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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 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.