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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have weakened the real consequences of Corona will only appear fully once the fiscal aid measures will have been withdrawn, and only then will a potential zombification become apparent.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.

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.