Program on International Financial Systems

Symposium on Building the Financial System of the 21st Century:

An Agenda for Europe and the United States

Zoom conference - July 21-22, 2020

Final Report

SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR EUROPE AND THE UNITED STATES

The 20th Europe-U.S. Symposium of the Program on International Financial Systems was held via Zoom conference on July 21-22, 2020. With the global economy disrupted by the COVID-19 pandemic, participants addressed the role of the government and financial sector in supporting the real economy during the crisis. Despite cautious approval of the performance of the financial sector so far, many participants were deeply concerned about the prospects for economic recovery and the long-term effects of an extended recession on economies and financial systems.

The Role of the Government and Financial Sector in Supporting the Real Economy During the Crisis

Economic Effects of the Pandemic

Participants agreed that the economic effects of the pandemic had been extraordinarily disruptive—and in some sectors, devastating. Shutdowns around the world had led to historic declines in GDP, employment, and trade. While some sectors were able to shift to a work-from-home model with relatively little disruption, sectors such as travel, in-person retail, and hospitality were particularly hard hit, and many small businesses were endangered. Even where lockdowns were over or had not been imposed, consumers and workers had turned sharply against in-person interactions.

Participants remarked on the unprecedented speed and extent of those effects as well as the many uncertainties associated with recovery. While China, where the virus originated, had shifted toward recovery following a concerted lockdown in areas of infection, the economies of Europe and the U.S. remained weak. In several countries, including the U.S. and UK, pandemic spread had yet to be controlled; even where efforts to control the pandemic had been relatively successful, such as in Germany and France, a return to normalcy remained uncertain. Moreover, even if growth and employment began to rebound soon, many participants expressed concerns about long-term effects such as excessive public and private debt and the likelihood that lenders would face rising rates of non-performing loans.

Participants held a range of expectations regarding recovery in the U.S. and Europe. Some expressed considerable optimism about the U.S., echoing the Trump administration's assessment that economic activity would bounce back strongly in the second half of 2020. These participants cited the successes of fiscal actions such as PPP and extended unemployment that had put a floor under business failures, as well as increases in employment and the likely effects of bottled-up demand as states began the process of reopening. They also anticipated that COVID-19 infections would decline. In Europe, optimists focused both on the successes of several countries in containing the spread of the pandemic and on fiscal and monetary actions that had cushioned employment and aggregate demand. In contrast to these predictions of a V-shaped recovery, other participants were far less sanguine, suggesting that W-shaped (double-dip recession) or L-shaped (long-term stagnation) were more likely. They argued that the pandemic was not under control, especially in the U.S. and UK, that it was premature for governments to reopen the economy, that consumers would remain wary of spending (especially in higher-risk service sectors), and that supply disruptions would continue to reappear with local disease outbreaks. Both sides saw the key to economic recovery as pandemic control, but their expectations differed considerably. Where some pointed to declining numbers of infections as an opportunity for economic reopening, others argued that disease outbreaks would remain a problem that could rapidly escalate. These participants argued that the prerequisites for pandemic control would be the development and distribution of effective vaccines and treatments for the virus; while some participants were optimistic that effective vaccines would be approved by the end of 2020 and widely available by early 2021, many were skeptical.

Uncertainty about the timing and effectiveness of vaccines and treatments contributed to uncertainty about what "recovery" would look like. A key question was how long different types of businesses and households could hold out until they became insolvent. Many participants predicted that some sectors (travel, hospitality, in-person retail) would be much slower to recover than others and that there could be permanent dislocations including bankruptcies and reductions in labor. Small businesses in general were seen as a vulnerable group, as they tended to be less capitalized and have less access to private and public credit. Since SMEs accounted for the bulk of employment in both Europe and the U.S., the possibilities of widespread failures and long-term dislocation of labor and capital was seen as a serious potential problem. Similarly, high levels of household debt and low levels of household savings created concerns about the ability of households to manage their affairs—this was seen as a particular challenge for countries with more limited social safety nets, such as the U.S. Finally, several participants noted that the effects on households had tracked existing fault-lines in society, including socioeconomic status and ethnicity, exacerbating political divisions and hampering pandemic control efforts.

While recognizing the economic and public health challenges facing their countries, participants gave generally high marks for the responsiveness of economic authorities in Europe and the U.S., pointing to the proactive fiscal, monetary, and regulatory responses to support the economy. In contrast, a number of participants expressed disappointment in the public health responses of some of these governments, particularly the U.S. and UK. They also expressed concerns about political effects of the crisis, especially heightened social divisions and populism.

Financial Sector Performance

Participants generally rated the performance of the financial sector and financial regulators positively. Unlike in the global financial crisis, in which the financial sector had been the trigger and transmitter of disaster, participants were impressed by the degree to which financial institutions and markets had remained stable and functional. Banks had stayed solvent and liquid, and had continued lending to the real economy. Exchanges and clearinghouses had similarly continued to function and (mostly) remain liquid despite considerable asset price volatility. However, some markets and products, such as commercial paper (CP) and prime institutional money market funds (MMFs), had been less resilient and had required interventions by central banks or regulators to keep from freezing up.

Many participants attributed financial stability in the face of the pandemic to the lessons of the global financial crisis and to post-financial crisis regulatory reforms. The effects of post-crisis regulatory reforms were seen as having been particularly important in the banking sector, where increased capital and liquidity requirements had ensured that banks were healthy despite the economic situation. A decade of stress testing and resolution planning had also helped banks to detect and reduce vulnerabilities.

Role of Financial Sector in Supporting the Real Economy

While participants agreed that financial stability and the health of financial institutions including banks, exchanges, and clearinghouses were important, much of the discussion focused on the role of the financial sector in supporting the real economy. In the short term, this meant ensuring

provision of credit and maintenance of market liquidity, although in the longer run, some participants worried that lending into the crisis could expose banks and other financial institutions to excessive risk.

Banks

Banks had taken a particularly important role in these crucial tasks. This was true not only in the bank-based financial systems of continental Europe, but also in the U.S. and UK. Participants pointed to two reasons for their importance. First, even in the U.S., SMEs were highly dependent on bank lending due to their limited access to market-based finance. With so many SMEs adversely affected by the pandemic, banks were their only lifeline. Second, governments were for the most part not able to provide credit directly to borrowers, so official lending programs necessarily operated through banks, which had the personnel and expertise to evaluate borrowers, manage paperwork, and service loans.

Thus, banks were lending into the crisis, both on their own balance sheets and as conduits for governments. Participants raised several questions about whether banks would be able to continue to play those roles. Starting with their own balance sheets, some participants expressed concerns about whether banks would be able to continue to play their positive role of lending into the crisis. One question was whether banks could expand their lending into the crisis while still being responsible to their shareholders. It was evident that many businesses were in distress and that there was a likelihood of increased non-performing loans. However, some participants cited evidence from the UK that losses on loans to existing borrowers would actually be higher if no new credit were extended. Thus, there was a case to be made for supporting existing customers' borrowing needs.

There were also questions of constraints on banks' ability to lend. In Europe, it was argued that banks were unwilling to eat into their capital buffers, other than the countercyclical buffer, even when central banks suggested they could use their buffers, e.g. stress capital buffer or GSIB surcharge, since use of buffers could trigger restrictions on dividends and share buybacks . This was less a concern for U.S. banks that had substantial capital in excess of buffers. Still, participants recognized that capital constraints would eventually affect banks' ability to lend even to healthy borrowers if the pandemic downturn persisted long enough. It was noted that, although banks were generally well-capitalized, their health varied considerably, especially in Europe where bank profitability was an ongoing problem. Variation in bank health would depend not just on their capital positions when the crisis started, but also on geography and sectoral lending profiles. Participants urged authorities to keep a close eye on this issue.

Banks' ability to serve as conduits for government programs also faced potential constraints. One of these was how capital, leverage, and liquidity rules would be applied. In the U.S., regulators had tried to offer regulatory reassurance by offering new standards or clarifications on how examiners would evaluate their behavior. For example, banks were allowed to exclude Treasuries and Fed deposits from the denominator when calculating leverage ratio excluding PPP loans from assets for calculating capital ratios and from the formula for deposit insurance, suspending some loan-loss provisioning requirements for small banks, and creating clear criteria for whether loan modifications under the CARES Act would be considered troubled loans or not.

A number of participants argued that a critical element in ensuring that banks would continue to serve as a conduit for government lending was whether they would be on the hook for losses incurred on loans that they undertook on behalf of governments, as under the Fed's Main Street lending program.. They pointed to evidence from the UK that loan guarantees for SMEs were most successful in spurring lending when they covered 100% of the loan amount and offered clear criteria for whether the guarantee would be paid if a particular loan went bad. Many participants agreed that banks were skittish about any uncertainty over their rights, responsibilities, and potential losses.

Financial markets

Financial markets were also seen by participants as having been important in supporting the real economy in the crisis, by supporting larger firms' liquidity and capital needs and facilitating government debt issuance. A number of participants argued that much of the non-bank sector had functioned as intended, albeit with some crucial government and central bank support. They noted that there had been massive issuance of government and corporate debt that had been absorbed by investors in an orderly fashion, that fire sales and cascading defaults had been avoided, and that exchanges and trading platforms had performed well.

Many participants agreed that post-financial crisis regulatory reform had contributed to the resilience of financial markets and the low incidence of liquidity-driven sell-offs. In particular, a number of participants gave positive evaluations of the performance of financial infrastructures, arguing for example that the resilience of exchanges and clearinghouses demonstrated the wisdom of efforts to shift away from over-the-counter (OTC) toward exchange-trading or central clearing of financial products. Participants suggested that the clearest evidence of this was that the market for risk-free Treasuries, which were not centrally cleared, temporarily seized up, whereas trading in centrally-cleared derivatives did not.. A number of participants also pointed to the positive role of long-term investors such as pensions, insurance companies, and sovereign wealth funds in reducing volatility and ensuring efficient price discovery.

However, many participants also expressed significant concerns about the performance of financial markets. A number of participants observed that stresses in financial markets in both Europe and the U.S. had required large central bank and government intervention to resolve. The Fed, ECB, and BOE had all been instrumental in supplying liquidity in financial markets of all sorts, both through outright purchases of assets and liquidity facilities for banks and non-banks. They argued that regulatory reforms alone were insufficient to prevent liquidity freezes and firesales; in the end, they argued, official backstops in the form of central bank liquidity provision or government guarantees were the essential elements of maintaining financial stability in the crisis.

There was also some debate over other lessons of the CP and MMFs liquidity stresses in March and April. Significant outflows from prime institutional MMFs had required asset sales, contributing to liquidity freezes that only ended with Federal Reserve support. CP markets were hit the hardest, requiring liquidity injections to bring market participants—especially banks—back into the market. Some participants argued that their woes were a result of post-crisis reforms not having gone far enough, in that they had focused primarily on banks and financial infrastructures. These participants argued that asset management firms should also have faced

stricter capital and liquidity requirements and that large ones should have been designated and supervised as structurally important financial institutions. Other participants rejected this line of reasoning. They countered that MMFs simply reflected the behavior of the beneficial owners, and that fund companies themselves were not a cause of instability. Moreover, they argued liquidity crunches had been partly caused by inflexible regulations—for example, it was argued that MMF asset sales in the U.S. had been driven by the 30% weekly liquidity requirement. They also made the case that it was the exit of banks from CP markets that had been primarily responsible for the rapid liquidity drops, rather than by the actions of asset management firms or other non-banks. They argued that banks were unwilling to have even high-quality CP on their balance sheets until central banks intervened to provide more liquidity.

A final concern was not over the operation of financial markets, but over pricing of financial assets. Many participants remarked that asset prices had diverged significantly from the performance of the real economy. While some political leaders pointed to strong stock prices as evidence of the success of their crisis management and the likelihood that economies would bounce back strongly, many participants worried that stock markets were very overpriced and not reflect the true state of the real economy. They worried that there would eventually be a large correction that could lead to big losses for investors and lenders.

Government and Central Bank Intervention

Participants agreed that, even beyond the impacts of post-financial crisis regulatory and supervisory reforms, government and central bank responses had proved to be essential in ensuring financial stability. Many praised the European Central Bank (CB), Federal Reserve, and Bank of England (BOE) for rapidly expanding their balance sheets and ensuring liquidity in the face of economic slowdown and uncertainty. Still, they cautioned that monetary policy alone would not address the simultaneous supply and demand shock posed by the pandemic. Thus, they agreed, fiscal action was necessary. Many participants agreed that fiscal authorities in both the U.S. and Europe had shown a willingness to act more quickly and boldly than they had during the financial crisis, although there were some criticisms of both the size and specifics of fiscal packages. Participants raised concerns about whether these policies would be adequate, due to the ongoing questions how long and severe the pandemic would be in each jurisdiction—indeed, many participants suggested that public health responses would be at least as important as economic policy in determining success. Moreover, many were concerned about the long-term financial sustainability of the policies being pursued, as public and private debt rose to potentially dangerous levels. A number of participants predicted that governments would eventually take on much of the private debt burden in addition to their own debt if the crisis persisted and banks and corporations were endangered by debt build-up.

Looking at Europe, many participants felt that authorities had been far more nimble and proactive than in 2008-10. A particular contrast was over fiscal policy, where even countries such as Germany that had advocated austerity in the earlier period had put in place aggressive fiscal stimulus plans. These took a variety of forms, including support to companies to maintain employment and direct subsidization of household income. The support of the European Council in the form of suspending the Growth and Stability Pact and authorizing the issuance of a historic €750 billion joint EU bond contrasted strongly with 2008-10 as well. Meanwhile, ECB support

for governments and economies had been large, swift, and relatively flexible—even devoting 30% of the asset purchase program to the private sector in the form of bonds, CP, asset-back securities, etc. ECB provision of liquidity to banks was also seen by many as increasing their ability to lend to SMEs, and it was noted that the ECB had the power to directly lend to SMEs if necessary. EU regulatory and supervisory action had focused particularly on banks, including guidance regarding capital buffers. While many felt that this made sense in the continental European context, they noted that liquidity in money markets had yet to return.

The U.S. had also had an aggressive economic response, in addition to the regulatory measures noted above. One participant characterized the Fed's response as "shock and awe," including reducing interest rates to zero; massive purchases of Treasury and agency bonds; expanded swap lines with foreign central banks; a variety of new facilities for banks, non-financials, SMEs, and local government; and adjusting supervision for banks, such as barring stock buybacks and imposing additional stress testing. The federal government had also passed several massive appropriations acts, including the $2 trillion CARES (Coronavirus Aid, Relief, and Economic Security) Act, providing a combination of direct aid to households, expanded unemployment insurance payments, sectoral support, support for employers (Paycheck Protection Program, PPP), and loan guarantees. Participants were generally positive about these efforts, but many felt that follow-on legislation to extend unemployment and other benefits would be necessary.

Despite generally positive assessments of the U.S. response, participants raised a number of concerns. A major one was over the Fed's Main Street Lending Program, which had been established to support SMEs. Despite supporting the idea in principle, many participants expressed disappointment with its implementation, noting that only about $12 million in lending had actually come of it, despite the potential to lever up to trillions of dollars. It was argued that the basic flaw of the system was that it was structured as debt rather than equity. They called for a shift to equity-based support, In fiscal policy, a number of participants expressed concern that political bickering might endanger the prospects for the next round of legislation. Other concerns had to do with the specific of the fiscal plans—in particular, a number of participants argued that support for state and local governments would be essential so that they would not have to cut services and payrolls due to weak revenues. In addition, participants noted that, as with infection rates by the virus itself, the effects of the various economic policy measures had differential effects based on ethnicity of individuals or business owners, geography, sector, and size of firm.

Finally, for both Europe and the U.S., participants made the point that additional government intervention would be needed if growth did not rebound. Given how much of the official support had been in the form of loan guarantees and other credit supports, many participants argued that a particular concern was how governments and central banks would deal with loans that would eventually go sour.

Domestic and International Coordination

One of the ongoing concerns in previous Symposiums was whether financial authorities would be able to coordinate effectively in the next crisis, both domestically and internationally. Within the U.S., the fragmented nature of the U.S. financial regulatory and supervisory system, as well as uncertainty over the ability of the Fed to act as lender of last resort had been of particular concern. At least so far in the pandemic, participants gave relatively high marks to the U.S.

financial authorities for coordinating policies and acting in a concerted manner. Bank regulators from Federal Deposit Insurance Corporation, the Federal Reserve, Office of the Comptroller of the Currency, and the Treasury worked together to ensure that banks had clear rules regarding their ability to dip into buffers, to modify loans, and for calculating leverage ratios. They also provided new supervisory guidance on calculating impairment for COVID loan modification. Similarly, the Fed and Treasury worked closely together on the creation of new facilities, despite earlier concerns among some observers that the Dodd-Frank requirement that Treasury approve new facilities could hamstring Fed crisis management. Some participants suggested that this showed that such concerns had been overblown. Others were skeptical. Some doubted whether the Fed and Treasury were actually on the same page with regard to acceptable credit risk (with the Treasury being more conservative). Others argued that the ease of coordination could be attributed to both a common understanding of the needs of the economy between the Fed and Treasury and a lack of a "villain" that was being bailed out. They worried that in future crises that had more political overtones, such cooperation would be not be assured.

Participants noted a striking degree of intra-EU cooperation as well, with EU institutions, the ECB, and national governments working well together to ensure an effective response. The EU suspended the Stability and Growth Pact to ensure that member states could use fiscal measures to support their economies, while also carrying out direct spending. Bank regulators also provided regulatory relief. Perhaps the most striking joint action at the EU level was the unprecedented joint EU bond authorization. National governments, meanwhile, added large-scale fiscal support as well as targeted measures such as moratoria on loan repayments. The ECB supported the actions of national governments and EU agencies through both asset purchases (including not only sovereign debt, but also financial and corporate debt), provided liquidity to banks, and took supervisory actions including modification of collateral rules.

Participants also discussed transatlantic cooperation. Several commented that the quality of cooperation was striking, given the political hostility between the Trump Administration and European states (and the EU). Many participants attributed the successful coordination of regulatory responses to the trust and mutual knowledge that had developed among European and American regulators since the global financial crisis. They noted that regulators knew each other well and had worked out processes for information exchange cooperation in a variety of venues including regulatory dialogues, colleges of regulators, and the Financial Stability Board. One important question was the sustainability of cooperation as circumstances changed. It was noted by a number of participants that, even at the political level, European and U.S. authorities shared a common understanding of the crisis and were therefore pursuing similar policy solutions even in areas where there was no real cooperation, such as fiscal policy to support SMEs and employment. They were skeptical that coordination would have worked nearly as effectively if European and U.S. authorities were in fundamental disagreement or if there were competitive advantages at stake. In this sense, they worried about the durability of cooperation, given the often divergent politics between Europe and the U.S.

Looking to the Future: Risks and Responsibilities

Hanging over all of the discussion of financial stability and policy responses was the question of sustainability over time. Participants asked how long financial stability could hold if economic

growth did not resume, or if particular regions or sectors remained in distress for an extended period of time. They expressed concern that debt build-up may be unsustainable for many firms, leading to future bankruptcies and/or zombie firms, as well as slower economic growth. Rising public debt also potentially raised risks for governments, even if low or negative interest rates made debt service inexpensive for the time being.

In addition to cyclical effects and debt build-up, some participants argued that people's behavior might be permanently altered by the pandemic, including increases in working from home, decreases in travel, and increased labor-saving automation. Sectors such as travel, hospitality, and commercial real estate might be hit particularly hard, as well as labor in general. Similarly, the tax bases of some localities could be significantly reduced. And current infrastructure, such as for public transportation, might need substantial new investment.

To be prepared for an altered world, the EU and many European governments were prioritizing environmental, social, and governance (ESG) principles for infrastructure and business investment. While ESG principles were not built into the U.S. policy response, it was noted that the election may bring about a new approach. Some participants strongly supported this stance, on the basis that investments made today would be paid back over a long period of time by the next generation, which should not have to bear the burden of poor environmental choices. Others were skeptical, arguing that adding non-economic conditions to new investments would only make it more likely that they would not be profitable and that in the aggregate it would slow growth and increase the likelihood of future defaults.

Participants agreed that long-term political effects of the pandemic were also likely. One question was whether massive fiscal deficits in Europe and the U.S. (or conversely, the need to raise massive tax revenue to service them) would be politically sustainable. Participants also worried about how governments could exit crisis management at the more micro level. They noted that government intervention had become pervasive—including direct payments, lending programs, etc.—and that many sectors, companies, households, and subnational governments had become reliant on continued government support. Participants asked what policy exit would look like, how would the timing and sequencing be decided and who would take responsibility for business failures and personal bankruptcies when they inevitably occurred. Several noted that the U.S., UK, and EU had quite different philosophical perspectives as to when government should intervene in markets, the appropriate role of market discipline, and the dangers of moral hazard. Thus, even though the U.S. and Europe had followed remarkably similar policy responses to the pandemic, they predicted that exit would vary much more considerably based on local political and economic conditions. It was noted that policy exit, like the pandemic itself, was also likely to have differential effects by geography, sector, ethnicity, and age that could exacerbate inequalities and social cleavages. Some participants feared that this could increase social strife, populism, and economic nationalism, and urged policymakers to approach both pandemic policy and exit carefully.

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