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Only strong European banks can limit future sudden stops

The moment that turns a downturn into a deep recession is, in peace time, most often tied to a sudden-stop in cross-border financial flows; any dry up in liquidity translates rapidly into insolvency. With the Covid19 crisis, however, the sudden stop was triggered by measures imposed to protect public health. Vaccine rollout offers the prospect of reopening economies yet concerns linger that as temporary support measures are lifted, a large number of firms could still fail, triggering a wave of non-performing loans (NPLs). Adaptability and well-adjusted policies suggest such fears are likely overdone. Ensuring a full recovery of the euro area, however, requires a much more determined effort to complete Europe's architecture.

When Covid19 first struck the global economy back in early 2020, financial markets were gripped by fear, but large-scale and fast-track action by central banks and governments quickly dispelled it. Equally important, European banks entered the present crisis with capital levels twice as high as in 2008 and soon became a primary channel of support, rolling out government guaranteed loans and providing moratoria. With liquidity assured, many firms found the financial space required not just to stay afloat but also to invest in adaptations and others yet have sprung up. Just taking France as an example, new start-ups surprised with record numbers. Encouragingly, experience from last summer also shows that once social distancing measures are eased, economic restart can be swift, aided by pent-up savings.

Back in June, the ECB warned that a severe scenario could leave the euro area with a cumulated real GDP loss of 27.7% over 2020-2022 compared to 2019 levels, with NPLs near tripling from just under €500bn to €1,400bn. The ECB's latest projections see a loss of 14.9% in the severe scenario, 9.3% in the baseline scenario and 4.3% in the mild scenario. While still marked, these new scenarios nonetheless ease fears of the most adverse NPL outcomes. Banks, moreover, have built important provisions and cost of risk remains contained.

Once the health crisis allows economies to reopen, policymakers must calibrate the lifting of temporary measures while still rolling out sufficient support for the real economy to recover. This observation holds true also for banking measures. Last spring, the Commission's Banking Package offered temporary flexibility to accounting and prudential rules. This, combined with the decision to defer the transposition of the final Basel III package by one year to 1 January 2023, increased the capacity of both banks and supervisors to respond to the Covid19 crisis. The appropriate timing of when to roll back policy support is well known from previous crises, but the extraordinary nature of the current one, with its unprecedented sector heterogeneity and likely permanent changes to consumer and business behaviours, adds to the uncertainty that policymakers must take into account to prevent error.

Avoiding a replay of another partial recovery, that the euro area suffered in the wake of the previous crisis, furthermore requires that European policymakers deliver on long overdue promises; a robust framework to tackle NPLs, completion of Banking Union and Capital Markets Union. The EU Action Plan of December 2020 to prevent a future build-up of NPLs is welcome but far from sufficient to complete Banking Union, which most importantly requires single jurisdiction. The Capital Markets Action Plan of September 2020 is likewise encouraging yet also falls short in recognising the parallel need for public risk sharing, and notably a single safe asset, absent which the euro area financial architecture will continue to bear the high cost of fragmentation.

As warned by the ECB, reform policies are particularly important in addressing long-standing structural and institutional weakness and in accelerating a fair, green, and digital transitions. Europe today, moreover, has a unique opportunity to become a global green leader, lowering the risk of future sudden stops triggered by the natural world. Strong European banks in a complete Banking Union are a prerequisite, not just to pave the way for the necessary private investment and jobs, but also to ensure that Europe is sovereign in its choice of economic growth model and to limit the risk of future sudden stops in cross-border financial flows.