Key Takeaways From the ECB’s November 2020 Financial Stability Review

November 25, 2020

Discussant’s contribution on the Key Vulnerabilities and Policy Trade-offs

Anna Ilyina
Monetary and Capital Markets Department

International Monetary Fund

The views expressed in this presentation are those of the author and do not necessarily represent the views of the IMF
Unprecedented policy support has:
- Kept markets functioning
- Maintained the flow of credit
- Helped avoid adverse macro-financial feedback loops…
- …and widespread bankruptcies

This presentation will focus on:
- Key vulnerabilities
- The role of policy support
- Policy trade-offs going forward
Strong Policy Responses Have Helped Ease Financial Conditions

Global Financial Conditions Indices
(Standard deviations from mean)

Financial Stability Risks Are Contained, but Not Out of the Woods Yet

Near-Term Growth Forecast Densities (Probability Densities)

Financial vulnerabilities are rising…
Many Countries Entered the Pandemic with Pre-existing Vulnerabilities

Proportion of Systemically Important Countries with Elevated Vulnerabilities, by Sector
(Percent of countries with high and medium-high vulnerabilities, by GDP [assets for banks, asset managers, other financial institutions and insurers]; number of vulnerable countries in parentheses)

Rising Public Debt and Fiscal Deficits May Limit Policy Space

Source: IMF October 2020 Fiscal Monitor and IMF staff calculations.
Corporate Sector: Policy Trade-offs

From “whatever it takes”…

Extraordinary policy support
- Allowed firms to offset cash shortfalls via increased borrowing…
- …and delay debt service payments

- Lower liquidity risks
- Fewer bankruptcies
- Higher indebtedness

…to “as long as needed”

Exit from extraordinary support
- **Type 1 error:** premature withdrawal of support, incl. to viable firms
- **Type 2 error:** overextending support, incl. to nonviable firms

- **Type 1 error:** A spike in bankruptcies
- **Type 2 error:** Debt overhang; zombification; resource misallocation
Policy Support Led to A Decline in Corporate Bond Yields...

**US and Euro Area Corporate Bond Yields and US HY Default Rate**
(Percent)

**Source**: IMF October 2020 Global Financial Stability Report, and IMF staff calculations.
Intensity of Policy Measures
(Index)

Distribution of Firms by Liquidity and Solvency:
Firms that were solvent pre-COVID 19;
Conditional distribution post-COVID-19
(Percent)

Source: October 2020 IMF Regional Economic Outlook (Europe).
Note: The intensity of policy measures is the principal component of each policy measure, taking into account information on the size of the budgetary envelope, the duration of the measure, and the coverage of firms. The bar represents the interquartile range, median (dash), mean (cross), and the minimum and maximum values excluding outliers (whiskers).

Source: October 2020 IMF Regional Economic Outlook (Europe).
Note: the chart shows the ex-post (conditional) distribution of those firms that were solvent pre-COVID-19. The original sample includes 4 million firms in 17 advanced and 9 emerging market European economies; the data are sourced from the Orbis database.
Defaults Are On the Rise, but Future Path of Defaults is Uncertain

**Global Speculative Grade Corporate Default Rates**
(12-Month Trailing, Percent)

**US Speculative-Grade Default Rate: Actual and Forecasts by Credit Rating Agencies**
(Trailing 12-month rate, percent)

---

**Source:** IMF October 2020 Global Financial Stability Report, and IMF staff calculations.
From “whatever it takes”…

Extraordinary policy support

- Borrower support policies
- Strong bank buffers and full use of flexibility in regulatory framework

Exit from extraordinary support

- **Type 1 error:** premature withdrawal of accommodation
- **Type 2 error:** overextending support to nonviable or insolvent firms

Banks: Policy Trade-offs

- Lower bank credit losses
- Increased capital space
- Delayed loss recognition

- **Type 1 error:**
  Higher bank losses; credit crunch

- **Type 2 error:**
  Debt overhang; weak growth; bank profitability pressures
Global Bank Solvency Scenario Analysis (October 2020 GFSR)

- Scenarios: October WEO, baseline and adverse
- ~350 banks in 29 jurisdictions (73% of global bank assets)
- Publicly available annual consolidated data (1995-2019)
- Stress test horizon: 2020-2022

Source: IMF staff estimates, October 2020 GFSR
Policy Support Has Mitigated Potential Bank Losses

Distribution of Bank Assets by Capital Ratio under Adverse Scenario, with Policy Mitigation:
(CET 1 ratio, percent)

<table>
<thead>
<tr>
<th>19</th>
<th>22</th>
<th>19</th>
<th>22</th>
<th>19</th>
<th>22</th>
<th>19</th>
<th>22</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>80</td>
<td>60</td>
<td>40</td>
<td>20</td>
<td>0</td>
<td>&lt;4.5%</td>
<td>4.5% - 6%</td>
</tr>
</tbody>
</table>

Bank Capital Shortfall under Adverse Scenario
(Billions of US dollars)

Source: IMF October 2020 Global Financial Stability Report and IMF staff estimates,
Note: Sample ~350 banks in 29 jurisdictions. The shortfall (RHS chart) is measured against bank-specific and fully loaded capital requirements, including a minimum CET1 of 4.5%, a GSIB buffer, a systemic risk buffer, a stress capital buffer, a conservation capital buffer, and a countercyclical capital buffer.
Non-Bank Financial Institutions: Policy Trade-offs

From “whatever it takes”…

<table>
<thead>
<tr>
<th>Extraordinary policy support</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ Stabilized funding markets and market liquidity conditions</td>
</tr>
<tr>
<td>➢ Put a floor under risk asset prices</td>
</tr>
</tbody>
</table>

➢ Outflows from investment funds reversed & stabilized
➢ Vulnerabilities remain

…to “as long as needed”

<table>
<thead>
<tr>
<th>Exit from extraordinary support</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ <strong>Type 1 error:</strong> premature withdrawal of the central bank support</td>
</tr>
<tr>
<td>➢ <strong>Type 2 error:</strong> maintaining support for an extended period</td>
</tr>
</tbody>
</table>

➢ **Type 1 error:** abrupt market re-pricing
➢ **Type 2 error:** rising liquidity & credit risks excessive risk taking; financial re-leveraging
Inflows Return to Investment Funds, but Vulnerabilities Remain Elevated

Cumulative Fund Flows
(Percent of assets under management)

Cumulative Returns and Bid-ask Spreads of Fixed-Income funds
(Percent)

A Bridge to Recovery

Interconnectedness and Policy Roadmap
Gradual Reopening under Uncertainty

 Monetary policy — Maintain accommodation to support the recovery
 Liquidity support — Maintain support but adjust pricing to incentivize a gradual exit
 Credit provision — Encourage banks to use capital and liquidity buffers to continue lending
 Nonfinancial private sector — Extend moratoria on debt service only if necessary to prevent widespread insolvencies, support viable firms through restructuring and efficient out-of-court workouts to reduce the debt burden, as well as by providing solvency support (as appropriate)
 Multilateral support — Provide support to emerging and frontier market economies facing financing difficulties

Pandemic under Control

 Monetary policy — Maintain accommodation until monetary policy objectives are achieved
 Liquidity support — Gradually withdraw
 Credit provision — Require banks to gradually rebuild capital and liquidity buffers, develop credible plans to reduce problem assets, and create markets for problem assets
 Nonfinancial private sector — Recapitalize, restructure, or resolve nonviable firms
 Green recovery — Encourage more proactive management of climate-related risks and green investments
 Digitalization — Encourage greater digital investment to enhance financial sector efficiency and inclusion

Post-pandemic Financial Reform Agenda

 Nonbank financial sector — Strengthen the regulatory framework to address vulnerabilities exposed during the coronavirus disease (COVID-19) crisis
 Lower for longer — Implement prudential measures to contain risk-taking in the lower-for-longer interest-rate environment