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Europe's worst case scenario

In 2020 Europe's economy has been on life support. Ending it prematurely could spell disaster unlike anything seen in 2008

In the final weeks of 2020 an optimist might see light at the end of the tunnel. Europe was hit hard by the second wave of Covid-19. But it is being brought under control. Several vaccines are in the pipeline and European manufacturers lead the race. Inoculation of the most vulnerable may begin even before the year is out. Then restrictions can be lifted. Social life will get back to normal.

This optimistic narrative is indeed itself a force to be reckoned with. As a self-fulfilling prophecy, it helps to bolster confidence and with it economic recovery.

By analogy with the timeline of the eurozone crisis, one might think that we are back, eight years ago, in late 2012, in the months after the president of the European Central Bank, Mario Draghi, had cast a magic spell with his 'whatever it takes' commitment. For tens of millions of Europeans, the economic pain continued. But the panic was stopped. The foundation for a recovery had been laid.

In 2020, the European Union's recovery package bolsters this upbeat narrative. It is a source of satisfaction in the European Commission that its new debt — a 15-year, €8.5 billion 'social bond' to support the SURE employment instrument — is meeting such an eager reception in the market. The latest tranche was 13 times oversubscribed and yielded a negative rate of minus 0.102 per cent. Which means that for every 102 euros the EU receives from its creditors it will have to pay back only 100. Even German bonds hardly do better.

Alternative scenario

We may have reached a turning point. But what if we have not? Imagine an alternative scenario. What if we are not in 2012 but in 2009? What if the relief we are experiencing is like the interlude of calm between the

banking crisis of 2008 and the eurozone crisis that followed (as Erik Jones has helpfully framed it)?

Imagine if the pain is only just beginning.

In 2020 Europe's economy has been on life support. Millions of jobs have been sustained by short-time working schemes. Guarantees of credit have been issued to staggering amounts. What if the support is ended prematurely?

Unemployment surges. The economy continues to contract into 2021. Credit falls off a cliff. As recession takes hold, loans turn bad and losses cascade through the financial system.

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Europe's banks, already in a weak position before the coronavirus shock, are caught napping. Their loss provisions in 2020 having been far lower than those made by their American counterparts, in 2021 they suffer a bloodbath. As their loan books deteriorate, weaker banks — above all in Italy — are downgraded to junk status, tightening their access to bond markets, further restricting their ability to lend.

The failure to make good on the promise of 2012 to complete a banking union is exposed. Without credit the euro-area economy is paralysed. Unemployment surges by 2022 to 12 per cent.

Worst case

This may sound dystopian — and it is. But I have not made it up. The people who did were economists at the ECB. This is the narrative that organises the adverse scenario of the bank's *Financial Stability Review*. It was chosen from among thousands of hypothetical model experiments to represent a 'mean outcome' in a worst-case scenario.

Since stress-testing of financial systems began in the early 2000s, the techniques have become ever more sophisticated. The *Financial Stability Review* is based on a macro-micro model known by the acronym BEAST — Banking Euro Area Stress Test.

This tracks interactions among 19 national economies and the balance sheets of 91 systemically important banks. The model predicts the way

each bank — Paribas, Deutsche and so on — will likely react to changing economic circumstances, by extrapolating from the bank's capital ratios, non-performing loans and rate of return on assets.

In a negative shock, banks will tend to slash new lending. Banks which are already overstretched will tend to do so more aggressively. As the ECB's economists discreetly remark, the European banking system is highly 'heterogeneous'. The model feeds all 91 bank balance-sheet reactions back into the forecast for the euro-area economy, with the self-protective behaviour on the part of the banks compounding the adversity of the initial scenario. The result is a vicious circle of contraction.

'Excessive deleveraging'

Narratives like that generated by BEAST exert a gothic fascination. But they aim to do more than send a chill down our spines. They help to guide policy. Crucially, they reinforce the ECB's determination to prevent what it calls 'excessive deleveraging' — a severe contraction of credit, from banks and non-bank financial institutions, to European households and firms.

This year the ECB has made significant interventions to maintain the credit supply to the European economy. Crucially, it stopped the distribution of dividends, which forced banks to hold whatever profits they earn in reserves. In addition, it released capital buffers, funds built up during the better years, to support new lending. This is how the macroprudential regime put in place since 2008 is supposed to work — tightening banking regulation in the upswing, loosening it in a recession.

But tweaking the dials on the financial system only goes so far. Ultimately, as the *Financial Stability Review* hammers home, the stability of credit depends on the broader balance of the euro-area economy. And given the unusual circumstances of the pandemic, that depends on government action.

In 2020 lending to small and medium-sized firms in particular has depended significantly on public guarantees and moratoria. Households across the EU have been sustained by the dramatic extension of short-time working, the great welfare-state innovation of the crisis. Were either form of support to be withdrawn, the shock would be serious.

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Of course, continuing that support has a budgetary impact. Ratios of debt to gross domestic product have surged — an increase of the order of 15 per cent of GDP across the euro

national balance sheets.

area. According to the ECB's calculations, two-thirds of that increase is due to spending decisions; one third is down to the collapse in GDP.

Were it not to continue, the bank warns, the European economy would face the prospect of falling off a cliff. What is at stake is not only the social fabric of Europe — as if that were not serious enough. An abrupt termination of fiscal support would pose a threat to financial stability.

Fiscal burden

So far, the overwhelming portion of the fiscal burden has fallen on national balance sheets. The funds from the July 2020 recovery package, when this comes into effect linked with the EU's budget, will provide support. This is a significant constitutional step. But its proportions have to be kept in perspective. As the *Stability Review* shows, SURE along with Next Generation EU grants and loans will provide funding to the tune of about €150 billion *per annum* between 2021 and 2026. Meanwhile, in 2020 alone, eurozone governments borrowed €1 trillion.

Here too there is a circular entanglement. It is not just government policy that helps to determine stability of private credit. Sovereign debt makes up a substantial part of the portfolios of bank balance sheets, and banks — particularly in Spain and Italy — own a significant share of public debt. That is a worry because during the debt crisis it helped to propel the 'doom loop': ailing banks pulled down government credit and *vice versa*.

Since 2012, progress had been made in disentangling the loop. But in 2020 the bank-sovereign nexus has tightened once again. As the ECB affirms, 'In 2020 to date, euro area banks' exposures to domestic sovereign debt securities have risen by almost 19% in nominal amount — the largest increase since 2012.' This has been most pronounced in Spain and France, though in France sovereign debt makes up only 2 per cent of bank assets.

Promise of support

Right now, this is not an immediate cause for concern. Demand for euro-area sovereign debt is booming. Greece recently borrowed short-term at negative rates. Italy's yields are at record lows. It would be cheering news if this were because investors were expecting a rapid rebound of the Italian economy. Nothing would be better than for Italian nominal GDP to be roaring along, clawing the debt-to-GDP ratio down from the

heights it will likely reach this year.

But not even the most optimistic forecasts suggest such a scenario. What sustains investor interest is the promise of ECB support. Ultimately, the entire edifice hinges on the ECB itself, on its willingness to backstop the sovereign-debt market.

Sound bank management is, no doubt, essential. Fiscal-policy decisions can boost or deflate the economy and influence creditworthiness of borrowers and, thus, bank balance sheets. But what supports the complex web of macro-micro linkages mapped by the BEAST model is the willingness and ability of the ECB to act as Europe's bank of last resort.

That is the transformation Draghi signalled in 2012. So long as it holds, our chances of finding ourselves back in 2009 are slim. If that promise is put in question, however — for all the sophistication of macroprudential policy and all the EU's institutional progress this year — all bets are off.

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