Threats to Europe's Economic Recovery

by Antonia Colibasanu - April 7, 2023

Recent data shows that the growth of consumer prices is slowing in some major European economies. In March, Germany's inflation rate was 7.8 percent compared with a year earlier, down from 9.3 percent in February, while France's was 6.6 percent, down from 7.3 percent. At the same time, business sentiment in both countries has improved.

However, March also saw significant protests and strikes in both countries. In France, there were violent street protests and strikes over an increase in the retirement age, while in Germany, a mega-strike organized by two major transport unions paralyzed major cities for an entire day.

In addition, European bankers and policymakers gathered to discuss new rules for the banking sector and measures to prevent U.S. financial turmoil from spilling over to the Continent. This comes after three regional U.S. banks collapsed and Credit Suisse was hastily rescued by Swiss regulators in a shotgun marriage with UBS. In two weeks, the amount of corporate debt in distress rose to $624 billion from $554 billion – mostly due to the U.S. and Europe – and it would have been tens of billions of dollars bigger had Credit Suisse not been rescued. Investors are becoming more worried about whether corporate borrowers will be able to repay or refinance their debts.

The most urgent concern for European stability is the weakening banking sector and the potential for a new financial crisis. Additionally, the war in Ukraine and Europe's reliance on imported natural gas may cause turbulence in the energy market, which could affect European businesses. Despite inflation slowing down due to lower energy prices and warm weather, strikes and protests continue. The OPEC+ decision to cut oil production in the coming months has caused an increase in oil prices, and energy prices are likely to stay high through the fall, potentially pushing inflation up again. Therefore, it is important to consider factors that could destabilize Europe in the short term, starting with an assessment of the financial sector and ending with the challenges of making policy in such an environment.

The Financial Sector

Eurozone states share one monetary policy, determined by the European Central Bank. Non-euro states have more freedom but still must track closely to what the ECB does. All EU states face the same soft limits on their public deficits and debt, but observance of the rules is spotty in the best of times. What links the eurozone and non-eurozone economies is the banking sector. Even in EU states that do not use the euro, eurozone banks are dominant, so shocks are transmitted through the system.

As a reserve, banks hold large amounts of government bonds, which are considered safe assets. When interest rates rise as they have been, government bonds lose market value. To protect themselves against this risk, banks need large reserves and diversification, or they risk a run on the bank. If this occurs, the most immediate risk is a liquidity crunch.

The diversity and complexity of the eurozone system meant the ECB could not hike rates as aggressively as the U.S. Federal Reserve. However, it has raised interest rates at a slow and steady pace, while keeping its quantitative easing policy in place until March 2023 to cushion the books of the countries that were most damaged in the crisis of the 2010s, COVID-19 and the energy crisis.

The stress tests conducted by the ECB in 2022 proved there was enough room for this move. In September, European banks' liquid assets were well above 150 percent of what regulators expect a deposit outflow in a crunch month to be. However, the speed with which deposits were transferred from Silicon Valley Bank and Credit Suisse suggests that such assumptions are overly optimistic. So, assessing the nature of bank liquidity becomes the logical next step to see whether European banks are indeed liquid or not.

The stability of deposits is what must be investigated first. However, the European banks' data on the nature of deposits is less detailed than in the U.S., which makes investors assume the worst, considering the current financial turmoil. In Europe, most deposits are held by households, and they are mostly insured. In the eurozone, about 70 percent of deposits are held by households, while 26.5 percent are held by corporations. Because Europe lacks money markets of the same depth and ease of access as the U.S., bank accounts are the most liquid and lucrative alternatives.

Banks are where corporations manage their short-term risks. This is one of the reasons why **more than 300 billion euros ($327 billion) in corporate overnight deposits in Europe were withdrawn and reinvested as "term deposits,"** less flexible but with a higher return. By doing this, businesses signal they will likely have enough cash flow to cover short-term operations – meaning that they are optimistic about their outlook in the coming months and that they can provide the necessary reserves for banks to stay liquid.

The second risk that European banks face is deteriorating assets. Existing loans lose value when interest rates rise, just like bonds. However, European regulators require all banks, large and small, to hedge against this risk, so it's fairly manageable.

The third threat is the failure of borrowers to pay back their loans. Investors are particularly concerned about credit extended to commercial property owners. Rising interest rates and a bleak economic outlook put downward pressure on prices and rents at a time when owners must pay more to service debts. However, European banks have lower exposure to commercial real estate than U.S. banks: The **median exposure to commercial real estate for European banks** is about 6 percent, compared to 36 percent and 16 percent for regional and large U.S. banks, respectively.

The bigger risk for the banking sector is economic stagnation. If this happens, a broader range of loans may go negative. Banks have buffers to absorb some losses: Their core equity funding increased from 12.7 percent to 14.7 percent of risk-weighted assets between 2015 and 2022, well above the 10.7 percent regulatory threshold. But this also means their profits would be limited. Since the 2010s, low profits have been commonplace for the European banking sector. Back then, it was low-interest rates, strict rules on assets, and slow economic growth that caused low profitability.

Banks were hoping that efforts to address inflation by increasing interest rates would reverse the situation. But central banks need to adjust to the economic reality. This goes back to the way that European central banks and national governments work to address inflation and public debt – or, better said, how they balance monetary and fiscal policy to create a profitable business environment. There is certainly no easy answer.

Uncertain Future

It has been more than two years now since talk began about inflation being a problem. While it has more recently been explained as a result of the energy crunch and food supply issues, it was really a response to a range of factors. The spikes in producer prices are still working their way through the value chain. And COVID-related changes in consumption patterns, along with supply chain problems, increased consumer costs.

The war in Ukraine added new vulnerabilities that producers and consumers perceived differently. The idea that Europe once again became a theater of war triggered changes in consumption patterns, as many became more careful about how they consumed energy and European firms diverted their investments from Russia to Europe. Manufacturers had to adapt to these new patterns, too. All of this added to existing inflationary pressures.

Furthermore, nominal wages either rose in 2022 or will rise this year. According to the ECB, wage increases agreed to by eurozone trade unions and employer organizations in 2023 stand at 5 percent. Because businesses will pass on these costs to their customers, core inflation will almost certainly remain higher than forecasts currently indicate.

At the same time, governments announced subsidies and increases in budgetary expenses. With tax revenue down due to the pandemic and government spending up, the ECB used secondary markets to refinance member states' rising budget deficits. In the real economy, this translated into growth in transfer spending along with public consumption and public investment. Such expansionary fiscal policy works for addressing short-term problems but adds to price pressures in the medium and long terms, especially when consumption patterns change due to shifts in the way the public perceives risk, as happened in Europe.

The real problem for European governments, therefore, is that they need to find ways to generate enough financial surpluses in the future to repay the debt they've incurred through expansionary fiscal policies – while their publics are focused more on saving everything from money to energy and time and less on producing value-added goods and services. Businesses understand government priorities – they know government debt is an asset that retains its value only as long as it promises to buy goods and services in the future. They are optimistic, and employees understand this as well – which is why they push for salary rises. But that ultimately triggers inflation, which governments need to fight.

Considering that inflation will likely continue in Europe (and the world), the bigger question goes beyond the health of the banking system. For Europe, the problem is discovering a way to create value, under current circumstances, when depositors hunt for better yields and ask banks to offer better rewards, while startups have difficulties finding funding.

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