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Financial Market Instability

IN FOCUS

A Four Point Plan to Avoid Economic Catastrophe in Europe

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Summary

2016 has been marked by a return of uncertainty in the financial markets and increased doubts over growth prospects in key global economies such as China, Europe and the U.S. Nearly ten years after the U.S. sub-prime mortgage crisis first erupted, the global financial sector has returned as a key concern of economists and global investors. This note identifies four key issues underpinning the current market turbulence. It argues that although these challenges are varied and serious, they are not insurmountable for Europe owing to the reforms undertaken since 2008. However, in order to prevent regular cycles of market speculation further economic reforms are necessary which will challenge existing national preferences and change the governance of both the European and global economies. Ultimately, for Europeans, the goal of these reforms is to lead to a more cohesive and robust European Union. However, the failure of the EU to act in a timely (and collaborative) manner will result in further periods of speculation. Four policy priorities – increased investment, further global cooperation, the completion of Banking Union and the maintenance of sustainable public finances – are identified as being necessary for the EU to withstand future financial crises.

1. "Why Did Nobody See It Coming"[1]

2016 has provided an unwelcome wake-up call to those in Brussels who viewed the agreement with Greece in 2015 as heralding the beginning of a post-crisis Europe. In fact, the tentative economic recovery evidenced over the past 18 months has been overshadowed by a number of external threats which have coalesced around long standing economic and structural weaknesses in the EU. Many of these threats are external in nature and based on specific concerns about China, migration flows and spill over effects in the global economy. However, other threats – such as speculation on the banking sector – are based on a combination of worries which include the unintended consequences of the economic policies undertaken to combat the crises of 2008-14. In this context, the "*new normal*" of a long-term, low growth environment for developed economies poses even more challenges for policy makers than initially envisaged.[2] Overall, the following issues underpinning the current market turbulence are identified:

From China to Infinity and Beyond! The reality of a slowing Chinese economy has three important negative implications for the global economy. First, doubts surrounding the credibility (and ability) of Chinese authorities to manage the transition to a more market based economy has challenged assumptions of a "*soft landing*" for the Chinese economy. A transition made more difficult by the large capital outflows from China over the past several months.[3] Second, the uncertain impact of a slowing Chinese economy on economies directly dependent on oil and commodity exports. These countries range from developed economies (such as Australia) to countries who utilise these exports as the primary source of government revenue (such as Russia, Nigeria, Saudi Arabia, and Azerbaijan). Third,

[1] Attributed to Queen Elisabeth II on a visit to the London School Economics, October 2008.
[2] Mohamed El-Elrian, *The End of the New Normal?* Project Syndicate, 2 February 2016.
[3] See George Magnus, *China's "Trilemma" Makes it Vulnerable to More Shocks*, Financial Times, 23 February 2016.

broader concerns of how a Chinese slowdown will impact upon global growth, particularly in light of the relatively slow recovery path of many developed states (including those in the EU) from the 2008-14 crises.

Banks: Too Big to Fail, Too Little Reform? Fears over the viability of the commercial banking sector have returned to the forefront of investors' minds since the beginning of 2016. Initial fears over the Chinese financial sector have escalated into concerns over the long term health of global banks based in both the U.S. and Europe. Again, this uncertainty is based on a number of distinct risks magnified by "*some grim medium-term trends implying pervasive mediocre growth*".[4] In the U.S. worries relate to a potential slowdown in the economy magnified by exposure to a domestic energy sector now facing a prolonged period of low prices. Allied to this has been a return of the debate as to whether large U.S. banks remain "*too big to fail*" and if breaking up banks or increasing the level of capital they should hold will return to the policymakers menu.[5]

In Europe, wider global worries have been exacerbated by fears that the partial implementation of Banking Union may be insufficient to deal with a prolonged deflationary period of low growth. Investor concern has centred on two key legacy issues from the 2008-14 crises. First, the issue of non-performing loans (i.e. loans that are in default or not being repaid) is best illustrated in the case of Italy where over 17% of total advances (over €350bn) are non-performing and remain on the banks balances sheets notwithstanding the recent agreement between the Italian government and the European Commission.[6] The failure of successive Italian governments to tackle this issue, allied to fears of how investors will be "*bailed in*" and forced to lose their investment in any banking resolution, have driven a collapse in the share price of Italian banks.[7] Second, the market is also punishing those banks viewed as not having reformed quickly enough to boost capital reserves, exit unprofitable markets and deal effectively with legacy litigation/fine issues for improper conduct. In this case, Deutsche Bank and Barclays Bank are examples. Despite the reforms carried out

[4] Nouriel Roubini, *The Global Economy's New Abnormal*, Project Syndicate, 4 February 2016.
[5] Neel Kashkari, *Lessons from the Crisis: Ending Too Big to Fail*, Speech of the President of the Federal Reserve Bank of Minneapolis at Brookings Institution, Washington D.C., 16 February 2016.
[6] James Politi, Martin Arnold and Jim Brunsden, *Italy Reaches "bad bank" Agreement with Brussels*, Financial Times, January 27 2016.
[7] See, for example, Silvia Merler, *Now You See It, Now You Don't*, Bruegel, 3 August 2015 for a summary of the Italian "bail in" experience in 2015.

since 2008, influential voices continue to warn of banking sector vulnerabilities.[8] This is particularly relevant for the EU given Europe's overwhelming dependence on banking finance as a driver of the economy.

The Unintended Consequences of Doing Whatever it Takes. Ultimately, however, it is the worry that banks will not be able to generate sufficient profits to earn a return for investors that is driving market uncertainty. Here, the actions of policymakers and regulators since 2008 are increasingly coming into focus. In broad terms, there is a realisation that the monetary policy response necessary to combat the threat of another Great Depression has had a series of unintended consequences. Consequences which, when considered cumulatively, may reduce the attractiveness of many banks as investment opportunities. The actions of the Federal Reserve, the European Central Bank and other global central banks to "*do whatever it takes*"[9] – coupled to the more vigorous approach adopted by banking regulators – have resulted in a situation where:

i. The ability of banks to generate traditional lending profits (e.g. the difference in the interest rate between their cost of capital and their lending rate to customers) has been challenged by the negative interest rate environment introduced by the European Central Bank, Japan, Denmark and Sweden in recent times. Such moves, in attempting to increase bank lending to businesses, reduce borrowing costs for consumers and reduce the risk of deflation, may also have the effect of supressing banking profits and, potentially, new lending, as the banks absorb the increased costs in order to maintain their customer base.[10]
ii. A key global response to the 2008 banking crisis was the acknowledgement that banks required more capital (i.e. the more capital a bank has the better able it is to absorb losses). The revised "Basel III" rules have acted as a global framework for increasing the capital levels of banks.[11] These rules will be implemented in the period up to 2019. However, many financiers argue that attempting to increase capital levels in a time of low economic growth, negative

[8] Sir. John Vickers was Chair of the British Independent Commission on Banking in 2010-11. He has been highly critical of the Bank of England's role in diluting his conclusions on the amount of reserves banks should hold.
[9] Speech by European Central Bank President Mario Draghi, *Unemployment in the Euro Area*, Jackson Hole, 22 August 2014.
[10] Morten Linnemann Bech and Aytek Malkhozov, *How have Central Banks Implemented Negative Policy Rates?* Bank for International Settlements, Quarterly Review, March 2016.
[11] In the EU, these revised standards are set out in the Capital Requirements Directive and Regulation (CRD IV/CRR Package), July 2013.

interest rates and a high level of legacy non-performing loans (discussed above) will reduce banking sector profitability and increase market uncertainty. The argument being that "*banks that are incapable of making profits are not safe, regardless of their capitalisation levels*".[12]

iii. In addition, within Europe, the current market uncertainty reflects a belated investor recognition of the importance of the European Bank Recovery and Resolution Directive (BBRD) which entered into full force in 2016.[13] This legislation, among many other elements, successfully breaks the direct link which saw governments having to bail out failing banks. This was most clearly seen in the case of Ireland where the direct cost to the Irish taxpayer was 64 billion euro. For many investors, however, the fear is that they will be *"bailed in*" in any banking failure. This is particularly relevant for investors in banks where doubts remain over the underlying strength of their historic assets (e.g. some Italian banks and Deutsche Bank)

iv. Overall, it must be acknowledged that the lasting effect of the 2008-14 crises has been to create an abnormal economic environment characterised by low growth, the threat of deflation and an expansive monetary policy. The vow of the ECB in 2012 to preserve the Euro settled investor unease over the perceived slow pace of structural reforms in the EU. However, the recent market uncertainty is based on renewed worries that global central banks, including the ECB, are running out of policy tools with which to further stimulate the global economy. In this context, the absence of additional monetary tools raises further doubts over the ability of the EU (and other global economies) to deliver the fiscal reforms necessary to drive growth in the coming years.

External Issues, Internal Pressures

The concerns over China, economic growth and the banking sector have been magnified in recent months by a continuing fracturing of the global geo-political situation. The continuing conflict in Syria and its impact upon migration flows into Europe, allied to security concerns following the Paris and Brussels terrorist attacks, have all contributed to market uncertainty over global financial stability. In addition, fears of a prolonged period of unrest in the Middle East have exacerbated existing strains in US/EU

[12] Gene Frieda, *EU's Ailing Lenders Require the Equivalent of Palliative Care*, Financial Times, 18 February 2016.
[13] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

relations with Russia and have undermined the ability to forge a global coalition against the ISIS threat. Within Europe, these issues are compounded by the failure of the EU to implement a coherent response to the migrant crisis.

This inability of the EU to act collectively on the migrant issue has reawakened the financial markets to the key structural reforms which still need to be implemented in order for the Eurozone economy to function sustainably in the long run. In short, the EU's disjointed response to the migrant crisis has increased fears that the fundamental economic reforms required in the EU will not be achieved owing to divergent national preferences. This, in turn, is feeding market speculation against the European banking sector.

Even in global economies where unemployment has reduced significantly in recent years – such as the US and the UK – new doubts have emerged as to the sustainability of existing growth rates. Given Britain's uncertain future in the EU these worries are compounded by a broader fear that the Brexit referendum may be a prelude to more significant institutional changes in the EU in the future. These potential changes include the development of a multi-tier Europe defined by differing levels of integration.

2. A Lot Done, More To Do!

Led by the European People's Party (EPP) and accelerated since the commencement of the Juncker Commission in November 2014 the response of the EU to the crises since 2008 has been based around three pillars. First, developing mechanisms to ensure sustainable public finances. Second, pursuing structural reforms to boost productivity and competitiveness.

Third, reviving investment which has declined significantly in Europe over the last decade.[14] Although many elements of the work undertaken since

[14] See remarks by Commission Vice-President Dombrovskis at the European Semester Conference, Brussels, 16 February 2016 for a brief overview of the current EU approach.

2008 have strengthened Europe's ability to deal with renewed economic shocks, key vulnerabilities remain including high public and private debt levels. As noted above, these are vulnerabilities which are magnified by the more uncertain external environment evident since the beginning of 2016.[15]

Since 2008, the EU has worked to stabilise the financial markets, both in an international and European context. The European Commission – in the lst eight years – has proposed more than 40 legislative and non-legislative measures with the ultimate objective of creating new rules for the global financial system including developing a real Banking Union in Europe to prevent a repeat of the events of 2008-09.[16] These measures have included dealing with specific financial sectors, such as hedge funds and short selling/credit default swaps, to the broader issue of resolving failing financial institutions.

Global Frameworks

On a **global level** the EU works with other states on international financial standard setting bodies and promotes the convergence of common standards in the regulatory and supervisory area. Working within the framework of the G20, the EU played a significant role in developing the global agenda for tackling the financial crisis. The 2008 Washington Declaration of the G20 sets out five key principles of financial market reform all of which are wholly consistent with the ongoing work of the EU. These principles are strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, reinforcing international cooperation and reforming international financial institutions.[17]

The specific measures to further these principles are developed by the Financial Stability Board (FSB) of which the EU is a key member. The FSB in currently chaired by Mark Carney, Governor of the Bank of England. In

[15] Ibid.
[16] For a full list of these proposals see: http://ec.europa.eu/finance/general-policy/policy/map-reform/index_en.htm. As of February 2016, all – bar five – of these actions have been completed.

[17] G20, *Declaration of the Summit on Financial Markets and the World Economy*, Washington D.C., 15 November 2008.

response to the recent market turbulence, the FSB has highlighted the continued importance of implementing financial sector reform. In addition, Governor Carney has stated that "*new and emerging vulnerabilities in the financial system, including potential risks associated with market-based finance, asset management activities, conduct, correspondent banking and climate change*" will continue to be addressed in 2016.[18]

As noted, a key achievement of this global cooperation has been the implementation of the Capital Requirements Directive and Regulation (the CRD IV package). The Directive contains provisions on increasing the amount of capital banks are required to hold in addition to providing for increased obligations regarding remuneration, governance, diversity and transparency. The Regulation provides for a **Single Rule Book** which provides a set of common rules and ensures a common regulatory approach for banks across the EU.

Key European Legislation

Although the scope of this research precludes analysis of all the initiatives undertaken by the EU in this area since 2008, the issue of **Banking Union** is addressed in further detail given its importance to the EU's banking sector and its role in building (and sustaining) market confidence.

The three core pillars of Banking Union – A Single Supervisory Mechanism (SRM), a Single Resolution Mechanism (SRM) and a European Deposit Insurance Scheme (supplemented by the Single Rule Book discussed above) – deal directly with many of the causes of the 2008-14 crisis. Underpinned by support from the EPP Group in the European Parliament the SSM became operational in November 2014. The ECB is now the banking supervisor for all banks in the euro area, directly responsible for supervising the 123 largest banking groups in the EU. Also in 2014, a detailed series of asset quality review and stress tests were carried out on these financial institutions. Together these assessments helped to dispel doubts over the financial viability of Europe's banks and aided the restoration of confidence in the European economy.

[18] Letter from Chair of the Financial Stability Board to the G20 Finance Ministers and Central Bank Governors, 27 February 2016.

The second pillar of Banking Union – the SRM – became operational in January 2016. In implementing the BBRD Directive, the SRM, as previously noted, applies an integrated and effective resolution process at European level for all banks in member states subject to the SSM. The BBRD Directive provides authorities with more comprehensive and effective arrangements to deal with failing banks at national level, as well as cooperation arrangements to tackle cross-border banking failures. In effect, it severs the doomed loop between member states and their banks. In ensures that the resolution of failing banks "*will in the first place be financed by shareholders and creditors and, as a last recourse, by a Single Resolution Fund, funded through bank contributions*".[19]

However, more measures are required to further weaken the feedback loop between banks and governments. A renewed focus is required on reducing the exposure of domestic banking sectors to their government's bonds. In addition, the Single Resolution Fund – with a planned capitalisation of 55 billion euros by 2023 – will require to be expanded in the future to ensure it is capable of dealing effectively with larger bank failures. This is important in ensuring its credibility as a resolution mechanism.

Proposals for the final pillar of Banking Union – a European Deposit Insurance Scheme – were set out by the European Commission in November 2015.[20] These proposals, when implemented, will result in all deposits of up to 100,000 euro being protected in case of a bank failure. The purpose is to ensure equal protection of deposits through the Banking Union regardless of the member state where the deposit is located.

The introduction of Banking Union has been complemented by revised EU fiscal structures which now place responsible budgetary policies as the cornerstone of EMU. The markets' lack of faith in the national fiscal policies of some member states prior to 2008 has necessitated a strengthening of the EU's role in the fiscal policy making process. This has already been achieved through a suite of measures including the so-called "Six Pack", "Two Pack" and the Treaty on Stability, Coordination and

[19] European Commission, *A Reformed Financial Sector for Europe*, Com(2014) 279 Final, 15 May 2014.
[20] European Commission, Proposal for a Regulation of the European Parliament and Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, 24 November 2015.

Governance. These measures – all of which are now operating – enhance the credibility of the entire EMU process in addition to providing for stronger co-ordination of national fiscal policies. However, in the long term, the ultimate credibility of the EU's revised fiscal rules will only be achieved if they are applied consistently and fairly in every situation, regardless of the size of the member state involved.

Future Steps

As highlighted in the sections above, the work undertaken by the EU – at both a global and European level have strengthened considerably the potential of Europe's banks and financial system to withstand future shocks. However, the unique nature of the Eurozone's institutional architecture – a monetary union with no corresponding fiscal framework – renders the EU increasingly vulnerable to continued market speculation.

However, a coherent plan for **Completing Europe's Economic and Monetary Union** has been mapped out by Commission President Juncker in cooperation with the other key European institutions.[21] *The "Five Presidents' Report*" acknowledges that the "*closer coordination of economic policies is essential to ensure the smooth function of Economic and Monetary Union*".[22] This report sets out short term (up to 2017) and longer term (up to 2025) measures which are required to safeguard the Euro and the wider European economy. The completion of EMU is a vital component in strengthening the EU against future possible financial shocks as speculation that individual states may be forced to leave the Euro has underpinned market uncertainty since 2008. This was most recently seen with Greece in 2015.

In the short term, key recommendations of the Five Presidents Report have already been implemented. The SRM is already established and proposals for a deposit insurance scheme are progressing. Proposals for a Capital Markets Union (CMU) have also been launched.[23] CMU is rightly considered as a key element in increasing non-bank financing in Europe and in supporting other proposals which aim to unlock the vast amounts

[21] Jean Claude Juncker, *Completing Europe's Economic and Monetary Union*, 2015.
[22] Ibid.
[23] European Commission, *Action Plan on Building a Capital Markets Union*, Com(2015) 468 Final, 30 September 2015.

of private capital in Europe to finance important long term investment projects. However, it is the more fundamental steps designed to complete the architecture of the EMU that will most challenge existing national preferences and change the governance of the European (and by extension) the global economy. Two key proposals – both necessary for the long term survival of the Euro – challenge deep seated national priorities and address the need for the Euro area to develop into a more integrated fiscal and economic union. These measures are:

1. **Creation of a convergent Economic Union**: this is required to make the convergence process more binding. In addition to making EMU stronger the development of common standards and some harmonisation will result in more resilient economies. The creation of a fuller Economic Union should also result in the CMU proposals complementing the ongoing moves to complete Banking Union. It should also result in more joint decision making on fiscal policy through some mechanism such as a Euro area treasury.

2. **A Fiscal Union with stabilisation functions**: a common feature of all long term monetary unions has been the existence of some sort of stabilisation fund which could be employed, when needed, in differing parts of the currency union in order to counter large external macroeconomic shocks. Although many member states are currently opposed to the creation of any stabilisation mechanism at the Euro zone level, the increased moves towards Economic Union (and economic convergence) will render a Fiscal Union more appropriate.

3. Responses to a Renewed Financial Crisis

It is often erroneously assumed that further moves to strengthen EMU will automatically result in more political integration. In particular, recent research has highlighted that "*while completing the architecture (of EMU) is challenging, doing so does not require a forced march to political*

union".[24] Regardless of the long term political implications of EMU, it is clear that considerable work has been undertaken, at both an EU and global level, to increase the resilience of economies to further market speculation.

Within the EU, the ability of national economies to respond to unexpected economic crisis in a unified and coherent manner has increased significantly in the period since 2008. However, Europe (and also elements of the Chinese and US economies) remain burdened by very high debt levels and an incomplete regulatory environment for global financial institutions. These are weaknesses which will attract speculation in any future crisis.

The events of 2016 have also illustrated that a future crisis could emanate from any number of global sources. A slowing Chinese economy, Middle East unrest, collapsing oil prices, Europe's uneven response to the migrant crisis, legacy bad loans in the European banking system, slowing profits in global financial institutions or even speculation about a member state leaving the Euro zone are all potential triggers for a renewed period of global financial unrest.

So what should be the response of policymakers in response to a future financial crisis? This note sets out four key priorities:

i. **Global Threats Require Global Responses:** As noted, the experience of sub-prime mortgages in the US highlights that a renewed crisis may arise from multiple locations in an increasingly connected global economy. In this context, it is imperative that the EU continues to play a key role in global regulatory bodies such as the G20 and the Financial Stability Board and continues to work towards the convergence of common standards in the regulatory and supervisory area. The revised capital requirements for financial institutions (implemented in the EU through the Capital Requirements Directive/Regulation) should be implemented among all G20 members in a timely and coordinated fashion.

ii. **Implement, Don't Hesitate!** Within the EU, policymakers should actively

[24] Barry Eichengreen and Charles Wyplosz, *Minimal Conditions for the Survival of the Euro*, VOX, 12 February 2016.

seek to implement outstanding economic governance proposals in the short term. In particular, all elements of Banking Union (including a European Insurance Deposit Scheme) and the BBRD Directive should be fully implemented as soon as possible. Such tools reinforce the credibility of the EU's economic governance mechanisms and will limit speculation on key banking issues. Political differences at member state level must not be allowed to further delay the implementation of these measures.

iii. **Growth, but not Debt Fuelled Growth:** High debt levels (at both a personal and national level) in many EU member states remains a key weakness of the European economy. Member states with very high debt levels and low growth – such as Greece, Portugal, Italy and Belgium – will be the focus of market speculation in a renewed financial crisis. In this context, it is vital that measures undertaken to increase growth in Europe – a mix of sustainable public finances and structural reforms – do not add further to Europe's debt burden. Sustainable public finances will enable Europe to better withstand any future financial crisis while reforms (such as those to increase labour market flexibility and enable the unemployed to re-enter the labour market) will improve economic growth and facilitate increases in consumer spending and investment.

iv. **For the Euro to Survive, Europe Must Grow:** However, as explicitly recognised by Commission President Juncker, fiscal sustainability and structural reforms must be accompanied by an increase in investment. Increased investment will create jobs across the EU and help tackle the significant decline witnessed in Europe since 2008. The European Fund for Strategic Investments (EFSI) has the objective of utilising some public financing to stimulate private capital to deliver long term, productive projects across the EU. In conjunction with the emerging Capital Markets Union proposals, the EFSI has the potential to (a) address elements of Europe's investment shortfall and (b) maximise the use of private capital in reinvigorating the EU's investment climate. All member states – from the smallest to the largest members – should participate fully in ensuring that the full potential of the EFSI is maximised for the benefit of all.