World banking system cannot weather a long lockdown

A pandemic shutdown lasting more than three months will cause economic 'system failure'

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We were in the political trenches together leading up to the Maastricht summit in December 1991. Both of us could see that the creation of the euro changed the character of the EU irreversibly and that there could never be a congenial place for Britain as a self-governing nation state in such a structure.

We became eurosceptics at the same moment, and for the same reason. People who accuse Boris of opportunism over Europe don't quite have the measure of this. He was deeply torn over the momentous decision of the Referendum – as I was – but that is a different matter.

His precipitous deterioration last night was so shocking – and such a stark reminder of what is happening at the frontline of the NHS – that I find it hard to write a newsletter about economics, let alone about the mundane materialism of markets.

But normal work must go on, so here is what I had been writing late yesterday, conscious that the first line now seems almost macabre.

Boris Johnson

Boris Johnson's deterioration last night is a stark reminder of what is happening at the frontline of the NHS CREDIT: JULIAN SIMMONDS

It is no easy task to prevent an induced economic coma from slipping control and turning into a secondary financial crisis. No major country has ever tried to do such a thing before.

The longer the sudden stop continues in Europe and North America, the greater the risk that we slide into a self-feeding credit and liquidity crisis. The economic and financial storms would then reinforce each other to overwhelm the defensive system.

Crisis veterans are watching the three month dollar Libor rate (not equity markets). This has jumped 60 basis points since mid-March despite a shower of liquidity and unprecedented emergency action by the Federal Reserve. Libor matters: some $9 trillion of contracts worldwide are priced off the benchmark.

Banks were the villains of the 2008 crisis. This time they are the designated saviours, deemed strong enough to hold the line against Covid-19. They are to be the conduit for disaster relief, the backstop lenders for drowning firms and households.

Regulators have eased capital rules to free up $5 trillion of loans worldwide. The European Central Bank has waived its capital rules, freeing up €120bn in bank equity base. "Rainy day" buffers are being activated. Excellent. But in doing so they are leaving the banks naked, should the economic damage from Covid-19 drag on, and tumbling earnings and soaring bad debts eat into their viability. Moody's has already placed the entire European banking system on negative alert.

Harvard professor Ignazio Angeloni, an ex-member of the ECB's supervisory board, says European banks could "cease to function or fail on a massive scale" as losses pile up. Governments will have to start taking them into "public ownership" to prevent a systemic credit crunch . "While free market diehards may turn up their nose, this is probably a lesser evil," he says.

It brings into play the infamous sovereign/bank "doom loop" from the eurozone debt crisis. The weak states of Italy, Portugal, and Spain (leaving aside the perennial tragedy of Greece), are left to rescue their own banks.

EU leaders pledged long ago to end this doom loop but never delivered. These Club Med states are also the ones suffering the biggest macroeconomic shock: they have lost a year's tourist season; and they are least able to afford the eye-watering costs of nursing their entire private economy through the pandemic.

The LSE's Lucrezia Reichlin says Germany is spending towards 5pc of GDP in direct fiscal support. Italy dare not risk much more than 1pc. Club Med debt ratios are likely to jump 20 percentage points of GDP (to 155pc in Italy's case).

Painfully slow recovery and post-crisis hysteresis will be slow torture for their banks. The risk is that the sovereigns and the banks will drag each other down in a horrible spiral. That is why the proposal for (ESM) bail-out loans – piling more debt on the debtors – is a Faustian Pact that resolves nothing.

Mr Angeloni said the EU has to "block this doom scenario" by recapitalising banks on the joint EU credit card. But it is not just Europe. Banks may not be strong enough to fulfil their new role as saviours in any part of the world, including the US, China, and Japan.

None of the major lending systems were ever stress-tested for an economic deep freeze lasting months. The Federal Reserve's "severely adverse scenario" for 2020 assumed a worst case rise in unemployment to 10pc over 18 months. This has already been blown apart. The US has lost 10 million jobs in two weeks.

The St Louis Fed warns that 47 million workers could be laid off in short order, pushing the unemployment rate to 32pc. Nothing like this was seen during the worst phase of the Great Depression in early 1933. It is outside the historical experience of all western democracies.

Peter Cecchetti, ex-chief economist for both the New York Fed and the Bank for International Settlements, says he is "profoundly concerned" that the global financial system will crack under the strain.

In a joint paper with Kermit Schoenholtz, a market guru and now finance professor at New York University's Stern School, he warns of potential bank runs and a cascade of fire sales across asset markets despite the heroic firefighting efforts of the Fed so far – ie, saving the US commercial paper and money markets, preventing panic flight from $3.4 trillion in BBB bonds, and acting as the world's lender of last resort through dollar swap lines to global central banks.

The Cecchetti analysis said capital buffers have been weakening for some time, but have gone parabolic since the pandemic hit, "threatening financial stability across all major jurisdictions".

Europe sticks out the most. The NYU Stern's SRISK gauge shows that the "weighted average leverage ratio" of European lenders is nearly 48, three times US levels.

Mr Cecchetti says banks must stop all dividends and share buybacks immediately. This is in fact happening. JP Morgan is poised to freeze dividends for the first time ever. Bank of America, Citigroup, Wells Fargo, BNY Mellon, and Morgan Stanley, among others, are suspending buybacks. The ECB has ordered the biggest banks under its purview to freeze both dividends and buybacks.

In short, a pandemic shutdown lasting more than three months will cause economic and financial "system failure" so we are in the lap of the gods at this point.

It is heartening that Austria and Denmark plan to relax their Covid-19 lockdowns but note that Singapore is suddenly facing its second wave, this time leading to closures of schools and malls that never happened the first time. Japan has declared a state of emergency for Tokyo and Osaka. We may face a treacherous landscape of fresh outbreaks and rolling on-and-off lockdowns.

There are glimmers of hope. Early results from the Italian bio-lab Meleam shows that 38pc of all Italians tested randomly for antibodies across nine regions have been exposed to the virus already. If validated, the disease has spread far more widely than supposed. The death rate is therefore very low. Italy – and others – are closer to the final exit of herd immunity. Ergo, we can call off the lockdowns sooner.

Or as one contributor to a controversial article in the British Medical Journal put it, "What the hell are we locking down for? Is economic meltdown a price worth paying to halt or delay what is already amongst us?".

But if it sounds too good to be true, it probably is. Meleam's sample size is 1,731 cases. There have been big problems with the accuracy of serological antibody tests even in countries with highly-sophisticated life-sciences industries.

German epidemiology – from 86,000 notified cases (PCR tests) – does not hint at a submerged iceberg of asymptomatic cases.

Basically, the jury is out. Those of us in the economic realm must navigate blindly through the fog. We face a plausible spectrum ranging from V-shaped relief to L-shaped awfulness at the other extreme. Perhaps it is superstition but Boris's fate somehow seems symbolic.