Leibniz Institute for Financial Research SAFE
Sustainable Architecture for Finance in Europe (https://safe-frankfurt.de/)

SAFE Finance Blog

The Coronavirus and financial stability

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Targeted and coordinated European measures needed to prevent a new banking crisis

Since the turn of the year, Covid-19, a novel virus, is spreading globally, creating the perception of an uncontrolled pandemic that may change our lives. The resulting reduction in economic activity worldwide is threatening to cause a global recession and damage financial stability. Several governments have mandated strict regulations to avoid unnecessary contact with those already infected, to protect vulnerable segments of the population. This has prompted the closure of educational institutions, factories and businesses, casting a pall on the world in a manner not witnessed for decades.

The implications for economic activity – production and, on an increasing scale, consumption – are severe, affecting supply chains all over the world, creating shortages. Once inventories are depleted, production may slow down, with the consequences spreading quickly. Massive interruptions can be witnessed in the services industries, including travel and entertainment. Anxiety among consumers will soon bear on individual consumption and, in turn, affect firm revenues.

Implications on financial markets

In contrast to the 2008 financial market crash, the corporate sector has been globally affected, due to the high level of interconnectedness of manufacturing and distribution around the world. While this interruption in economic activity would initially cause liquidity problems for individuals, firms and banks, their interconnectedness could transform the liquidity problem into a solvency problem for firms and banks.

With diminished cashflows, companies would struggle to pay their suppliers, employees, and ultimately their banks, even if their business models remain sound. Yet, the Coronavirus-induced fall in production is a temporary, interruptive event, as opposed to a longer-term disruptive event; once the epidemic dies out, earnings are likely to revert to normal levels. Thus, in an ideal world, the epidemic poses a liquidity problem, not one of long-run viability for firms. In reality, information spreads imperfectly, and access to funding may be denied to some firms, turning the liquidity squeeze into a solvency problem, possibly causing default, or even bankruptcy.

In Europe, banks are the main creditors and would have to build loan-loss provisions, leading to impairment in their capital adequacy. We are already witnessing this in Italy, where banks have started to grant moratoria on their outstanding loans, to avoid default. However, the infection chain may well affect governments trying to offer a bailout to banks (in addition to direct support to firms and individuals). If sovereign debt levels remain heightened, the funding capacity of the state is limited, as the debt terms of the sovereign also spiral downwards, triggering the doom loop between bank and sovereign default risk, as in 2011.

The virus situation also differs from the 2011 Euro crisis, because today's crisis is due to an exogenous shock, which should alleviate moral hazard concerns. However, the potential stress in the banking system may also be exacerbated on the deposit side. Absent a credible European deposit insurance, there may be doubts about the resilience of the banking system, potential causing a bank run. Thus, the current health crisis may mutate into a full-blown banking crisis. The virus epidemic creates systemic risk and may even spiral into a global phenomenon, yielding a case for some form of a joint and mutual insurance scheme – compensating firms for crisis-induced cashflow shortfalls, though not for "legacy" poor performance, and thus limiting (or avoiding) the knock-on effects in production, consumption and banking.

Actions on a European level

There is need for urgent action at the European level, since the implementation would be complex. If it fails, it may lead to the next financial crisis. If managed well, this common action may define the risk sharing that renders Europe's banking union sustainable and maintains solidarity without moral hazard. Governments are already taking political and financial actions aiming to stabilize the economy. Various countries and their central banks are working on actions to mitigate damage to global growth. However, so far, the ECB has taken no action but has stated that it would be ready to intervene.

Our analysis suggests joint fiscal action, leaving a more limited role for monetary policy. Given the looming insolvency of firms and individuals, monetary tools such as interest rates or asset purchases are unlikely to help given the liquidity crisis coupled with bank capital adequacy. The need of the hour is a quick, targeted provision of liquidity to firms face interruptions in production and their supply chain, and those facing sharply lower demand. The current challenge for Europe has two dimensions: first, to find appropriate instruments to quickly measure the cashflow shortfall at the firm level and find a way to channel funds to the affected individuals, firms, and banks.

A tried and trusted way to reach firms a direct, targeted manner could be via Kurzarbeit-schemes, which are well established in Germany. In such schemes, firms with cashflow shortfalls can temporarily externalize part of the wage bill, with employees working part-time but at only modestly reduced salaries, with the gap being funded by unemployment insurance, funded by social security contributions. Thus, there is, for a limited period, employment risk sharing among workers, conditional on their employer being eligible. The eligibility criteria limits exposure to moral hazard – a precondition for the scheme to be both, economically efficient and politically acceptable. Alternative schemes include leniency in value-added tax (VAT) payments through government-backed loans.

State development banks in Europe may serve as channels to reach eligible solvent firms. Supranational financial institutions, notably the European Investment Bank and the European Bank for Reconstruction and Development, through their access to banks and capital markets across Europe, may provide the necessary funding. The scheme, if applied successfully, would provide a bridge over the crisis period, to help affected firms escape bankruptcy proceedings.

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The full version is available as SAFE Working Paper No.78 (https://safe-frankfurt.de/policy-center/policy-publications/policy-publ-detailsview/publicationname/the-coronavirus-and-financial-stability.html).

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