

Financial Risks in Europe: The End of the Beginning



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Monetary Dialogue Papers,
February 2020

Abstract

It appears that recession may be on the way for the EU as a whole and the euro area in particular. Having used all of its instruments in the previous crisis, the European Central Bank has little left that can be helpful when the inevitable happens. This brief examines the financial risks facing the euro area and details how flexibility and non-intervention – the direct opposite approach from the global financial crisis – should characterise the response to the next crisis.

This document was provided by Policy Department A at the request of the Committee on Economic and Monetary Affairs.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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Manuscript completed: January 2020

Date of publication: January 2020

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This document was prepared for the February 2020 Monetary Dialogue between the ECON Committee and the ECB President. It is available on the internet, also as part of a compilation, at:

<https://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html>

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For citation purposes, the study should be referenced as: Hartwell, C.A., *Financial Risks in Europe: The End of the Beginning*. Study for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2020.

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LIST OF ABBREVIATIONS

ECB	European Central Bank
EFB	European Fiscal Board
ESRB	European Systemic Risk Board
EU	European Union
GFC	Global Financial Crisis
NPL	Non-performing Loans
PMI	Purchasing Manager's Index
RoE	Return on Equity

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EXECUTIVE SUMMARY

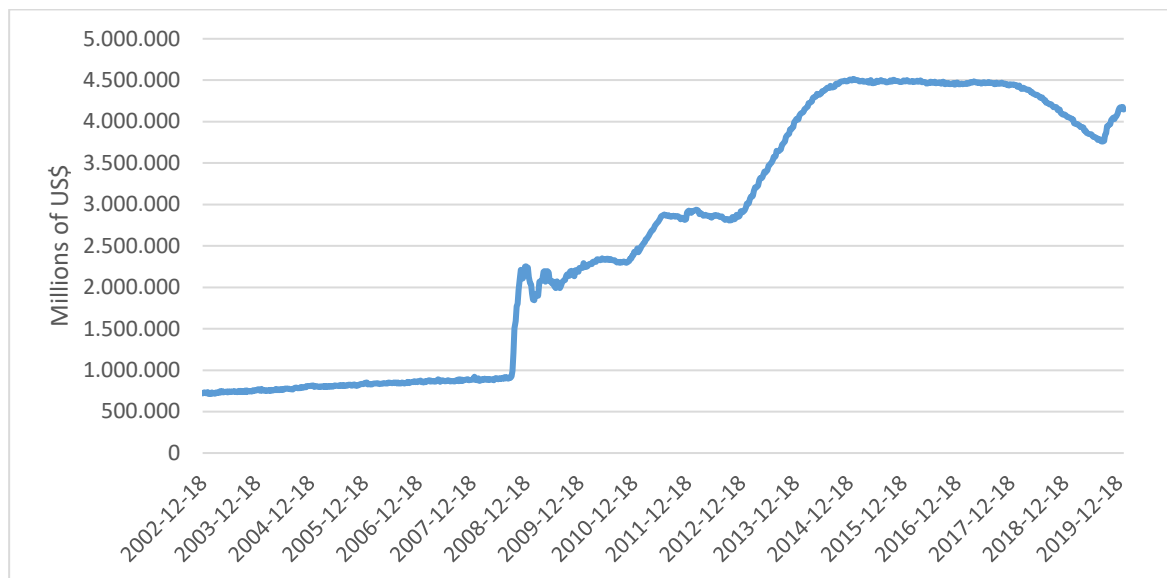
- **The global economy appears to be heading for a recession in 2020, and the euro area is not immune.** Indicators throughout Europe show slowing growth, slack demand, and a number of risks both internally and externally.
- **The financial sector in the euro area has been operating on the edge for the past decade,** buoyed by excessively loose monetary policy but without fundamental improvements within the euro area to make the recovery sustainable. Any recession could strike the financial sector quite harshly, albeit with effects differentiated across Member States and to different degrees.
- **This paper examines the internal and external risks to the euro area financial sector,** concentrating on the broader macroeconomic threats but also focusing on the political issues globally which could push the financial sector over the edge.
- **Internally, banks in the euro area are facing a higher and similar risk profile,** occasioned by the regulations put in place in response to the global financial crisis. At the same time, unconventional monetary policy has made many banks far less profitable, reducing their own buffers to be able to weather an economic downturn. Compounding this all is continued political uncertainty, including still surrounding the aftermath of Brexit but extending to the ECB's own policies, which is holding back real progress.
- **Externally, a phalanx of threats are arrayed against the financial sector in the euro area.** Possible slowdowns in the US, precipitated by a crash of asset prices, and in China, as it reaches the limits of growth, have negative consequences for the entire euro area. Meanwhile, the populist wave which has hit the world post-global financial crisis may have crested but it shows no sign of heading out to sea, meaning more protectionist and anti-growth policies to threaten the global economy.
- **These internal and external threats may do more damage than is usual in an economic downturn due to the fact that both the ECB and Member States have little ammunition to fight.** With the ECB's foot on the gas pedal throughout the tepid recovery of the past decade, the only monetary solutions that can go beyond current levels are patently absurd. On the fiscal policy side as well, governments have been expanded in the midst of a recovery, leaving little that can be done in terms of spending.
- This paper recommends that **the coming recession should be seen as an opportunity for re-normalisation of monetary policy, a re-set of monetary expectations,** and in particular a **pullback from the ECB as the driver of the euro area economy.** This means letting the chips fall as they may, as occurred in the United States during the 'forgotten depression' of 1920 to 1921. This will entail some painful adjustments, especially in the financial sector, but the euro area economy which emerges will be stronger for it.

1. INTRODUCTION

Since early 2018, consumer confidence and overall sentiment regarding the state of the European economy has reversed itself abruptly. Looking solely at the benchmark Economic Sentiment Index (ESI) put together by Eurostat, declines in both EU-wide and euro area GDP have led to an abrupt decline of the ESI and a reversion to its long-term average as of the fourth quarter of 2019; at the same time, additional indicators such as industrial sentiment have turned negative and persisted throughout 2018. Not all is gloomy, as unemployment has reached new lows across the continent and household consumption has been high, but this could be due to inflated asset prices (according to the Flossbach von Storch Research Institute in Germany, total euro area assets have increased in value by 19.2% since 2014). However, such sanguine results cannot be expected to continue given that firms Europe-wide anticipate cutting back on investment (European Commission, 2020). Within the financial sector, in Europe's south in particular, banks have become very reliant on central bank funding while at the same time price/earnings ratios are far above immediate pre-crash levels from 2007. Clearly, the warning signs are present that the mild recovery experienced across Europe since the end of the euro crisis in 2013 is now at an end and recession may be imminent.

While the old joke - that economists have predicted 12 out of the last 8 recessions - is an important caveat to our forecasting, these unmistakable signs of weakness in Europe are compounded by global fragility. In the largest example, the US Federal Reserve (the Fed), *primus inter pares* when it comes to central banking, has essentially resumed quantitative easing via both lowered interest rates and renewed monetary injections (primarily in the repo market, see Figure 1). Indeed, operations of the Federal Reserve, after a brief taper away from the unconventional, once again spiked in September 2019 and have remained at supra-normal levels: Fed assets are approximately 85 % greater at this moment than they were at the depths of the crisis in 2008 and have grown by 10 % from September 2019 to January 2020 alone.

Figure 1: Assets of the Federal Reserve, 2003 to 2020: the slightest taper reversed



Source: Federal Reserve Bank of St. Louis FRED indicators.

At the same time, slowing growth in China (forecasted at 6 % in 2020), due to its trade war with the United States, protests in Hong Kong, and recent biomedical disruptions, has the ability to bring the

global economy to an abrupt halt. The IMF, while projecting global growth of 3 % (its lowest level since the global financial crisis), has warned of a synchronised slowdown across developed economies, creating a 'precarious outlook' for global markets (IMF, 2019). Given the inherent fragility of the euro area's economic performance since the global financial crisis, any external shock has the ability to push the monetary union over the edge and into recession.

Of course, it should come as no surprise that business cycles still exist (despite the halcyon predictions of some in the 1990s, see especially Weber [1997]), and that the current era of expansion, no matter how mild, had to come to an end at some point. Where the difficulties begin, however, is in the reality that the EU has very little ability to cushion the blow of the coming recession; the fact of the matter is that the key economic policymakers are still engaged in fighting the previous crisis, having never pulled back from the tools utilised since the depths of the global financial turmoil. Indeed, the ECB has been engaged in 'unconventional monetary policy' for so long that it is in fact the new normal. The downside to such a permanent loose monetary policy (among other things) is that, if one believes that monetary solutions are feasible for cyclical or, worse, structural issues, then when the economic tides turn there is very little left beyond the bizarre, truly unorthodox, or overtly damaging that can be attempted. With business cycles and economic trends persisting even with a central bank doing 'whatever it takes', the reality is that, simply put, the ECB has very little wiggle room left for when the inevitable occurs.

This paper argues, continuing a theme from earlier briefings for the Monetary Dialogue (Hartwell 2019a), that unconventional monetary policy has made a painful recession more, not less, likely; more importantly, however, this paper goes beyond this observation to explore how Europe's financial sector has also become more fragile rather than more robust. More than anything, the global financial crisis (GFC) demonstrated the power of problems in the financial sector to impact the real economy, and thus the health of the financial sector has been on the minds of policymakers almost constantly since the GFC. Unfortunately, the tools which have been in place in Europe (and elsewhere) over the past decade have created greater systemic risks, similar risk profiles, and an overall fragility which could be exposed by the next recession. For policymakers who have exhausted both their standard and unconventional tools, the financial sector should be the main worry of European policymakers.

Building on this theme, this paper delves deeper into the specific risks to financial stability that the EU faces, focusing on both the risks internal to the euro area and those which are external. As can be gleaned from the more macroeconomic overview thus far, not all of the issues related to financial stability are exclusively derived from the financial sector, nor are they generated entirely within the EU. In fact, the EU's integration into the global economy, coupled with the prospect of a global synchronised slowdown, means that financial risk can come from any direction, and no grouping of countries (no matter how powerful in terms of aggregated GDP) is an island.¹ Only by understanding how internal and external risks may interact may we have a better sense of where the difficulties will come in an economic downturn.

The rest of this paper is structured as follows: the next section goes in-depth into the internal risks facing the euro area, while Section 3 focuses on the global and external risks to the European financial sector. Section 4 discusses the bind policymakers find themselves in, while Section 5 concludes with recommendations and a way forward.

¹ At the same time, even the most optimistic (and, in many ways, overwrought) forecasts of the impact of emerging markets beyond the G7 show an impact of no more than 25 % (Carstensen and Salzmann 2017), and it's likely that even these results are far overstated for the euro area (as well as the US and the UK).

2. THE ENEMY WITHIN

As noted above and in Hartwell (2019a and 2019b), the economic recovery in the euro area has been precarious at best, with euro area growth of barely more than 1 % being driven almost entirely by household consumption. With Germany experiencing effectively zero growth (and seeing two quarterly contractions in the past year), one of the drivers of the euro area has been effectively put out of service. As the real economy slows, the financial sector of the EU (and in particular the euro area) is likely to feel much more stress; the purpose of this section is to focus in on the areas internal to the EU and the financial sector in particular which may be problematic for the future.

2.1. More risk, more problems

A key portion of the overall response to the GFC by policymakers globally was an attempt to reduce risk within the financial sector. Such an objective drove multilateral initiatives such as Basel III capital requirements and buffers, as well as underpinning the move towards macroprudential policies. The prospect of 'too big to fail' also drove a more proactive stance towards financial regulation, with regulators scrutinising at both the individual institutional and systemic level the health of banks.

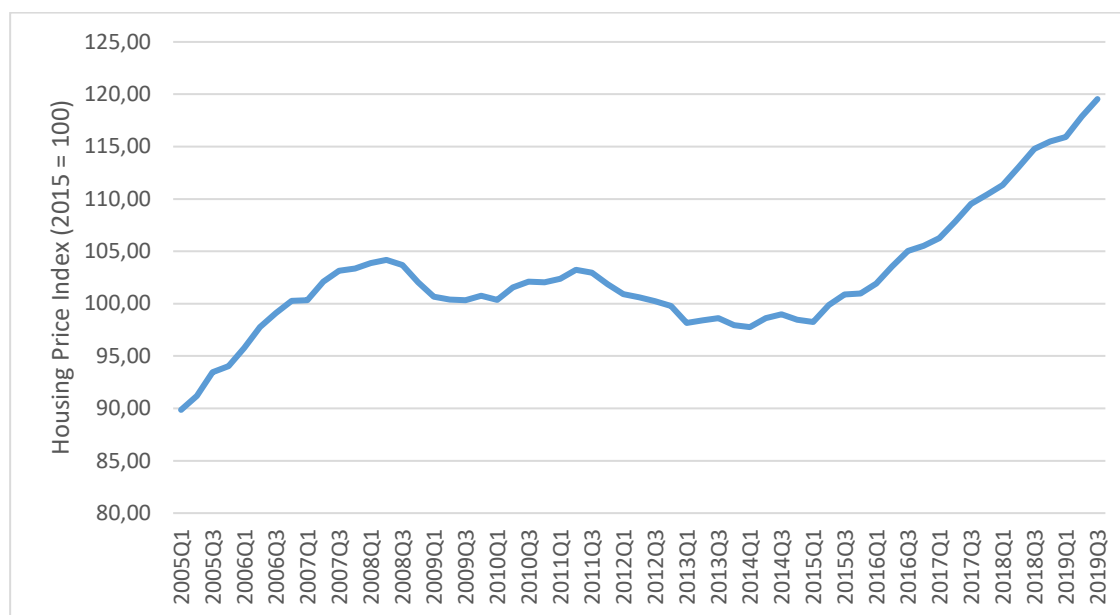
A look at the standard risk indicators, such as non-performing loans (NPLs), shows some improvement, as NPLs have shrunk to 3.41 % as of Q3 2019 from 7.48 % in Q2 2015, according to the ECB, although the persistence of 'zombie loans' from smaller players is somewhat worrying (as Kapounek *et al.* 2017 note, small banks are highly sensitive to demand-side factors, and thus rolling over bad loans is a way to hold on until external conditions improve). At the same time, credit derivative swap (CDS) spreads have been on the decline throughout 2019 while loan to deposit ratios have remained high (albeit uneven across the euro area) over the past three years. By these metrics, the financial sector is, for the most part, showing signs of resilience.

However, some of the policies adopted in order to lessen risk at the individual institution level have paradoxically increased systemic levels of risk. One of the key drivers in this regard has been the increasing requirements for greater 'zero risk' holdings such as government bonds. There is ample evidence that the regulatory changes accompanying the post-financial crisis response created incentives for firms to both deleverage and move into government bonds; according to Naceur *et al.* (2018:8), higher capital ratios created 'greater incentives for banks to strengthen their capitalisation encourage substitution out of retail-and-other-loan assets, and into risk-free, more liquid government bond securities.' While the move away from retail credit has been problematic enough for the real economy, regulations in this vein have had the additional effect of forcing disparate financial institutions into almost uniformly similar risk exposure to government operations. Put another way, if additional sovereign debt crises were to occur in the euro area, the financial sector would be exposed in an area where no risk was assumed. While some Member States have recognised that this is a real possibility given current regulations, reforms on more accurately calculating sovereign risk have been discouraged by the ECB as perhaps disadvantaging European banks.

Additionally, as is often the case in a monetary-fuelled boom (Tempelman, 2010), the easy access to liquidity created by low interest rates has allowed banks to lend when they normally might not. This is not to say that credit standards have changed appreciably: according to the latest risk dashboard from the European Systemic Risk Board (ESRB), credit standards have undergone a slight easing over the past year across the entire euro area (with a substantial decline in standards in the Netherlands), but not one of any significance. And, over the whole of the crisis period, bank lending declined across Europe with deleveraging (as noted above, accompanied by a move into bonds). On the other hand, there is a signal that not all is well, as recent trends have shown that similar effects are occurring in

Europe since late 2018 as happened in the United States in 2004 and 2005, mainly a move away from firm investment and into consumer residences, with growth of loans in this area over 20 % in late 2019 alone (ECB 2020).²

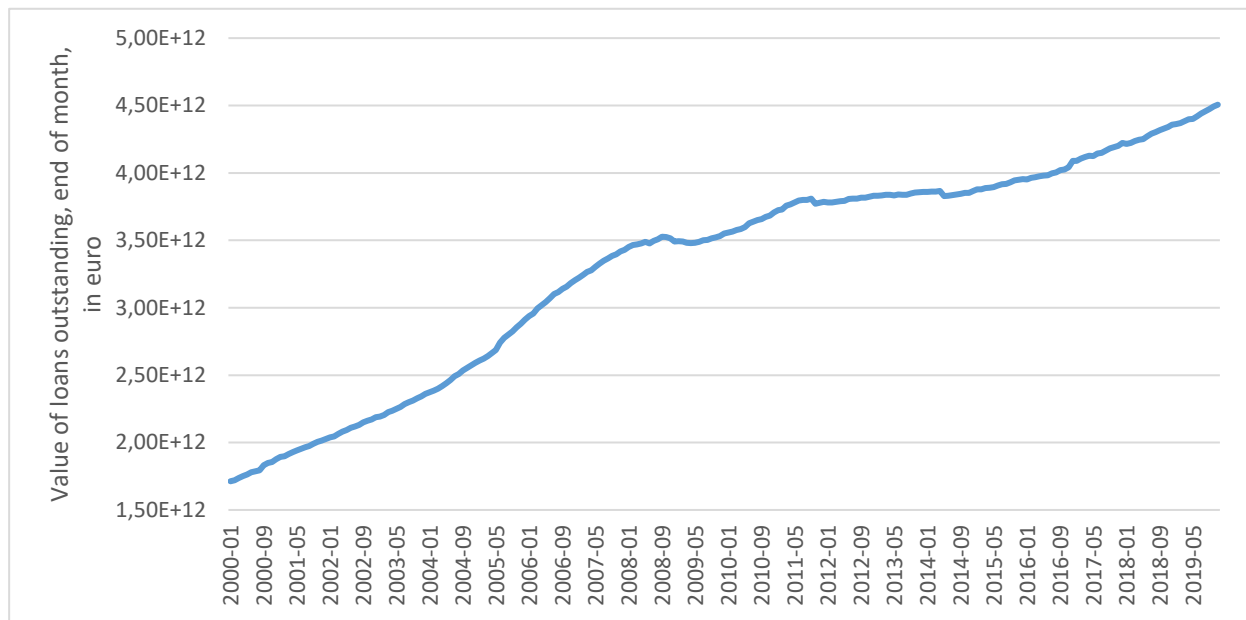
Figure 2: Housing prices in the euro area at new highs



Source: Eurostat.

In fact, while the overall economic outlook appears gloomy for the EU, one curious statistic stands out in the ESI report for end 2019: the construction industry across Europe is optimistic for the future. It is not hard to see how this might be the case, as case after case of pre-recessionary booms has been characterised by a construction frenzy, whether one looks at Thailand in the late 1990s or the Gulf States or the United States in the mid-2000s (Mark Thornton has coined this phenomenon ‘the skyscraper curse’, see Thornton [2005]). Although these earlier booms in skyscrapers were linked more to commercial real estate than residential, the shift towards residential lending in Europe has many of the same attributes as these previous bubbles, including lower quality of loan applicants (the ECB notes that loan rejections for both residential loans and consumer credit have been on the rise) and increasing size of loans commensurate with a dramatic increase in home prices (see Figure 2). All of these factors mean that the financial sector is increasingly exposed to the residential market across the euro area (Figure 3), an increasing risk given the faltering real economy. Can the next recession also hammer both the financial sector and the real economy via the housing market, just as the previous one did?

² Although asset prices are not counted as “inflation” in the conventional definition, and although some economists cling stubbornly to ideas such as the belief that inflation is attributable to oil prices, this increase in home prices coincides rather neatly with the most interventionist activities of the ECB. It seems that inflation is still a monetary phenomenon.

Figure 3: Volume of euro area loans for house purchases

Source: ECB.

2.2. Banks at the water line

In addition to the standard metrics for risk and the composition of risk, another consequence of unconventional monetary policy has been to decrease the cushioning banks need to absorb changes in their external environment. Indeed, the unnaturally low interest rates across Europe over the past decade have had another effect in increasing financial sector fragility, mainly by keeping bank profitability incredibly low. According to the European Banking Authority (EBA, 2018) and 2019, return on equity (RoE) for the EU decreased from 7.2 % to 7.0 % over 2018 and 2019, below their average cost of capital of between 8 and 10 %, with even these results driven by the high-yield countries of Central and Eastern Europe (principally the Czech Republic and Hungary, neither of course not part of the euro area). Return on assets also remains low at less than 0.5 % in 2019, meaning that euro area banks may have capital buffers for their outstanding loans and/or liabilities, but as a business they are struggling to stay afloat.

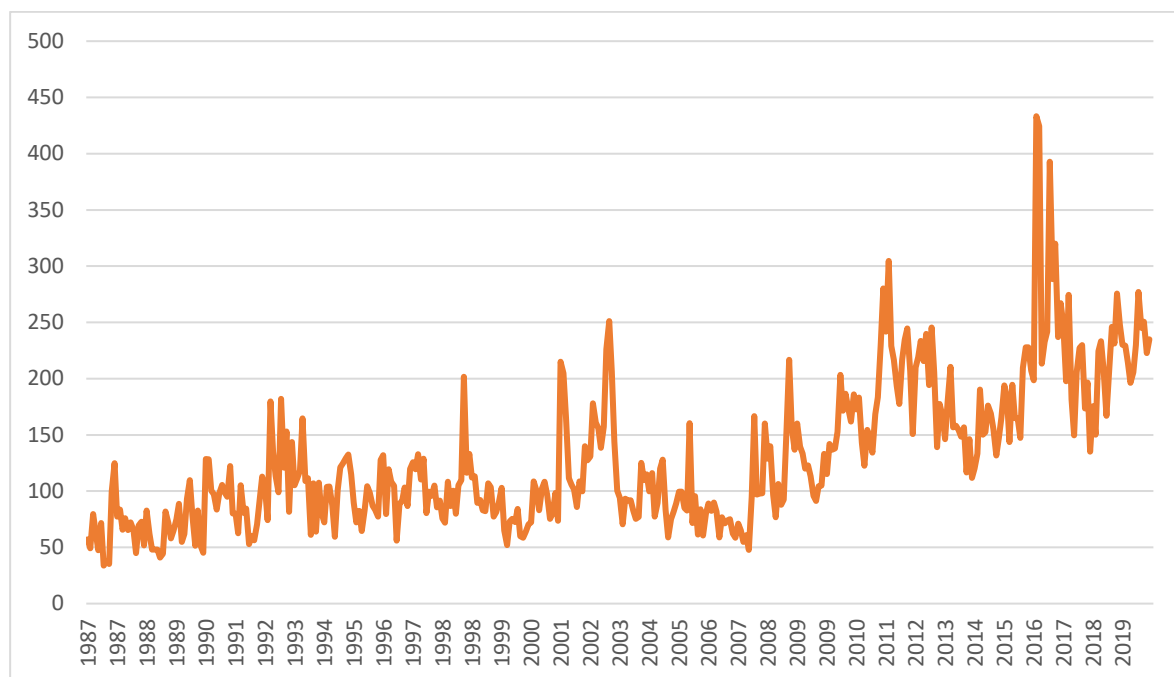
Given this low level of profitability even during an expansion, any economic downturn is certain to push some banks at the margin into bankruptcy; as Albertazzi and Gambacorta (2009) show, bank profitability is procyclical due to net interest income (which comes via lending activity and is much more active in a good economy) and loan loss provisions (which is linked to credit portfolio quality, which suffers in a recession). The question is, how widespread would such a wave of failures be? Some failures are to be expected and, as we will show below, even welcomed in a recession, as the strongest capital providers are able to consolidate their business and emerge leaner and stronger. However, a severe recession would take down some banks which, during normal and conventional times, might still be solvent; more troublingly, the spatial effects of bank failure would not be the same across Member States, as banks in Germany, Greece, Portugal, and Belgium have had the lowest levels of RoE (EBA 2018). There may be some space in larger markets such as Germany to absorb bank failures, but for Greece or Portugal, declining profitability means weaker banks which means greater risks (and more prospect for need of a bail-out) during a downturn.

2.3. Continued policy uncertainty in the EU

Finally, the experience of the post-GFC world has been one of heightened uncertainty driven by both economic policies and political events. The extraordinary events of the past decade in this regard have included the populist wave in Europe and elsewhere (and which shows little sign of abating), as well as the momentous decision of the United Kingdom to 'Brexit' the EU., which have led to policy uncertainty hitting new heights (Figure 4). With data running through January 2020, the Baker-Bloom-Davis uncertainty index (Baker *et al.* 2016) shows that Europe continues to see levels of uncertainty at the level of, or in some instances higher than, the depths of the global financial crisis.

These events, far from being discrete moments easily absorbed by markets, have instead sown the seeds of future uncertainty and created longer-term unease about the rules of the game within the EU. This is true even if one assumes that the worst of the Brexit uncertainty has finally been surmounted with the majority election of Boris Johnson in the United Kingdom and the clarification about the UK's exit at the end of January 2020. Of course, Brexit is not a one-off event and will continue to entail large bouts of uncertainty for firms and trade channels, as well as affecting financial sector institutions in coming years (not least of which regarding the divergence in financial regulation and/or difficulties encountered by customers affected by the disruption of trade). The issues surrounding Brexit may crystallise in coming months, but by no means has the policy uncertainty around Brexit abated, meaning financial sector institutions may continue to need to keep additional buffers against uncertainty. As Howarth and Quaglia (2017) also note, the fact that the UK kept financial regulation in the EU more pro-market may mean that additional moves from the EU will also create an uncertainty shock for the financial sector.

Figure 4: Economic policy uncertainty in Europe



Source: 'Measuring Economic Policy Uncertainty' by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

This last point regarding financial regulation should call our attention to a crucial point, namely that policy uncertainty is not an exogenously generated shock for an economy, it is endogenously generated by policymakers themselves. Early signs for 2020 have not been good in terms of lessening the avoidable uncertainty which can harm business planning, as ill-advised and peripheral policies like a European Green Deal (aided and abetted by an ECB which has become unfocused and eyeing policy debates well outside of its mandate) create more problems than they might conceivably solve. Moreover, the fiscal weapons need to be brought to bear to achieve such goals as set out under the Green Deal would be difficult in the best of times, in an era of uneasy recovery and looming recession they seem foolhardy at best.

Finally, and crucially, policy uncertainty has been magnified by the reality of institutional uncertainty. Despite a decade of efforts, the Institutions of the EU are no better off than they were in 2008 for forging coordination amongst Member States. Indeed, Member States have diverged on some key issues (immigration being one, but also defence and foreign policies) and, despite the proliferation of European-wide bodies, there still remain crucial challenges in even coordinated macroeconomic policy. It is difficult to say whether a financial crisis in Greece or Portugal would create the same sort of coordinated response as in, say, Italy, and this reality also sows uncertainty in markets. How then should financial institutions respond? Avoid high-risk jurisdictions? Diversify across the entire euro area? Limit offerings in some countries? The lack of common policy, as well as the example of Greece, does not instil confidence and instead creates its own uncertainty.

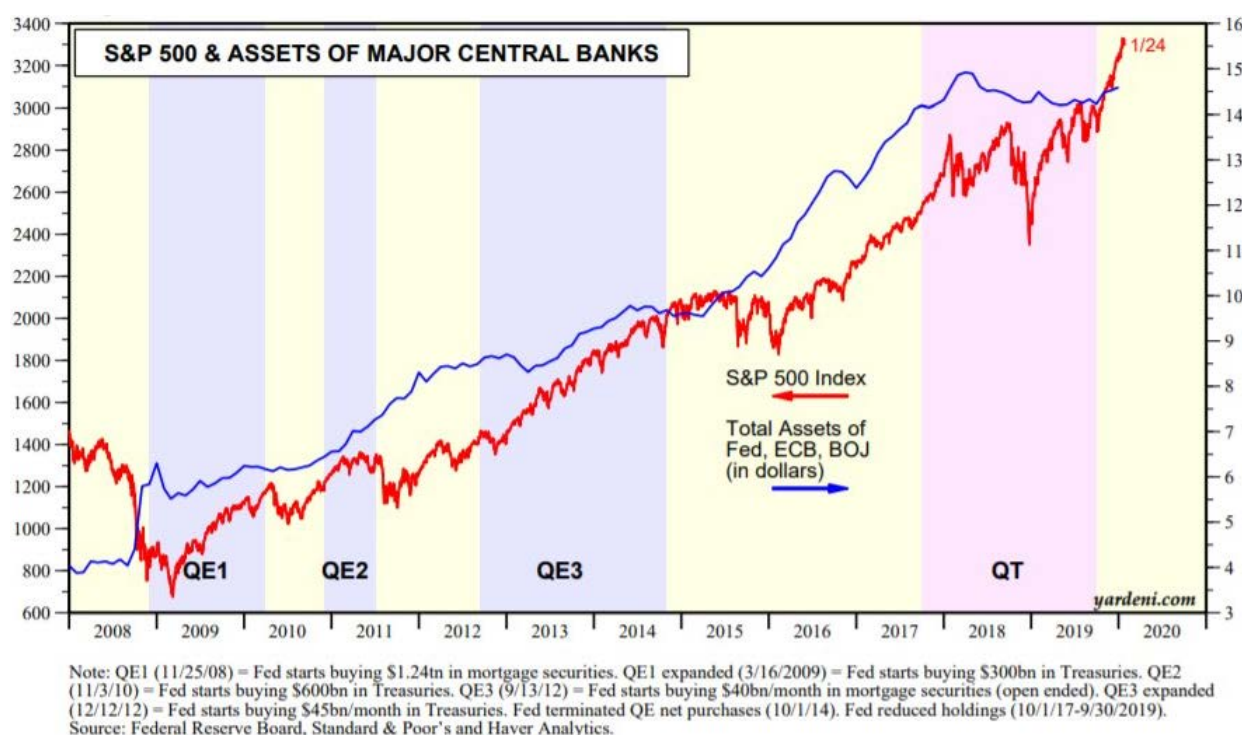
3. BARBARIANS AT THE GATES

In a globalised world of finance and trade, movements of capital or goods across borders can have just as important an impact on a country's financial system as domestic demand or conditions. Without a doubt, the GFC showed just how important the global financial system was, as a problem localised in American mortgage markets soon reached into financial sectors of countries with no exposure and threatened the real economy everywhere. Given the weaknesses in the euro area noted above, risks emanating from outside Europe also have the potential to create difficulties for the euro area financial sector.

3.1. Asset price collapses in the United States

The Dow Jones Industrial Average and the S&P 500, the main indices of equity markets in the United States, have been on a massive climb since the GFC: from its low point in March 2009, the S&P 500 has risen 332 %, while from the same point the Dow has gained 313 % (with the steepest gains coming from January 2017 onward). While the US economy has grown appreciably faster than the euro area, it is difficult to argue that the performance of US corporates justifies such a tremendous increase in valuation. Moreover, much like valuations in Europe, the US stock markets have gone hand-in-hand with loose monetary policy, as shown in Figure 5 from market-watcher and economist Edward Yardeni, meaning any tapering would lead to a deflation of asset bubbles.

Figure 5: S&P 500 & assets of major central banks



Source: Yardeni.com, used with permission of Edward Yardeni.

Indeed, much like Europe, it is doubtful that markets can continue to run fuelled on monetary stimulus alone. By the end of 2019, the main manufacturing index in the US, the purchasing manager's index (PMI), contracted to 47.2 %, its lowest level since June 2009, signalling slowdowns in production and

an increase in input prices. Meanwhile, while the headline unemployment rate holds firm at an incredibly low 3.5 %, as throughout the Obama years, the participation rate in the workforce remains worryingly low at 63.2 % (December 2019), a number below all of the EU Member States (Croatia is the lowest at 66.3 %, according to OECD data).

The prospect of a slowdown in the US, as in Europe, is compounded by the reality that the Fed has not been shy about keeping the monetary taps fully open, meaning that the US as well is exposed to a downturn. In such a situation, with a decline in US asset prices and its concomitant effects on the financial sector in the US, European banks with exposure to the US market would once again suffer as in 2008. While the US has far greater fiscal space (see below) to combat a recession, due mainly to decentralisation and greater buffers (and a much more homogenous yet giant market), this is not to say that any financial downturn in the US will not harm Europe – and Europe's banks – first and foremost.

3.2. Slowing growth in China

An additional macroeconomic variable with potentially grave consequences for the global economy is any slowdown of growth in China. China played a valuable role in during the GFC, a role it continues to play, through vigorous consumer demand and fiscal stimulus supplied to the developed world via bond and asset purchases. However, in 2019, Chinese growth slowed to approximately 6 %, its lowest growth rate in 30 years, with investment plummeting (albeit still the envy of developed economies), domestic demand weakening, and exports falling (in part due to the trade war with the US). China's growth more than anything has probably been responsible for the tepid recovery in the euro area and the growth seen in the US, as it is unlikely that monetary stimulus alone could have created the conditions for resumption of growth. Once monetary stimulus has reached its limits in effectiveness, however, as it seems to have, and China's version of fiscal stimulus is withdrawn, how will the global economy react?

The EU has acknowledged these risks in its 'EA and EU Outlook' as early as 2015, noting that 'Apart from direct trade and financial linkages between the EU and China, there are indirect channels operating via countries heavily exposed to China. Vulnerable emerging markets and commodity producers may face a combination of lower export demand and low commodity prices and may see some downward adjustment in their exchange rates as global capital flows respond to the shifting environment' (European Commission, 2015:56). The ECB has also noted that slow growth in China might directly affect the financial sector via increasing interbank spreads, driven by increasing risk in Beijing, leading to a dampening of liquidity and an increase in costs within the euro area (ECB, 2017). None of these consequences would be good for the euro area financial sector, even though, as the ECB also noted, direct exposure of the euro area to Chinese banks are limited. Rather, the real effects and especially a slowdown in global growth brought on by China would be the main conduit for financial stress in Europe.

3.3. Continued policy uncertainty globally

With impeachment hearings in the US hurtling to an almost-inevitable conclusion (President Trump still in office), the uncertainty does not end there for the US economy, as when it ends there is still an election this year – and if someone like Congressman Bernie Sanders is able to ascend to the highest office in the land, it is highly likely that the US economy (and especially the financial sector) will take an outstanding hit from anti-growth, populist/socialist policies. Uniformly across the Democratic party, candidates have taken strident anti-financial sector stances, with the largest being the wish to repudiate over a trillion dollars' worth of student loan debt. The consequences of such a write-off, either

to the fiscal position of the US or to individual financial corporations, has not been costed but can create severe stress (as well as moral hazard for the future).

In addition to the normal, formal political volatility seen in the US, there are other informal political issues which have the potential to disrupt the global economy. First and foremost, the continuing protests in Hong Kong can have longer-term ramifications for China and the region, especially if they are resolved in a violent manner. Moreover, Middle East tensions have escalated throughout 2019 and early 2020, typified by increasing violence against Israel, the war of words (and missiles) between Iranian proxies and the US in Iraq, and the persistence of conflict in Syria. While it is a fallacy to believe that long-run inflation is driven by oil prices predominantly – inflation remains a monetary phenomenon (De Gregorio *et al.*, 2007) – any increase in oil prices can instead affect the real economy via inputs and thus have the potential to create disruptions. This too can then rebound to the financial sector's detriment, both in terms of distressed loan recipients (harmed by the rising price of inputs) and in terms of volatility around exchange rates and commodity prices.

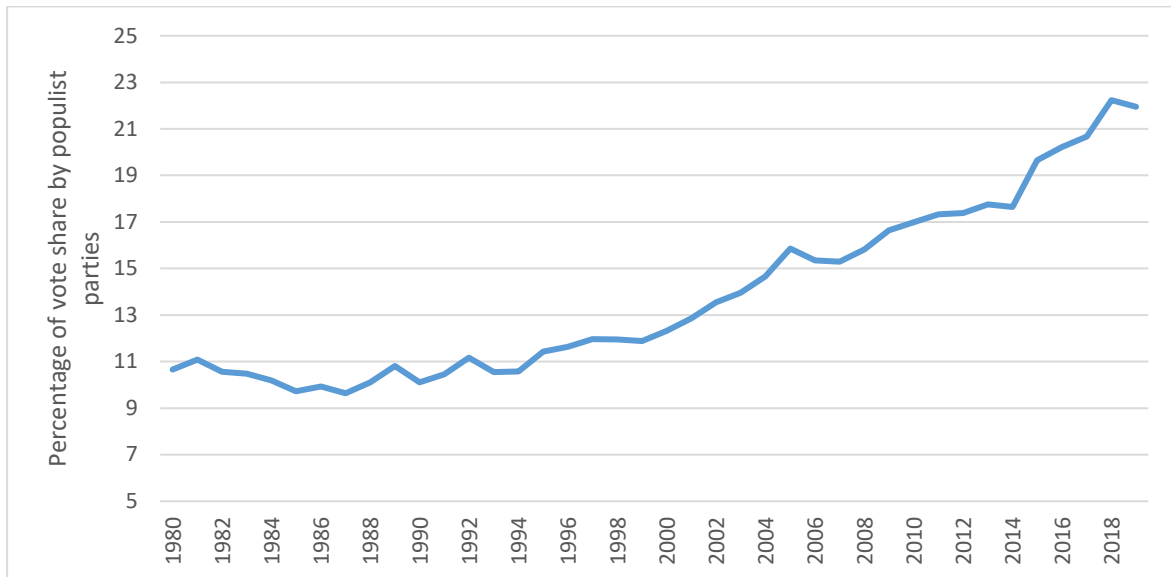
3.4. Domestic political alignments and the rise of populism

Finally, the biggest source of continued policy uncertainty globally has been rise of populism across Europe and in the US (Figure 6), which, if not directly attributable to the response to the global financial crisis (although I argue it is, see Hartwell [2019b]), is a reality of the post-GFC world. Shifting political alignments globally have pushed left-wing governments more leftwards and, in terms of fiscal policy at least, have pushed right-wing governments leftward as well.³ This has resulted in a wave of anti-business, anti-growth policies such as the trade disruptions and explicit call to end free movement of Brexit, the trade war with China initiated by the United States, bans on foreign ownership in countries as disparate as New Zealand and Poland, and outright nationalist/protectionist policies in Latin America and Africa.

The continuing popularity of populism means that various policies undertaken by governments prior to the global financial crisis, policies with demonstrable benefits for the populace such as trade liberalisation, flexible labour markets, and capital account liberalisation, may be halted or reversed, with an eye towards protecting indigenous industry. This may also entail a rise in industrial policies, the use of public funds for private actors, and a general deterioration in the quality of governance worldwide; all of these macroeconomic trends are a threat to real growth and, thus, a threat to the financial sector in Europe.

The way in which this may play out in the financial sector is much more specific than populism's effect on real variables however, as the financial sector is also often a *bête noire* of populists, with 'bankers' or 'speculators' seen as the source of society's ills (Kazin, 2016). With particular ire directed against bankers for their role in exacerbating inequality or supporting failed policies or whatever the fashionable theme is, policies can be put in place to either break-up larger banks (Thirkell-White, 2009) or to bring the financial sector under control of political-friendly operators (Ellner, 2005). Such a continued move in countries where European banks have a strong presence (as in Latin America, where Spanish banks prevail) could further threaten bank profitability, create unneeded additional uncertainty, and threaten specific institutions.

³ Thanks to Paul Vaaler for this phrasing.

Figure 6: The rapid ascent of populist parties in Europe

Source: Author's calculations based on Timbro Authoritarian Populism Index. Line is average of the vote share of all populist parties in Europe over 20 to 33 countries from 1980 to 2019. Europe broadly defined to include the EU and Eastern Partnership countries.

4. REACHING THE LIMITS

Not all of these risks detailed in the preceding two sections may come to pass, and there may plausibly be combinations of these risks or various permutations which can play out over the coming years. But regardless of which of these risks turns into reality, the truth of the matter is that the EU is ill-prepared for any downturn. This is due mainly to the fact that policymakers have had their foot on the gas pedal all the way to the floor for a decade, leaving no more power to help the car go faster. This is true in both monetary and fiscal policy.

4.1. Monetary policy at its limits

Leaving aside the question on if the unconventional monetary policy has been a net negative for the Eurozone, the threat to the European economies in case of a recession is that there is little recourse to additional monetary tools. As noted above and in Hartwell (2019a), the unconventional monetary policy that the ECB has been pursuing since the GFC has not abated and, in fact, has continued up to and including the most drastic measures.

The main problem that the ECB will face in confronting a new recession is that it has already tried to control the two main levers of monetary policy over the past decade. That is, central banks have long faced the constraint of targeting monetary growth (and then letting interest rates adjust where they may due to monetary supplies) or, as done more recently, setting interest rates and dealing with the monetary supply consequences. Indeed, interest rates have been the preferred method of policy control over the past 20 years, as money growth was an admittedly noisy and chaotic (Solomon and Solomon, 1991) tool (but Benhabib *et al.* [2002] showed that interest rate targeting could also be chaotic). However, the scale of the global financial crisis, and the charge towards ‘whatever it takes’, led central banks to believe that they were able to control both levers simultaneously, using their ‘normal’ interest rate levers and then switching over to explicit monetary growth targets.

This can be seen in the actions of both the Fed and the ECB, as the plummeting of interest rates to zero or lower was accompanied by quantitative easing, asset buy-backs, and other direct injections of liquidity; while some have breezily dismissed the idea that money growth is no longer part of any monetary policy, such a view ignores the explicit goal of ECB (and Fed) policy over the past ten years (and of Japan for the past twenty years at least). Massive injections of liquidity directly have all targeted money supplies, meaning that central banks have tried to have the best of both worlds and use both a ‘targeted’ interest rate tool and blunt monetary targeting.

Of course, this attempt to circumvent laws of economics was enabled by swathes of the academic community and its reliance on a theoretical models such as vector autoregressions or cointegration, which merely modelled past relationships as if they would hold forever and ever (with the warning of Lucas [1976] not heeded if nebulous ‘expectation functions’ were included) without any understanding of the underlying economic incentives or interactions. Getting into the weeds of the statistical properties of the data but without understanding the economics of human action led to papers in respectable journals such as Carstensen (2006), using new techniques to tease out policy recommendations which were wholly worthless: Carstensen’s (2006) entire last paragraph says that perhaps excess liquidity was too high in the euro area, or perhaps it was not, depending upon where one arbitrarily set the reference point.⁴ With such wide margins of confidence emanating from academic circles, central banks joined in the hubris to believe that there were ways in which they could

⁴ As it turned out, Carstensen (2006) appeared to come down on the side that excess liquidity in the euro area was not an issue, a prediction on the eve of the global financial crisis which, in hindsight, seems as misguided as Irving Fisher’s assertion of a ‘permanently high plateau’ for stocks in October 1929.

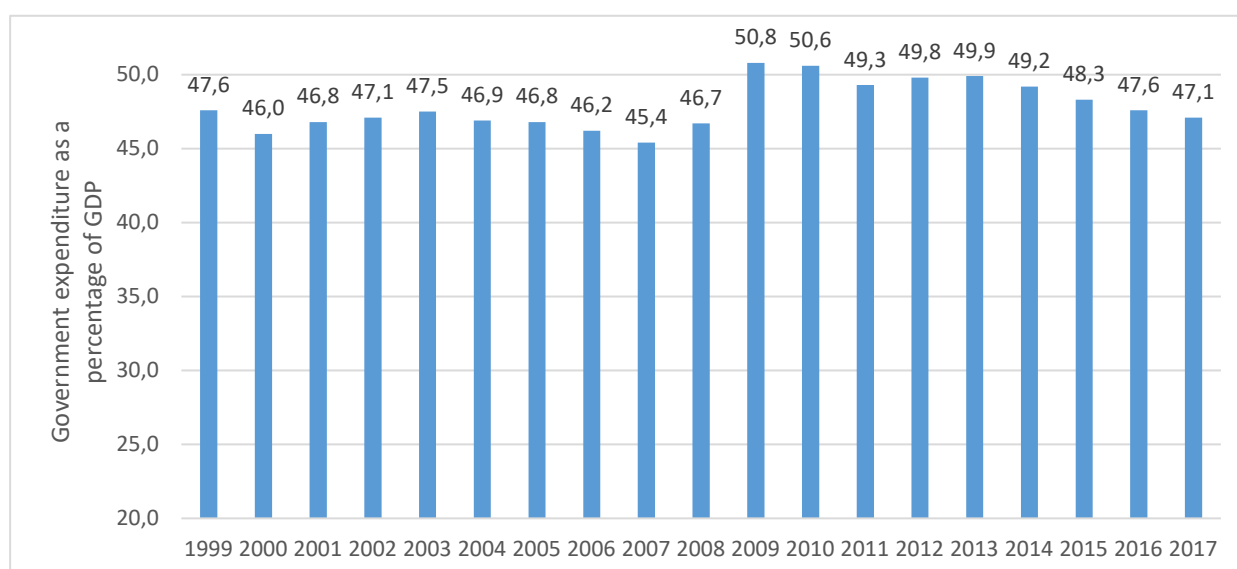
simultaneously abnegating the time value of money while also inflating money stocks but without having it translate into price inflation. Research such as Belongia and Ireland (2018) supported this, promising that central banks could have it all (interest rate decreases and monetary targeting), especially once the zero lower bound had been reached.

However, what these analyses overlooked was precisely what Lucas (1976) predicted, in that the fundamental relationships among variables would change due to policy (a reality which was explicitly eschewed in the models that econometricians were using). In particular, single-shot models of 'money demand functions' ignored the cumulative effect of utilisation of so many instruments, with little ability to say what a package of policies at time t might do to expectations or demand at time $t+5$. More critically, these models had little predictive power if external conditions were to change dramatically, say if economic growth were to slow or other exogenous shocks were to strike.

Unfortunately, this eventuality is precisely what the euro area is confronting as its next recession looms. With central bankers having run out of instruments via continuing to try and influence monetary supplies *and* interest rates, the only solutions which have been mooted have been in the realm of the fantastical: 'helicopter money', continued asset purchases, or a recourse to 'modern monetary theory' (where unlimited streams of fiat money are issued forth to flood the real economy). All of these 'solutions' have even more deleterious consequences for the real economy and cannot be expected to rescue the euro area. But the fact that they are seriously even contemplated shows just what a bind the ECB has put itself in by exhausting all possible realistic options *during an expansion*.

4.2. The search for fiscal space

At the same time, the other commonly used lever of stabilisation policy, fiscal policy, is showing similar limits. Much as monetary policy was kept going at maximum levels during the most recent expansion (for fear of lapsing into another recession), fiscal policy across the euro area has also been highly expansionary and procyclical. For the most part, Member States continued their spending ways throughout the crisis, with slight increases in spending and, despite worries about 'panic-driven austerity' (De Grauwe and Ji, 2013), no real cutback in their large public sectors (Figure 7). This approach, of course, satisfied no one – not the Keynesians who wanted to see the purse strings loosened entirely nor the budget hawks who saw the bloated public expenditures in the euro area as part of the problem.

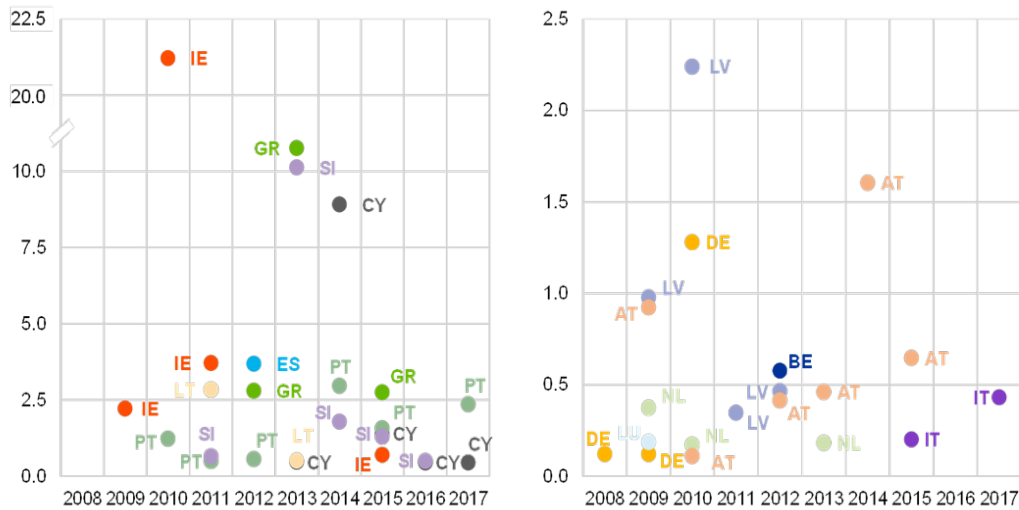
Figure 7: Government spending in the euro area: well-hidden austerity

Source : Eurostat.

Meanwhile, with expenditures still running high across most euro area governments, the ability to turn on the fiscal taps during a recession will be circumscribed. This is especially true when one considers that expenditures may actually increase in coming years. The ECB itself noted in a 2019 paper (Attinasi *et al.*, 2019:10) that, despite the slowdown in the euro area, it was anticipated that ‘austerity’ measures on public sector wages were soon to be scrapped:

‘In Italy, after being frozen during 2010-15, wages are accelerating again in 2018, due to the application of the 2016-18 wage negotiation round. In Spain, an increase in wages is projected on the back of the wage increases legislated in the 2017 and 2018 budgets. In France, wages accelerated in 2017 reflecting the increase in the remuneration of teachers and the estimated impact of the reform of the public sector general salary grid for both 2017 and 2018. In Germany, public wages have started to grow at a robust rate due to labour supply bottlenecks and composition effects related to skill upgrade of the public sector workforce. Among the small countries, public wages have also accelerated significantly in Ireland in 2017, as a result of the new national pay agreement lasting until 2020 and aimed at unwinding the pay cuts enacted during the crisis. A gradual acceleration of public wages is ongoing also in Cyprus, where wages indexation to the cost of living allowance (COLA) has been re-introduced as of 2017 after a period of wage freeze.’

Figure 8: Net impact of financial sector support measures on the general governmental deficit in the euro area



Source : ECB Economic Bulletin, Issue 6/2018, Chart B.

With financial sector clean-up left to the monetary side – and outsourced to the ECB – and social and public sector spending remaining high during the expansion, the reality remains that Member States have very few buffers available to cushion the financial sector in event of a severe downturn. These costs may be substantial, especially for the countries of southern Europe and smaller euro area members, as the impact of financial sector support measures for some countries such as Ireland ran to 21 % of GDP at the height of the crisis (Figure 8). At the same time, as the European Fiscal Board (EFB) noted in 2019, eleven of the euro area countries had not yet achieved their medium-term budgetary goals (EFB, 2019), with the largest outlier in terms of debt also being the biggest threat to financial stability in the euro area (Italy). Without fiscal space in precisely the countries which need a buffer the most, this unfortunately means that monetary policy will likely once again be called on to do the heavy lifting during the next recession, even if (as already shown) it too has reached its limits.

5. CONCLUSIONS: WELCOMING THE COMING RECESSION

In no uncertain terms, European policymakers and in particular the ECB have dug themselves a hole that would be difficult to climb out of in the best of situations. With risks of recession looming from both internal and external sources, the needs of the exposed financial sector may be far beyond what the ECB is able to cover from monetary policy (in addition to being beyond what national governments can cover via fiscal policy). In this sense, by reducing resilience and pushing stabilisation policies into overdrive during an expansion, one cannot say that unconventional monetary policy has been good for the euro area; the only question with regard to fiscal stability is whether or not the financial sector can survive the next economic downturn.

If a recession were to hit in the next 12 to 18 months, the only way ahead would be for normalisation and a return to economic fundamentals, which would necessarily mean a negative monetary shock to the financial sector. This would also mean that the financial sector as it exists today would no doubt not exist after the recession, as the frailties of certain institutions (and in particular larger banks) would be exposed and exploited. And policymakers, rather than promising no pain for all gain must prepare the public for a period of disruption. Is this good politics? No, it certainly is not. But neither is promising a decade of holidays from economic rules.

To put it in more formal economic terms, expectations must be re-set within the euro area, not necessarily regarding inflation (these expectations are already plummeting and the 5 year forward expectations measure of the ECB bottomed out at 1.12 % in October 2019), but of expectations regarding monetary policy. To this point, investors and financial markets in general have been following a second-order set of expectations akin to Keynes' 'beauty contest': as the reader may recall, Keynes (1936) castigated capital markets as being similar to a newspaper beauty contest where readers had to guess which contestant other readers thought was most beautiful. Thus, it was not one's own subjectivity which was part of the rankings but how one perceived the subjectivity of others. Keynes argued that this was how the stock market worked, with investors trying to out-game each other, and thus equity markets were unmoored from fundamentals and instead based on mass psychology, delusions, and of course 'animal spirits'.

In Europe today, however, it is not 'irrational' capital markets who are creating unrealistic expectations but instead the ECB, as all market participants constantly try to guess the ECB's intentions towards monetary policy – and, as noted, have built in assumptions that the ECB will not be changing any time soon. At the same time that market participants are watching the ECB, the ECB itself is trying to survey market expectations and fashion policy (and monetary demand function) off of participants who have already set expectations based on prior ECB behaviour. In this way, the ECB has inserted itself wholly and permanently into expectations formation. Never has the Lucas Critique rung so true, in that ECB policy has truly altered the fundamental relationship of variables, making its forecasts and its own policies less and less effective. Additional hysterical tools such as helicopter money, deeper negative interest rates, and the like would only continue to push back the day of reckoning and ratchet expectations downward even further. Only by re-setting expectations of normalisation – and, following from the credibility literature, following through with it – can the ECB hope to climb out of the hole that it has created for itself. And such an approach can also allow for better targeted assistance (both monetary and fiscal) if needed during the recession.

It is always difficult to fashion counterfactuals when it comes to economic policy, but the coming recession could likely be similar to the Depression of 1920 to 1921 in the United States. In the wake of the Great War, monetary policymaking in the US refused to normalise, and inflation rates regularly topped 15 % (reaching over 20 % at the end of the war in November and December 1918). This great

inflation necessarily led to a reckoning in the real economy, as the bubble burst and the US entered an incredibly sharp and painful Depression: output fell by approximately 30 % (O'Brien 1997), the stock market declined by 50 %, and unemployment rose in a period of nine months to 8.7 % from 5.2 % (Romer, 1986). At the same time, according to Meltzer (2004), M1 contracted by 10.9 % from March 1920 through January 1922 and the monetary base shrunk by 6.4 % from October 1920 to January 1922.

In response, with capital scarce, the Fed priced it accordingly, raising the interest rate to a high of 7 % in 1920 from 4 % in 1919, while government spending was slashed and the federal government refused to contemplate bailouts (Grant, 2015). With no safety net, the market worked itself out and the economy bounced back within 18 months from the start of the downturn. The financial sector did not suffer unduly simply because the automatic stabilisers in the market allowed the crisis to resolve itself quickly; any protracted crisis (as in 1929 onward) could have threatened banks more generally, but the non-response to the reversal of easy monetary policy allowed for expectations to re-set and the strongest banks to weather the storm. This did not mean that the financial sector did not suffer, as '505 banks failed in 1921, and the number of failures continued to rise, averaging 680 per year from 1923 to 1929', but the vast majority of these banks were 'small banks in small rural communities', isolated from any diversification (Gorton and Metrick, 2013:50). And although the monetary contraction deepened the decline (Pilgrim, 1974), it hastened the recovery, meaning that the financial sector was soon to enjoy the ensuing demand from relatively vibrant economic conditions; Anderson (1979) also noted that the lack of government intervention – i.e. the setting of appropriate expectations – led to banks working overtime to identify their core customers and readjust strategy accordingly.

It would likely be politically difficult to undergo a similar response to the next European recession, but it is something that needs to be contemplated in order to normalise monetary policy and expectations. Indeed, the next recession will be an opportunity for the ECB to unwind itself from a decade of easy money and re-think its strategy, much as the banks of 1920-1 did. As an astute reader would have no doubt noted, the title of this paper comes from Winston Churchill's famous speech in 1942 after pushing back the German advance in Egypt, where he cautioned 'now this is not the end. It is not even the beginning of the end. but it is, perhaps, the end of the beginning'. The relevance for the future of the euro area economy in the face of recession should be obvious: just as El Alamein did not mean the end of the Second World War, the massive rescue operation by central banks in the wake of the GFC did not mean that the structural imbalances and deficiencies underpinning the global monetary system were solved. Instead, the coming recession will show just how much needs to be done at the structural level in order to return the global economy to a sustainable path. That is the next phase, the beginning of the end, and in order to successfully complete it, the ECB and other monetary players will need to re-orient their strategies... and be prepared to accept some casualties.

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It appears that recession may be on the way for the EU as a whole and the euro area in particular. Having used all of its instruments in the previous crisis, the European Central Bank has little left that can be helpful when the inevitable happens. This brief examines the financial risks facing the euro area and details how flexibility and non-intervention – the direct opposite approach from the global financial crisis – should characterise the response to the next crisis.

This document was provided by Policy Department A at the request of the Committee on Economic and Monetary Affairs.
