

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

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A Bridge to Recovery

Unprecedented policy support has:

- Kept markets functioning
- Maintained the flow of credit
- Helped avoid adverse macro-financial feedback loops...
- ...and widespread bankruptcies

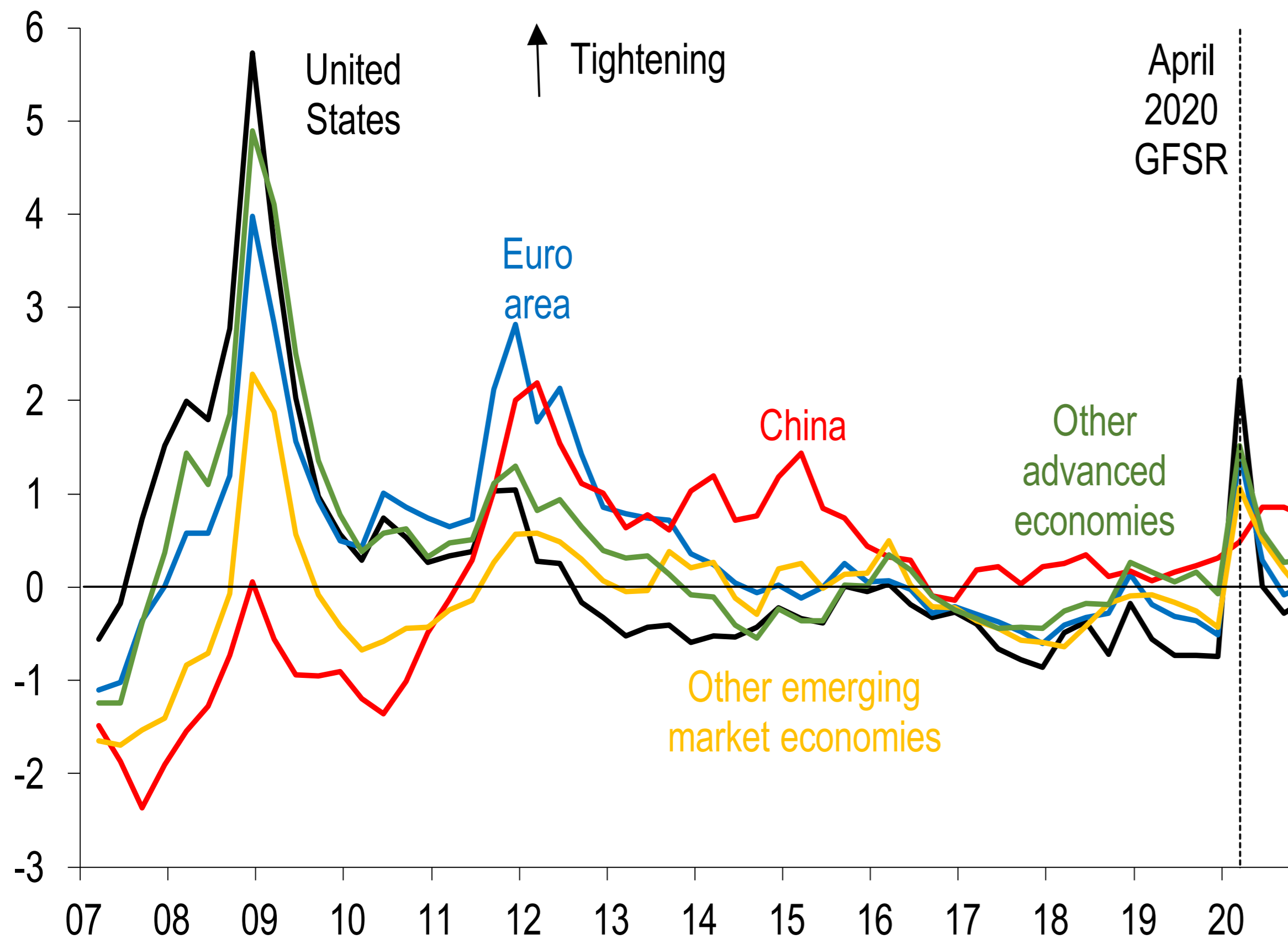


This presentation will focus on:

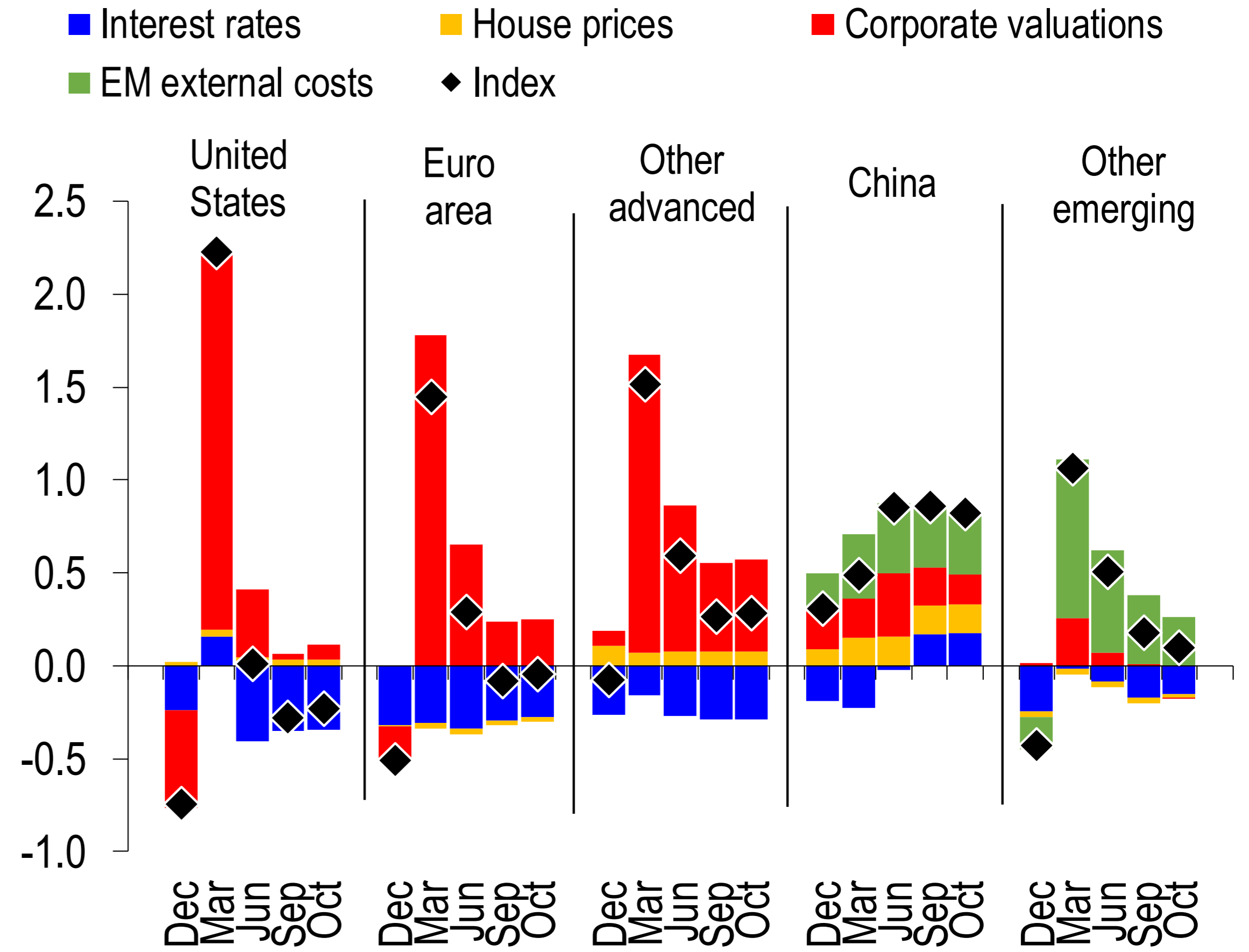
- Key vulnerabilities
- The role of policy support
- Policy trade-offs going forward

Strong Policy Responses Have Helped Ease Financial Conditions

Global Financial Conditions Indices
(Standard deviations from mean)



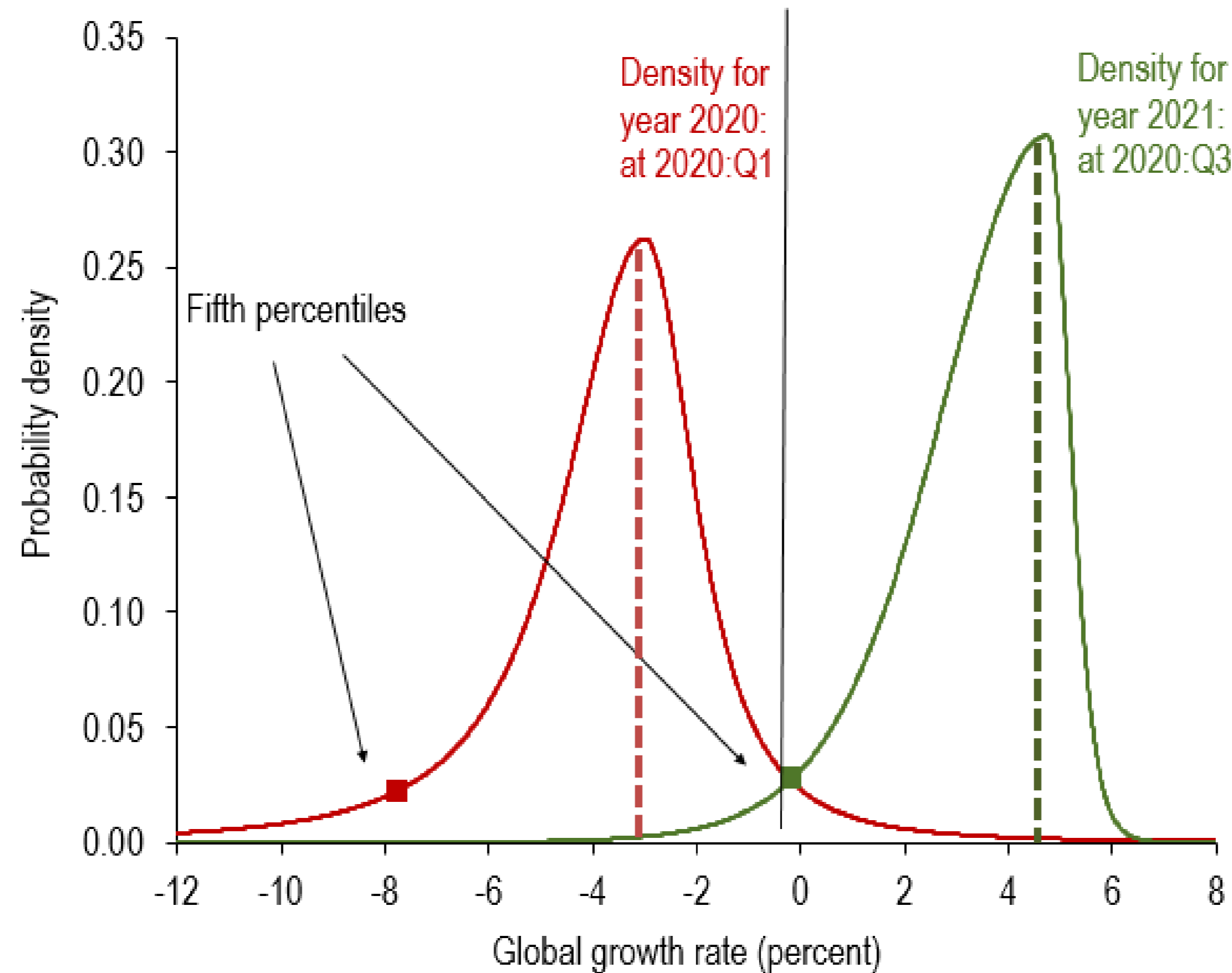
Global Financial Conditions Indices
(Standard deviations from mean)



Source: IMF October 2020 Global Financial Stability Report, and IMF staff calculations.

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

Near-Term Growth Forecast Densities
(Probability Densities)



Source: IMF October 2020 Global Financial Stability Report, and IMF staff calculations.

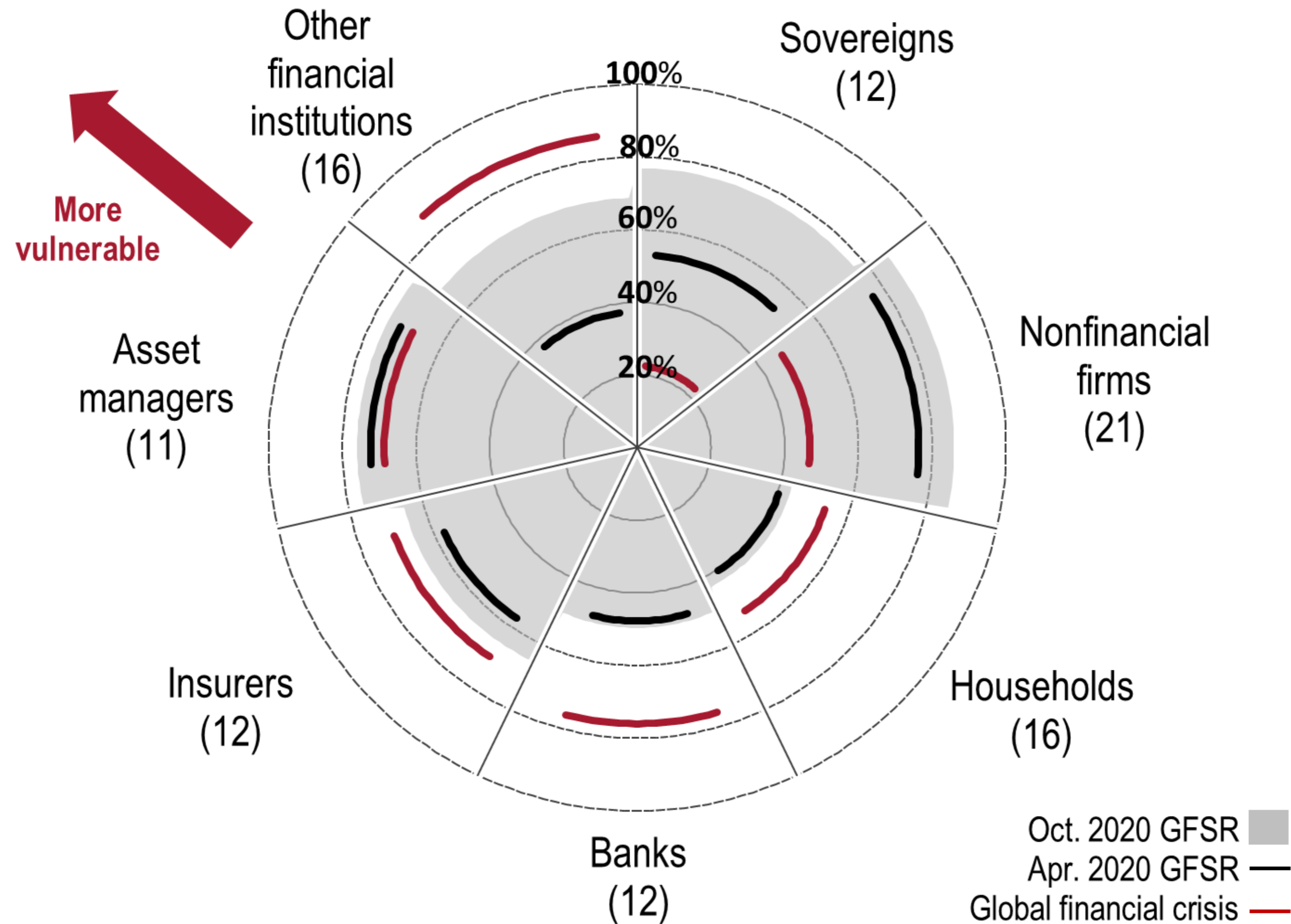
A Bridge to Recovery

Financial vulnerabilities are rising...



Many Countries Entered the Pandemic with Pre-existing Vulnerabilities

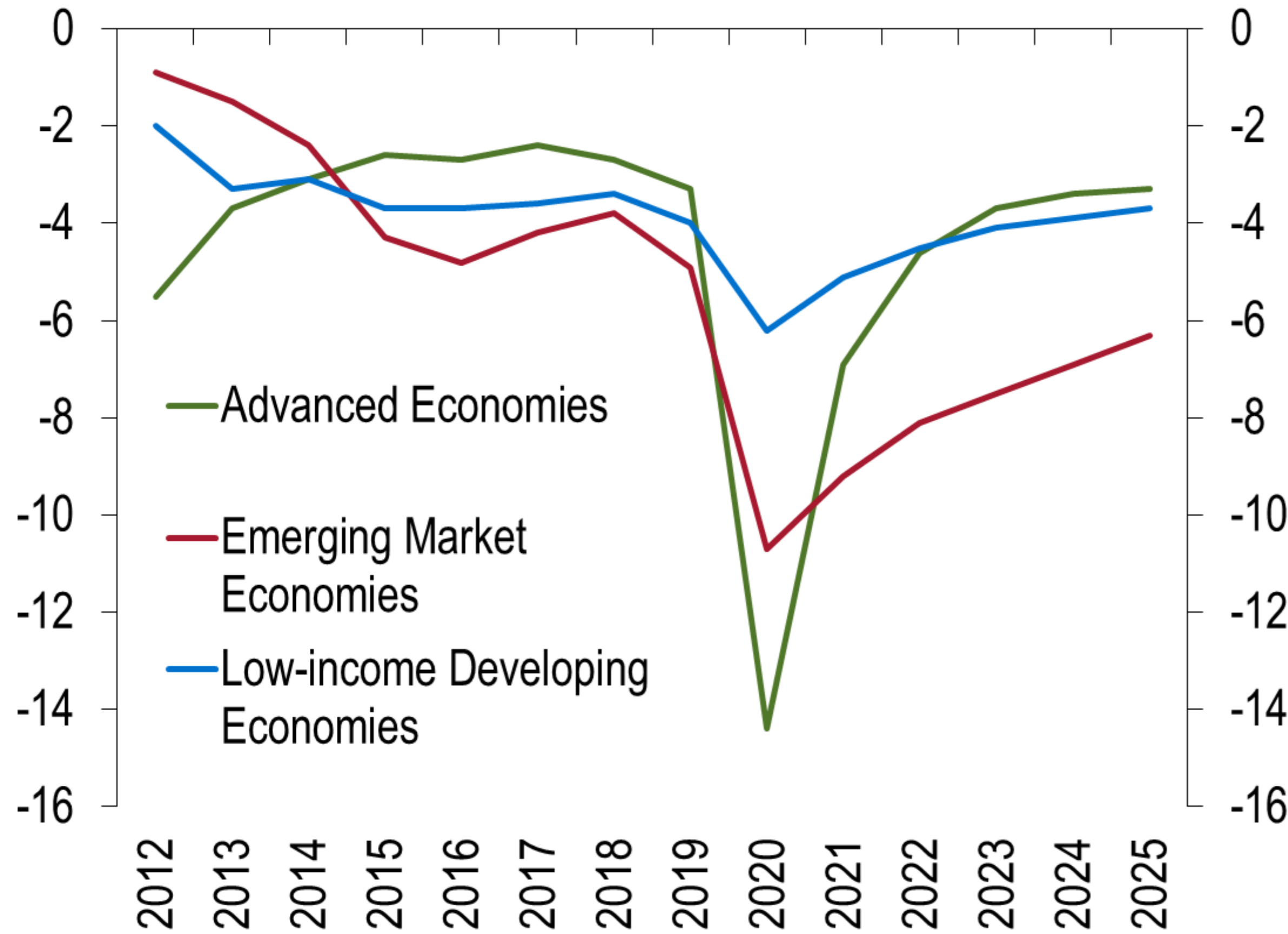
Proportion of Systemically Important Countries with Elevated Vulnerabilities, by Sector
(Percent of countries with high and medium-high vulnerabilities, by GDP [assets for banks, asset managers, other financial institutions and insurers]; number of vulnerable countries in parentheses)



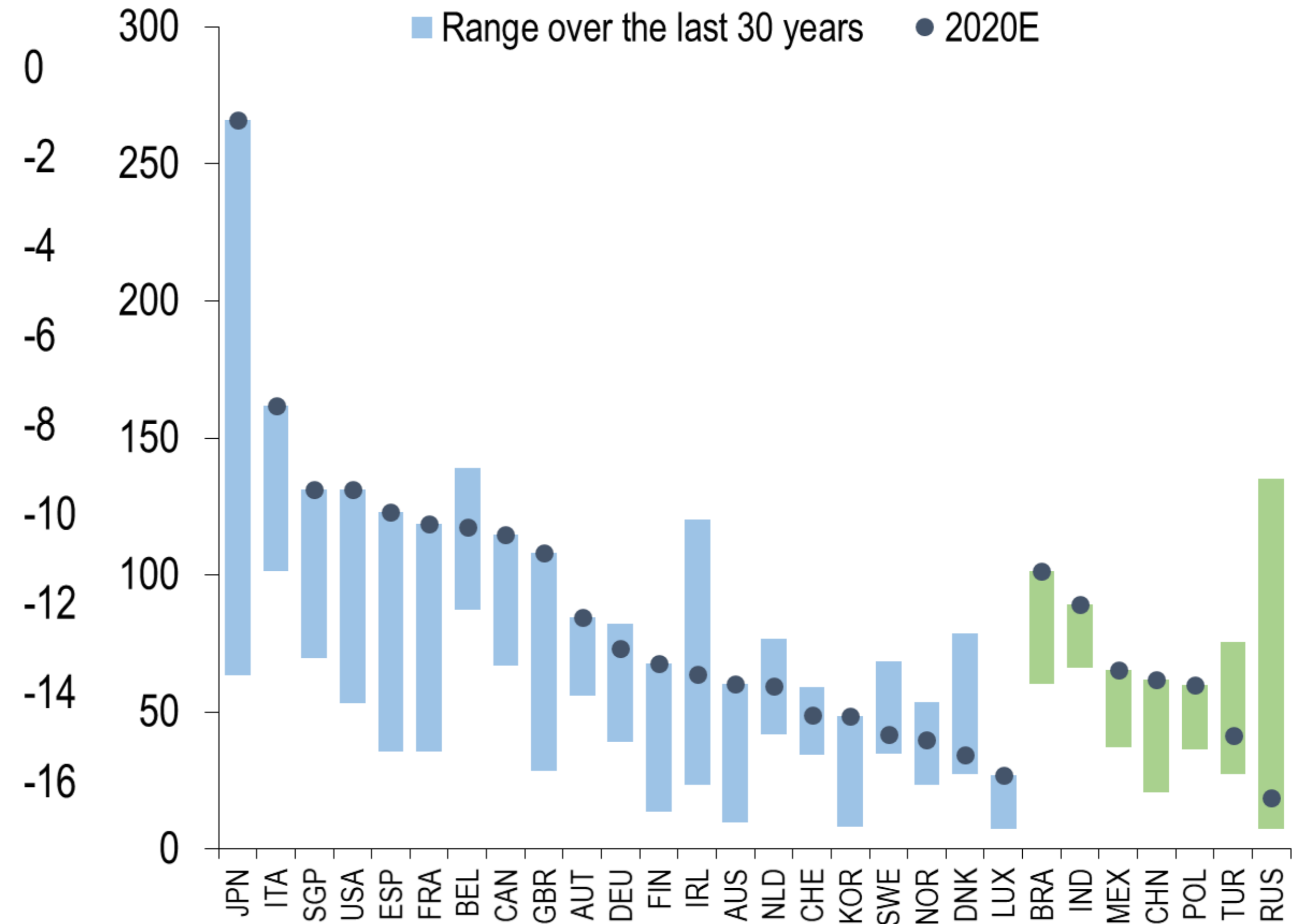
Source: IMF October 2020 Global Financial Stability Report, and IMF staff calculations.

Rising Public Debt and Fiscal Deficits May Limit Policy Space

Fiscal Deficit
(percent of GDP)



Public Debt
(percent of GDP)



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”**

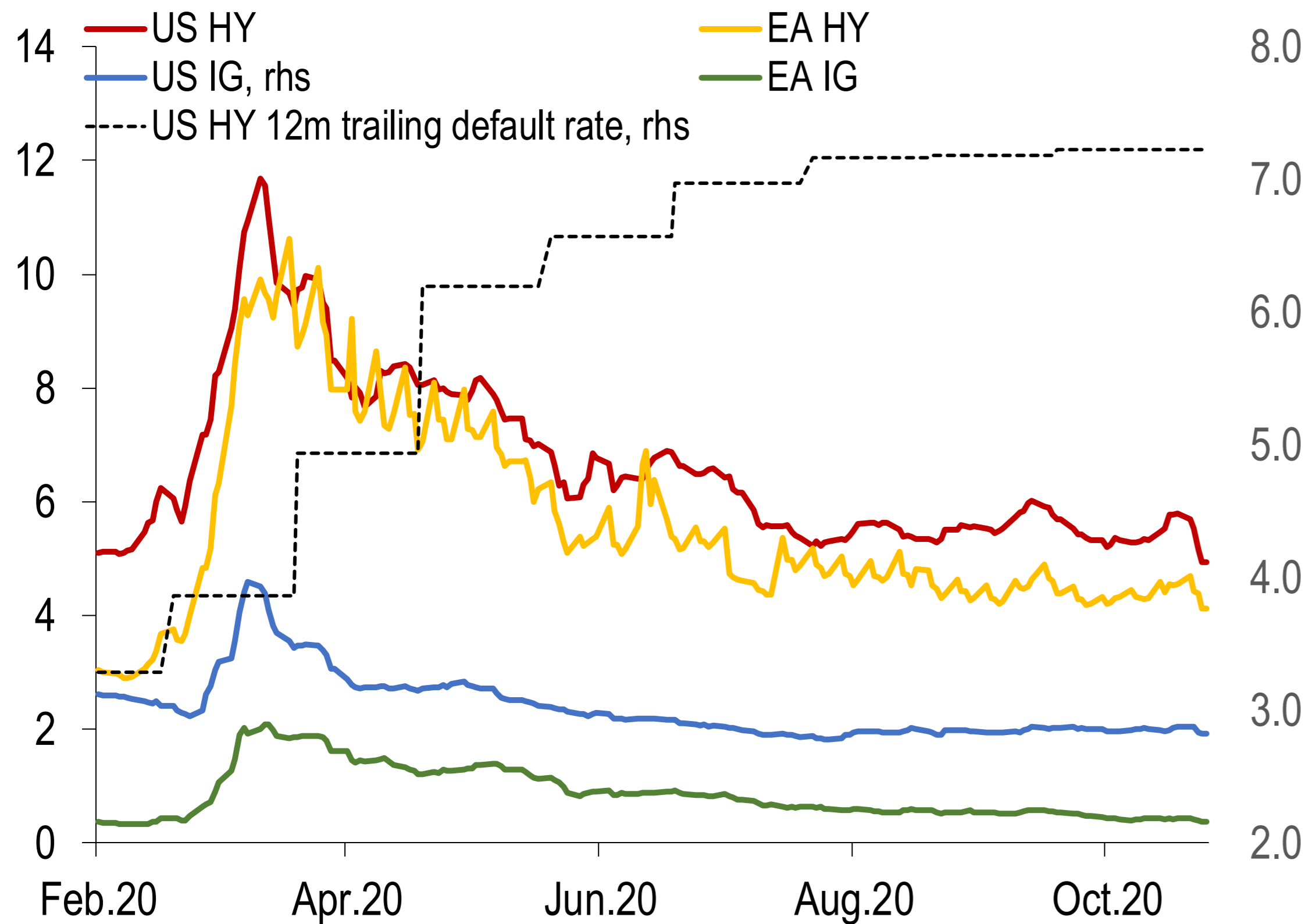
Exit from extraordinary support

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

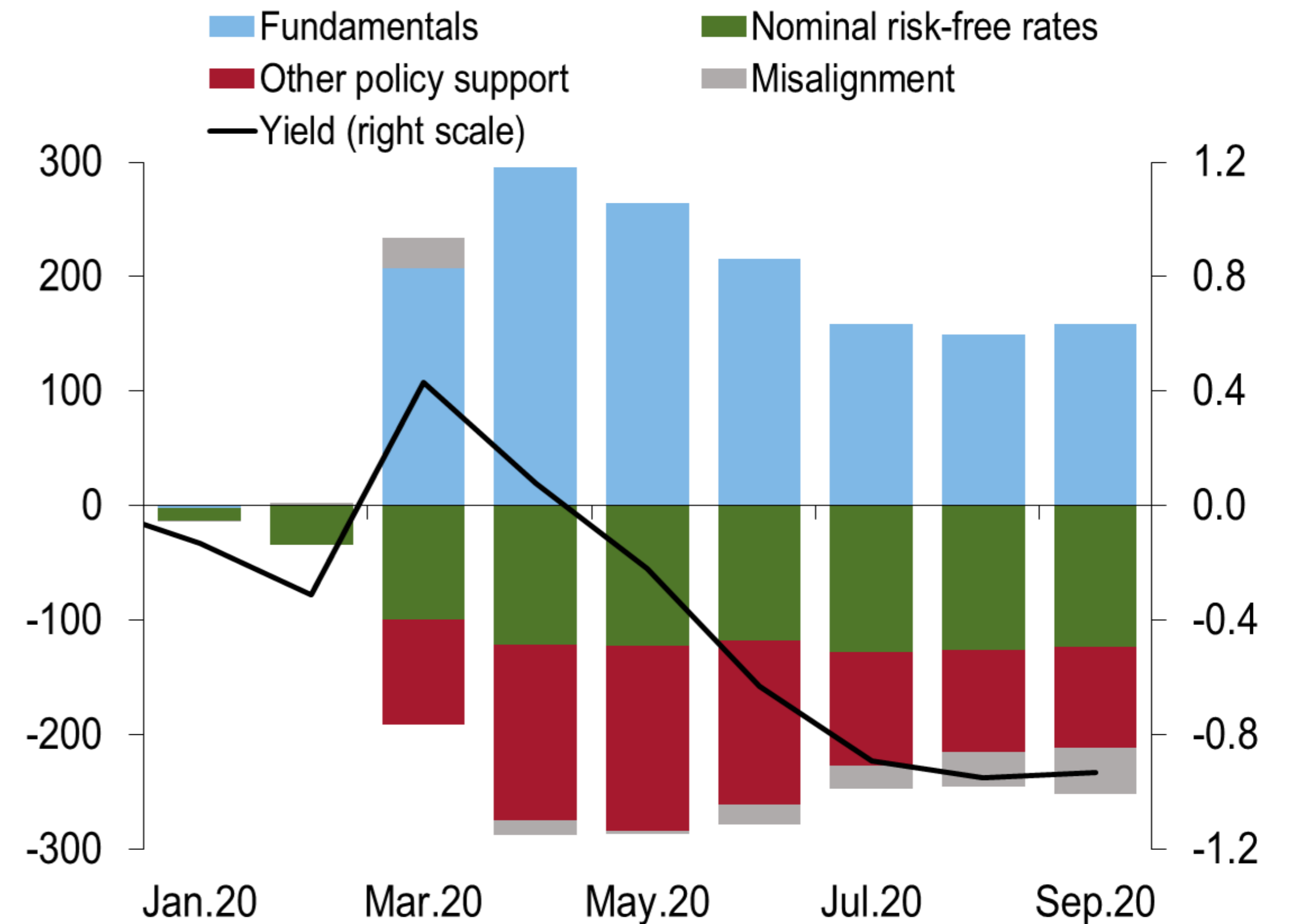
- **Type 1 error:**
A spike in bankruptcies
- **Type 2 error:**
Debt overhang;
zombification;
resource misallocation

Policy Support Led to A Decline in Corporate Bond Yields...

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

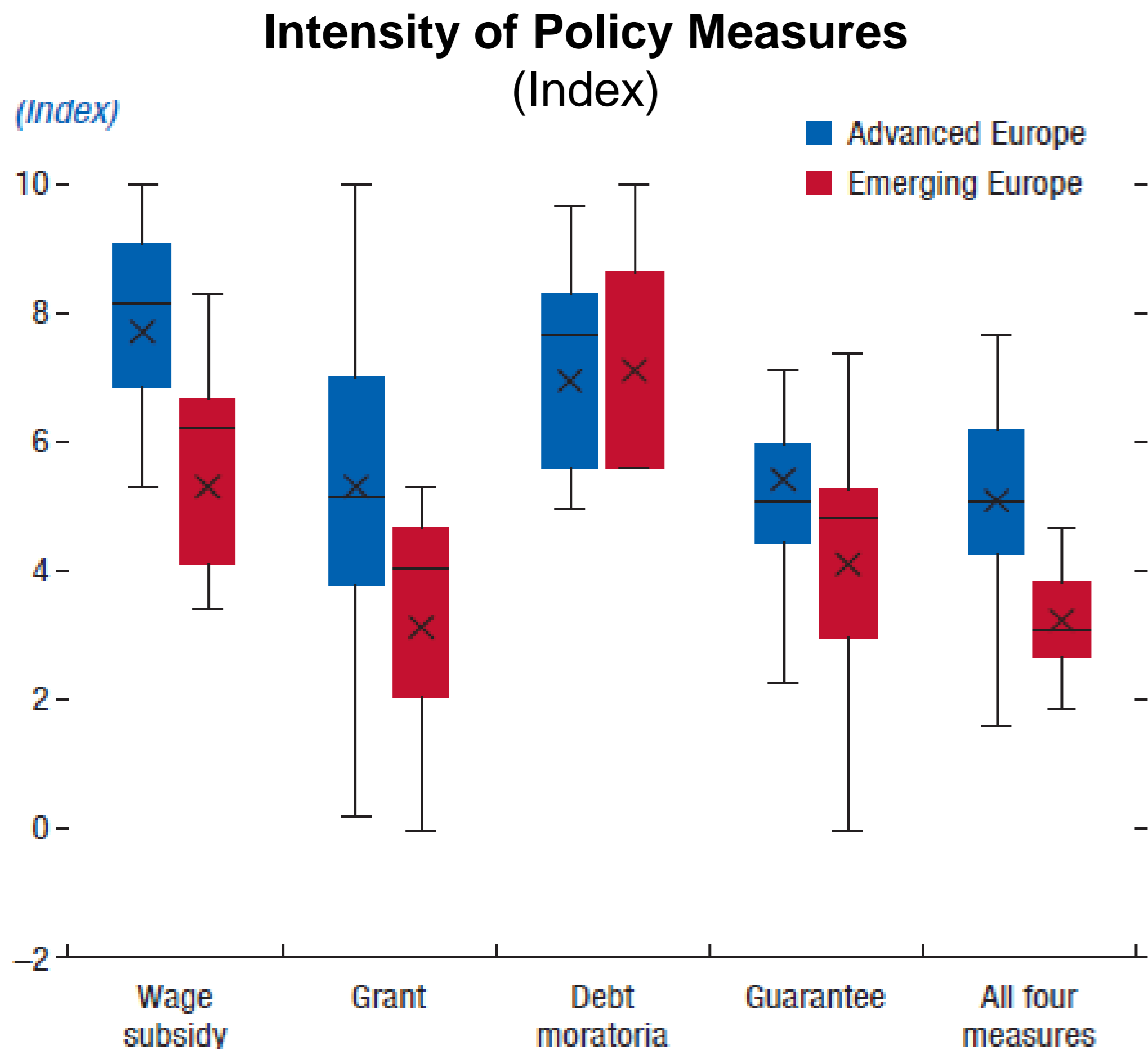


US Investment-Grade Corporate Bond Yields: Decomposition of Changes since Jan. 2020
(Basis points, left scale; percentage points, right scale)



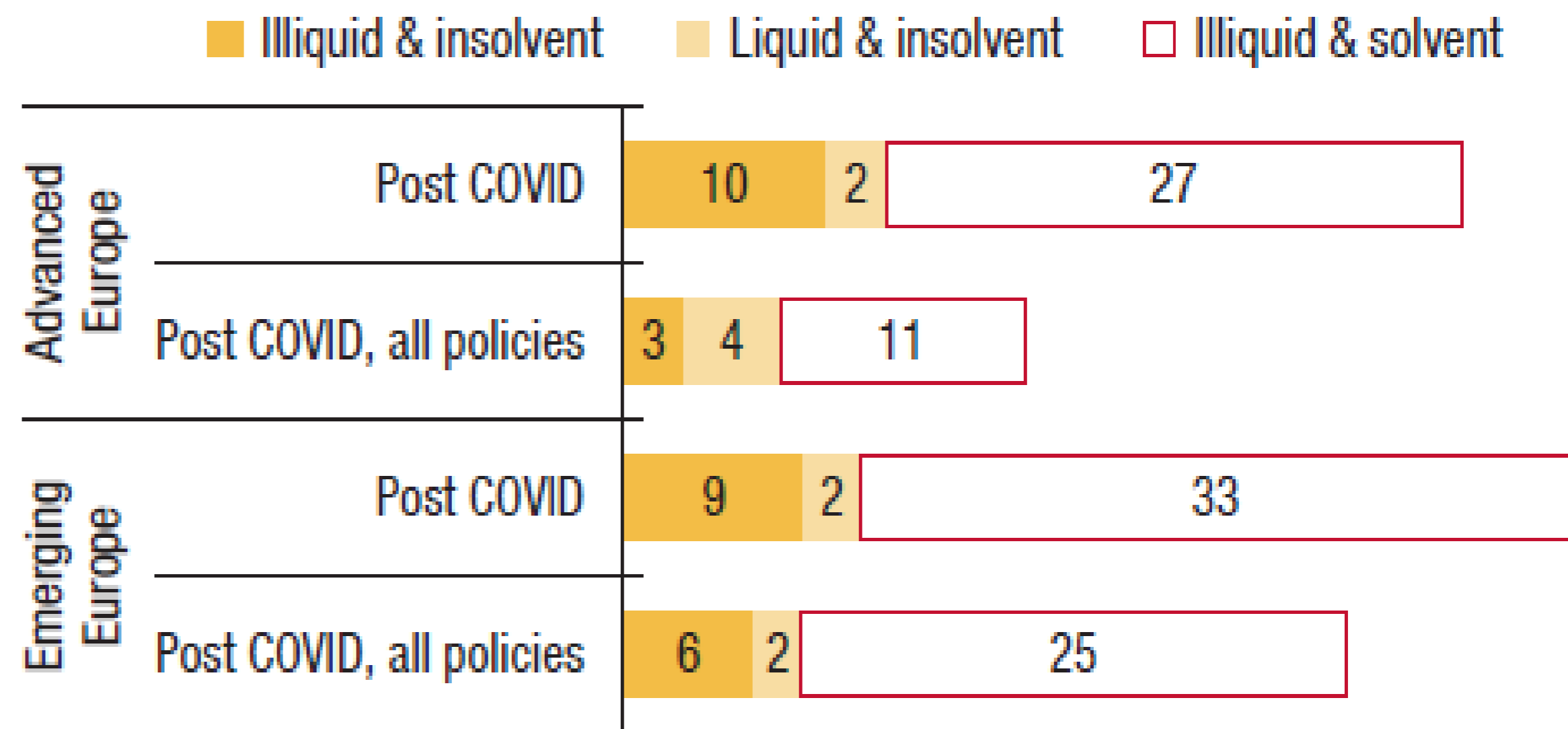
Source: IMF October 2020 Global Financial Stability Report, and IMF staff calculations.

... and Mitigated Liquidity and Solvency Pressures on Firms



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).

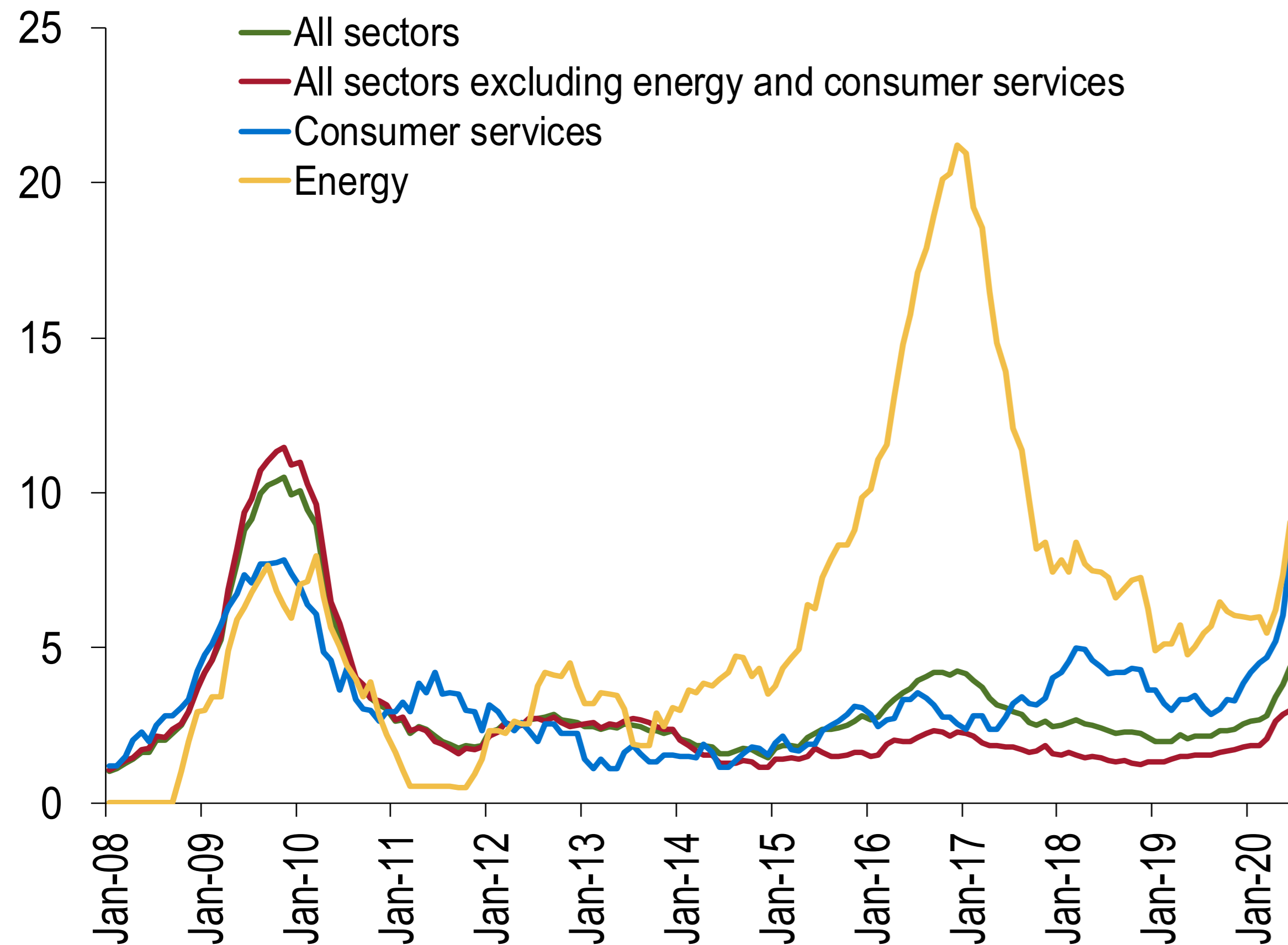
Distribution of Firms by Liquidity and Solvency: Firms that were solvent pre-COVID 19; Conditional distribution post-COVID-19 (Percent)



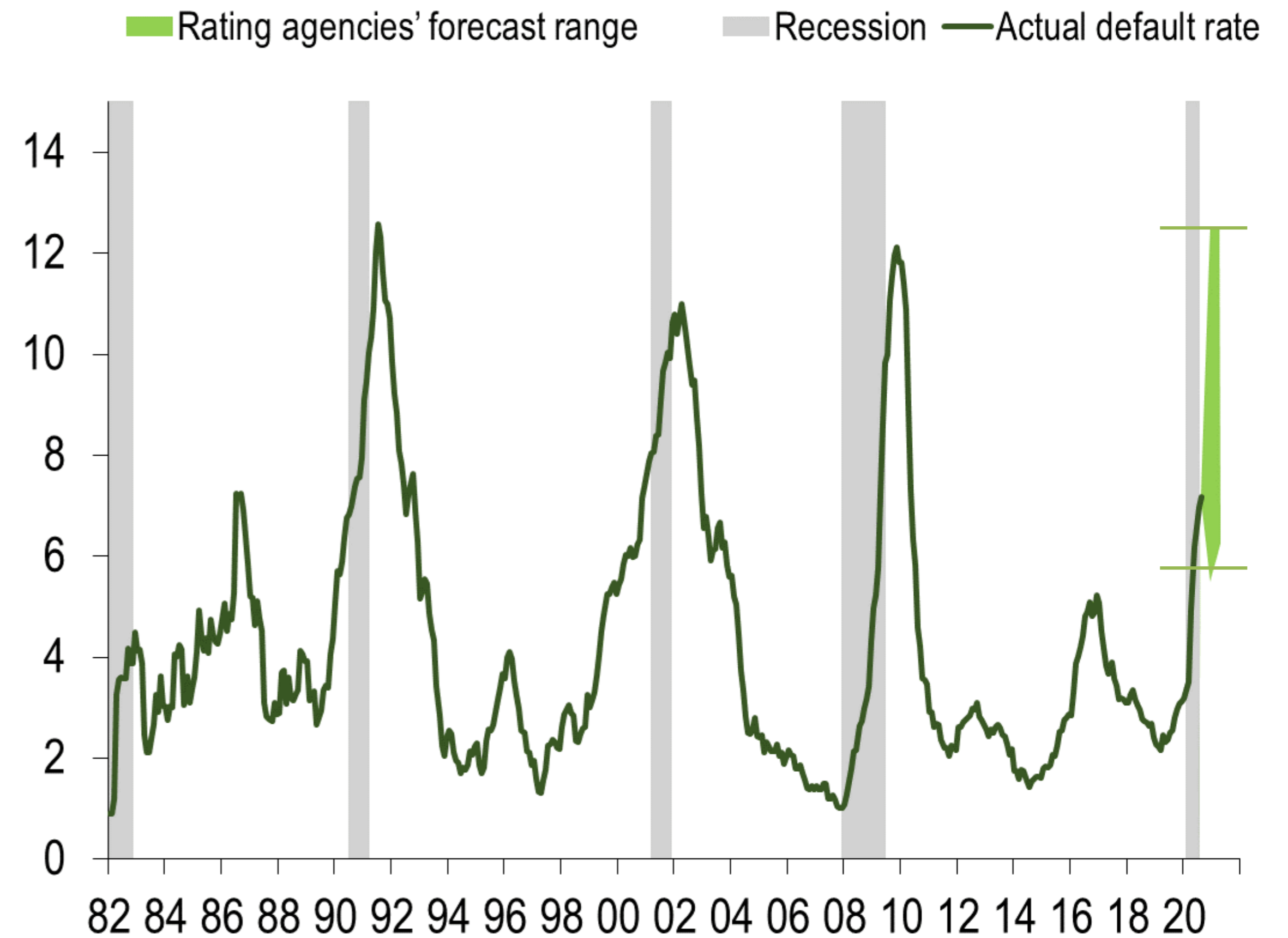
Source: October 2020 IMF Regional Economic Outlook (Europe).
 Note: the chart shows the ex-post (conditional) distribution of those firms that were solvent pre-COVID-19. The original sample includes 4 million firms in 17 advanced and 9 emerging market European economies; the data are sourced from the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

Banks: Policy Trade-offs

**From
“whatever it
takes” ...**

Extraordinary policy support

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

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

**...to
“as long as
needed”**

Exit from extraordinary support

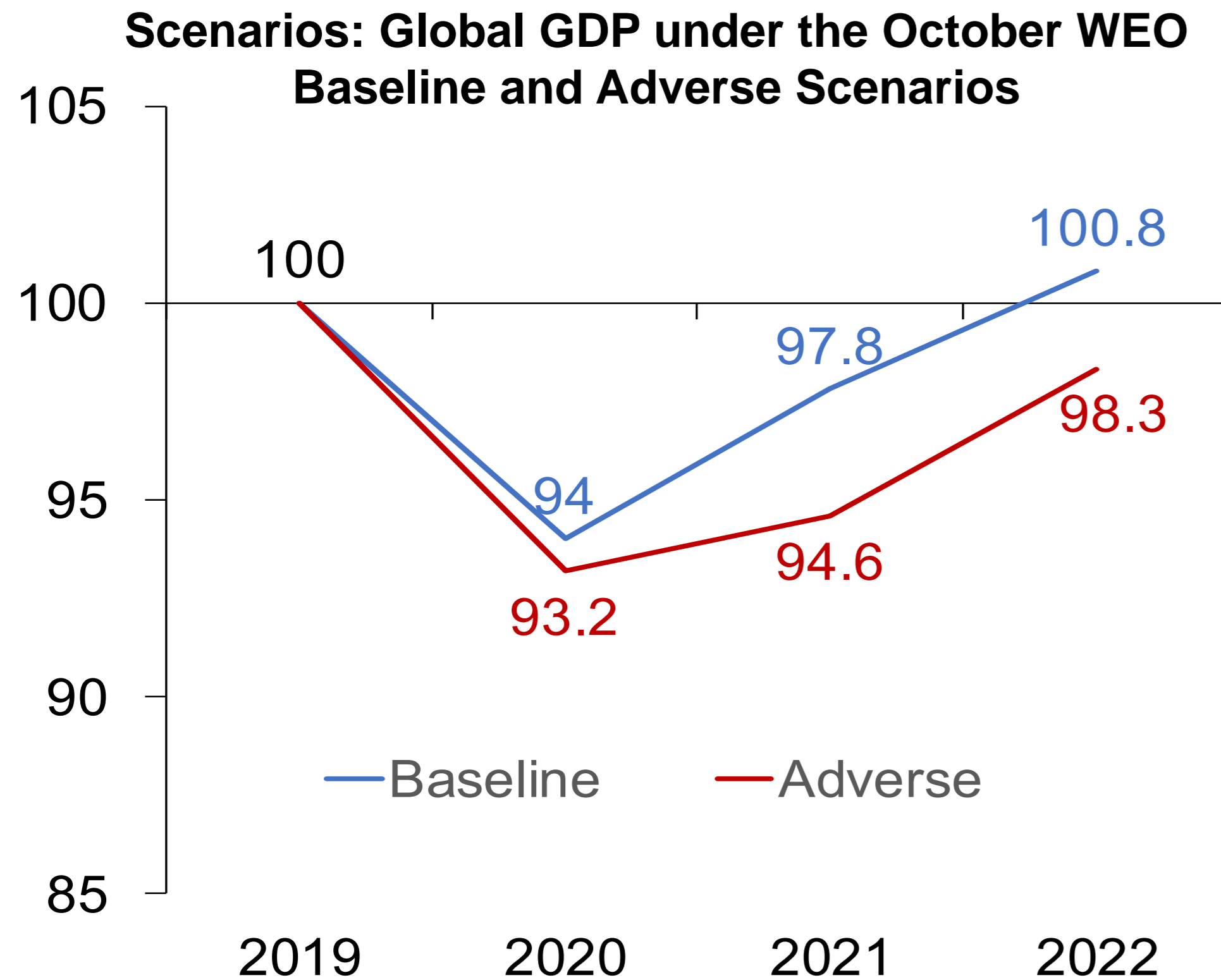
- **Type 1 error:** premature withdrawal of accommodation
- **Type 2 error:** overextending support to nonviable or insolvent firms

- **Type 1 error:** Higher bank losses; credit crunch
- **Type 2 error:** Debt overhang; weak growth; bank profitability pressures

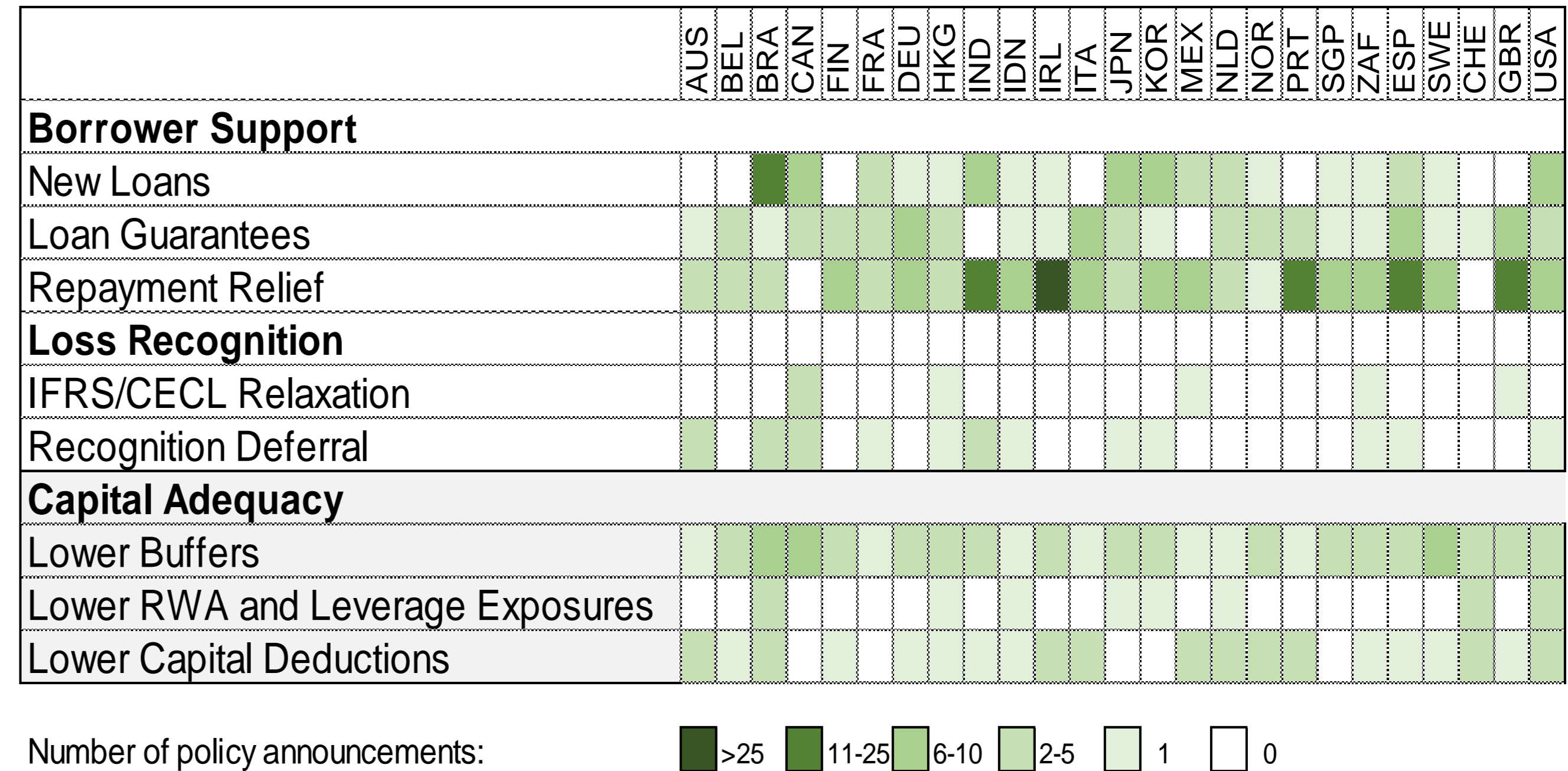
Global Bank Solvency Scenario Analysis (October 2020 GFSR)

- 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

Mitigation Policies Announced in Response to COVID-19 (Number of Policy Announcements)



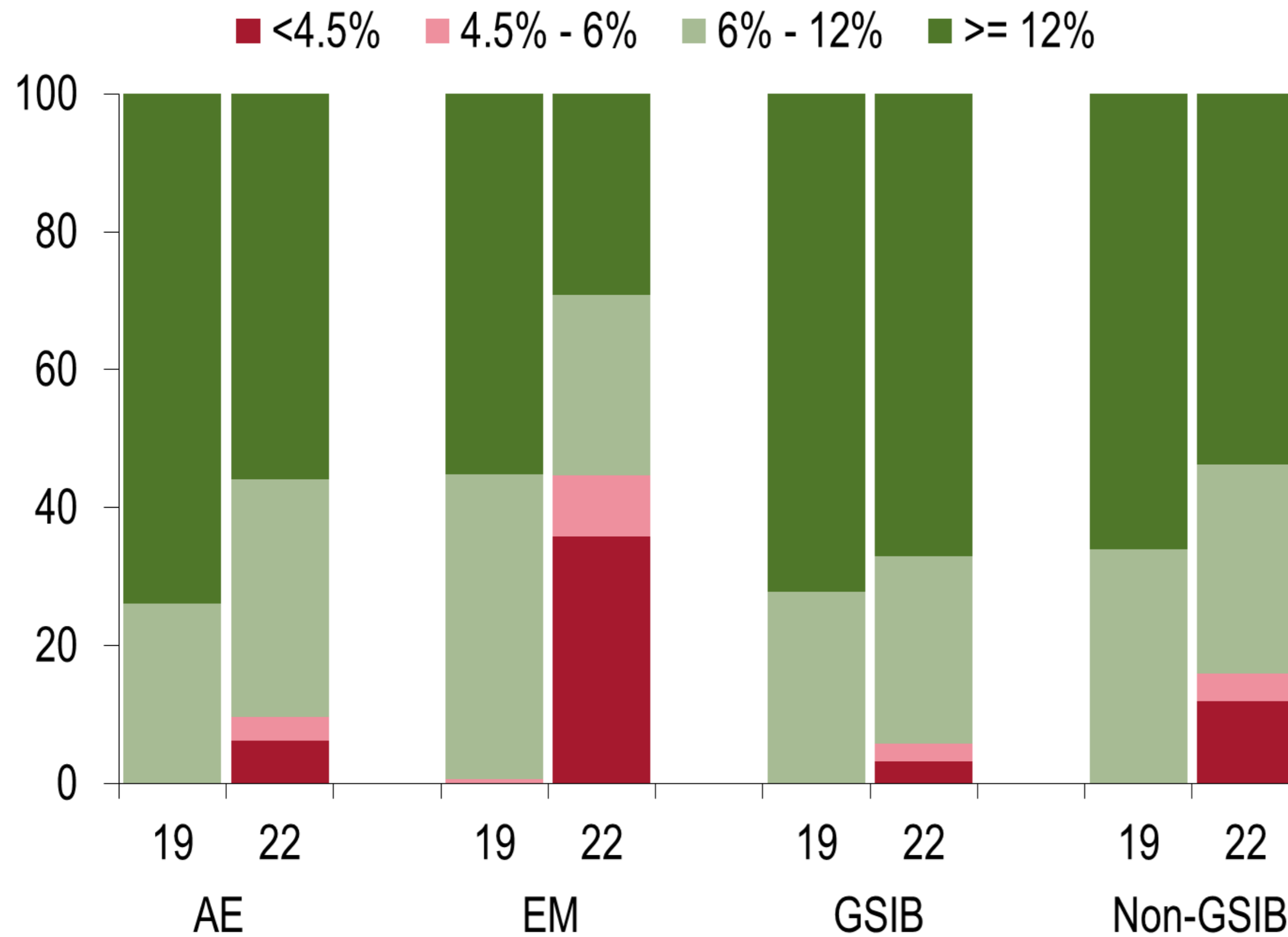
Source: IMF staff estimates, October 2020 GFSR



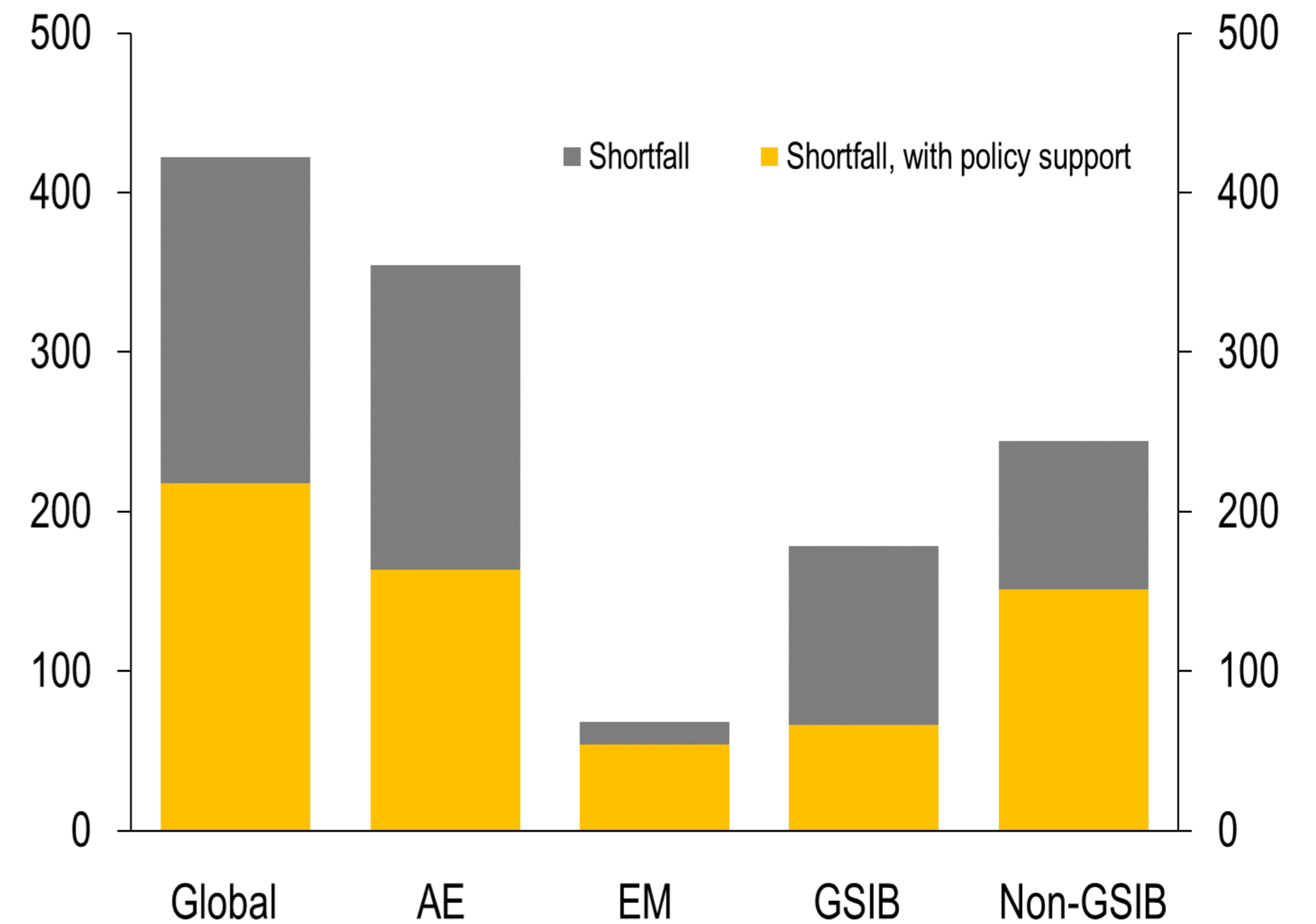
Source: IMF staff estimates, October 2020 GFSR

Policy Support Has Mitigated Potential Bank Losses

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



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” ...**

Extraordinary policy support

- Stabilized funding markets and market liquidity conditions
- Put a floor under risk asset prices

- Outflows from investment funds reversed & stabilized
- Vulnerabilities remain

**...to
“as long as
needed”**

Exit from extraordinary support

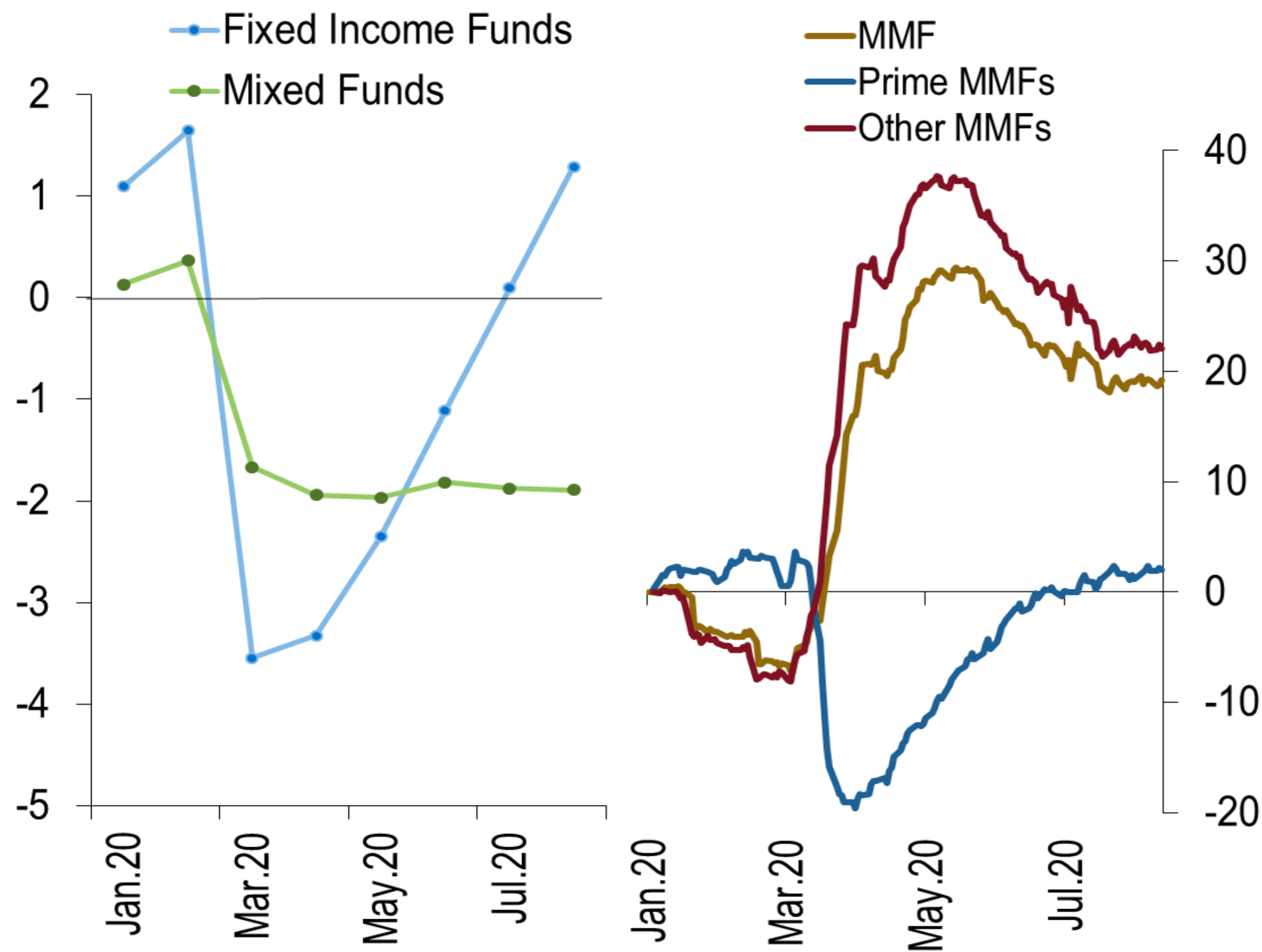
- **Type 1 error:** premature withdrawal of the central bank support
- **Type 2 error:** maintaining support for an extended period

- **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

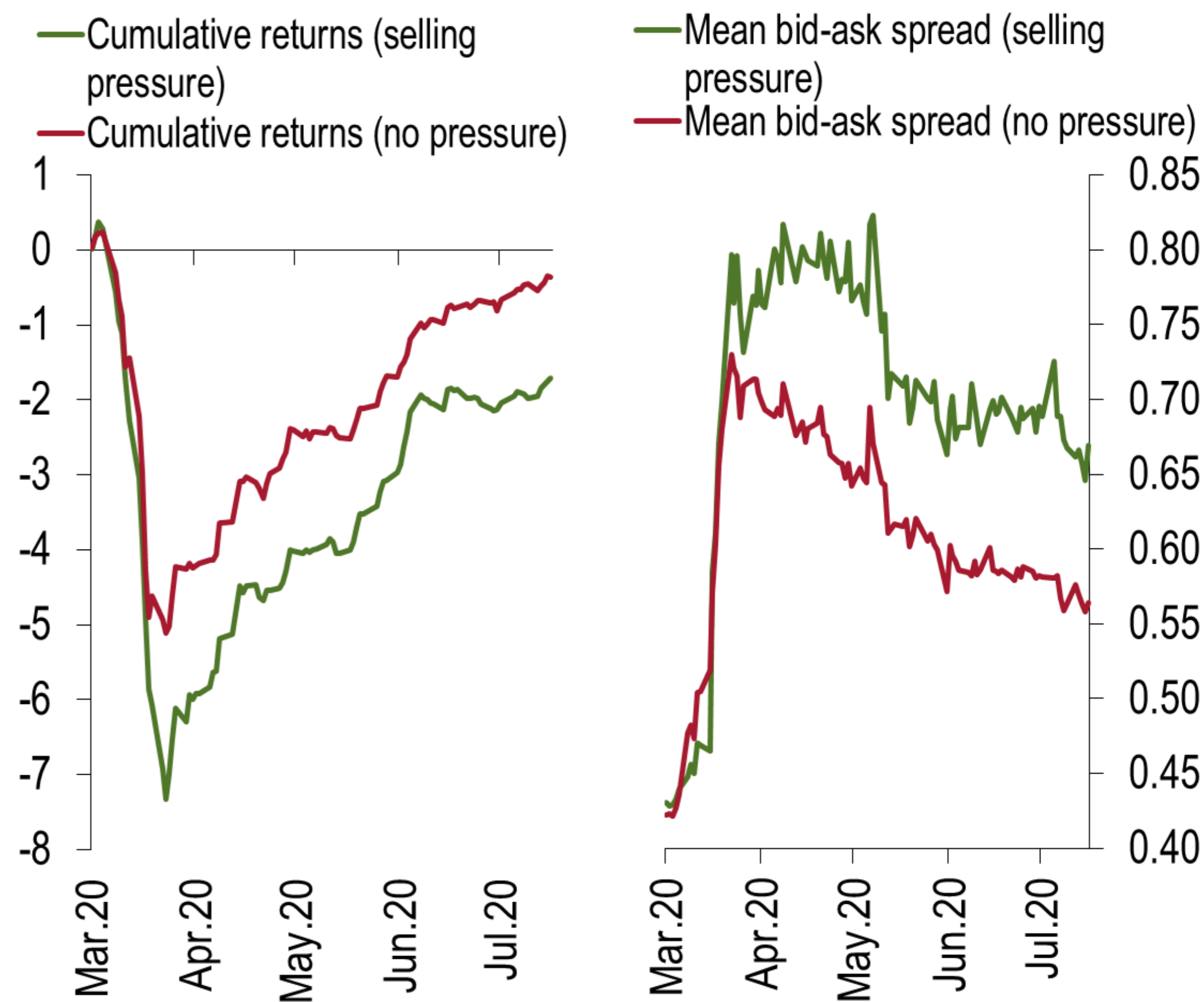
Cumulative Fund Flows

(Percent of assets under management)



Cumulative Returns and Bid-ask Spreads of Fixed-Income funds

(Percent)



Source: IMF October 2020 Global Financial Stability Report, and IMF staff calculations.

A Bridge to Recovery

Interconnectedness and Policy Roadmap



Policy Roadmap (October 2020 GFSR)

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