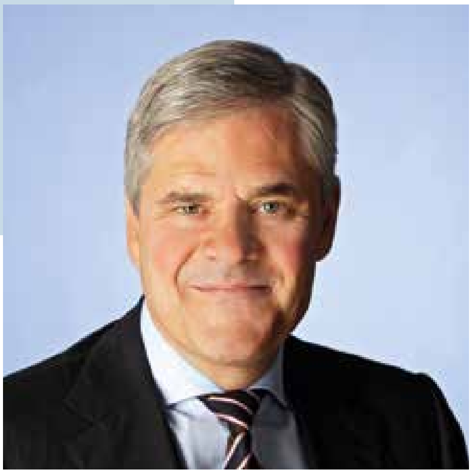
Insurers must adapt and transform their business models to survive. They can no longer offer long-term products combining security, liquidity and yield. It would take time to adapt the offers and its success with customers. In the meantime and under pressure from low interest rates, insurers have already implemented measures in order to seek yield, such as adjusting asset allocation by focusing on riskier and sometimes less liquid assets.

In the medium term, the risk of low interest rates could increase with the 2020 review of Solvency 2. Initially, the calibration of capital requirement in the standard formula did not foresee a risk of negative rates. There is no doubt about the reality of negative rates and the formula has to be adjusted in particular in the computation of the interest rate SCR submodule within the standard formula. However, other items in the calculation should be adapted in order to achieve a balanced review that does not result in a substantial increase in capital requirements. Maintaining the very accommodating monetary policy helps reorient insurers' investments towards equities, unlisted investments or real estate.

The risk of low interest rates could increase with the 2020 review of Solvency 2.

This movement is favorable to the economic recovery at the end of the pandemic crisis. In these conditions, it is necessary that the Solvency 2 review does not penalize this movement. In current EIOPA advice on 2020 Solvency 2 review, there are positive adjustments such as slight reduction of risk margin or simplification of criteria for long-term equities investment qualification. However, these propositions are not sufficient to compensate other very penalizing propositions as interest rate SCR recalibration and the change of methodology for the extrapolation the interest rate used for technical provisions valuations. A balanced review of the prudential framework is essential so that insurers can continue to offer long-term products and be actors in the economic recovery, by promoting the investment of amounts entrusted by policyholders in the economy.

A sudden and disorderly rise in rates after a long period of low rates would also constitute a risk. Large capital losses would expose insurers who may then be unable to meet demand for redemptions, especially since the differential in return to market assets would induce policyholders to invest outside of life insurance. However, there is an opportunity in case of a controlled rise to slight positive levels, stimulating for savings and investment and not dissuasive for its financing.



ANDREAS DOMBRET

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Monetary policy's powerful role in the wake of the pandemic

2020 is now firmly behind us and the annual financial statements are being finalized. While the balance sheets of most companies have weakened the real consequences of Corona will only appear fully once the fiscal aid measures will have been withdrawn, and only then will a potential zombification become apparent.

The effects of the pandemic are already visible. Several banks have profited in their capital markets business from the increased volatility. Central bank purchase programs and low to negative interest rates have further reduced profitability of banks. The real surprise of the last 12 months, however, was that loan provisions increased much less than most observers had predicted.

The key question is how long this state of limbo can last. At the fundamental level, the evolution of the pandemic and the speed and shape of the economic recovery are the key drivers, both of which cannot be predicted with any certainty. Secondly, the ability of sovereigns to maintain their far-reaching support and the real economies' ability to restart will determine how much of the economic pain can actually be buffered away.

That said, the 2020 financial statements will lead to a widespread deterioration in credit ratings, particularly as almost all businesses will have less equity. This is likely to put considerable pressure on the capital situation of banks. An increase in non-performing loans can be assumed certain, even while estimates vary widely with regard to the extent of such increase. Banks themselves must be quick in providing both the necessary staff and the tools required to deal with a higher number of company failures. A certain standardization of restructuring approaches is helpful. Banks should also make full use of preventive restructuring.

Fiscal policy needs to carry most of the burden, while monetary policy needs to be targeted more to aid recovery and growth.

In addition, market-based mechanisms should be established to handle NPLs. This includes functioning secondary markets and a uniform framework for securitization rules - very much in the spirit of the European Capital Markets Union. Mutualising credit risk across national borders, on the other hand, is still associated with far too high political and economic side effects.

Regulators play a key role. Warnings of supervisors recommending banks to build sufficient buffers and adequate provisions have been plentiful. Regulators will need to carefully consider when and how to expire the regulatory relief granted on the assumption of a short-term liquidity crisis, which is rather difficult to withdraw once balance sheets have deteriorated.

The big open issue, however, is the role of monetary policy. The low interest environment has without any doubt been a significant factor keeping economies afloat. But together with the strong fiscal stimulus, which monetary policy has made possible considering the significant debt burden of many countries, it carries two important risks:

- First, the funding glut may mask a deterioration in asset quality at the level of the individual borrower as well as on the systemic level. This smoke screen may persuade investors and banks to maintain, or even expand, their exposures for too long, thereby preventing a more proactive and timely management of their position with deteriorated credit quality.

- Second, the risk of a sharp and sudden correction in interest rates has risen as evidenced by the recent turbulences in US treasuries. In the worst of cases, a reversal of the current environment could lead to a strongly correlated market environment in which the prices of equities, bonds and real estate assets all experience downward pressures simultaneously. In such a scenario NPLs would jump considerably, adding to the already existing problems. The risk of such a dynamic might become a constraint for monetary policy, severely limiting policy space in case inflation were to pick up markedly. Fiscal policy therefore needs to carry most of the burden, and monetary policy needs to be targeted more to aid recovery and growth.

Progress on vaccination shows a light at the end of the unexpectedly long tunnel. But to avoid negative consequences of the pandemic and to enable the system to work properly through the inevitable rising amount of bad debt all parts of the financial system will need to prepare, need to remain vigilant and proactive.