



MIER POLICY BRIEF

Will Covid-19 Morph into a Global Financial Crisis?

BY LIM MAH HUI

That is the million dollars question to which no one can provide a definite answer. However, we can outline the variables that determine this answer by providing an analogy. Suppose a category 5 storm were to hit a house, will the house stay intact, collapse, or be partially destroyed? The answers depend on the intensity and duration of the storm, on the one hand, and the strength and foundation of the house, on the other hand. A third variable is what builders or architects can do to shore up the house.

Covid-19 is a health calamity of great intensity that has hit humankind with colossal speed. Within a matter of three months, every country in the world is affected. Over 3 million people have been infected and over quarter million have died. Half the world's population remain in some kind of lock-down exacting huge economic costs. This has caused not only an initial break-down in the global supply chain, but more ominously a close to total collapse of demand globally in many industries and services.

This double whammy forced governments and central banks around the world to rush to the rescue of their economy and citizens. The United States unleashed over \$3 trillion of rescue fiscal package, while the Federal Reserve Bank pumped in trillions of liquidity and promised to do all it can to maintain the financial system. The Fed's balance sheet shot up to \$6.4 trillion in a matter of weeks. The Fed not only bought US government treasuries followed by quasi government papers to shore up the housing mortgage market, it started to buy private sector bonds, including high-yield bonds, i.e., bonds with risky credit status. This shows the extent of their desperation. The European Central Bank likewise has pledged it would do whatever it takes to keep the financial system afloat. In Malaysia, the government announced a RM250 billion package close to 20% of its GDP.

Duration - how long will this disruption continue? That in turn depends on how long it takes to find a therapeutic medicine and a vaccine to prevent further outbreak of the virus; and the extent and speed with which the virus mutates. Most health professionals estimate it takes at least between 12 and 18 months for a vaccine to be tested and certified safe before it can be put in the market for mass use. The duration of the health crisis is critical. The longer it drags on, the more serious the damage to the economy and the harder for it to recover.

Dr. Lim Mah Hui, a former professor and banker with the ADB, explains that, "The outflows during the COVID-19 crisis at \$100 billion over a three-month period were even larger than during the GFC. Risks are further compounded when a large chunk of external debt is denominated in hard currencies exposing debtor countries to currency risks. The health and debt problems facing developing economies could not have come at a worse time with exports and commodity prices collapsing even before the pandemic crisis, and credit spreads widening for developing economies with the crisis."

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MPB Advisor: Tan Sri Dr Kamal Salih
MPB Series Editor: Dr Shankaran Nambiar

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The next variable in the equation is what was the condition of the global financial system when the pandemic hit the world. A house can withstand a storm only to the extent it has a strong structure and foundation. How resilient is the global financial system? Or conversely how fragile is it? To answer this question, we need to take a longer view of the financial system and what has happened over the decades.

Here we shall confine to comparing the financial system before and after the Great Financial Crisis (GFC) of 2008. The GFC was the most severe financial crisis since the Great Depression of 1930. Financial liberalization and deregulation since the late 1970s culminated in a financial industry that was over blown and over leveraged. Interest rates were low, the economy awash with liquidity, banking regulations and supervision were lax, major banks were over-leveraged, many at 40 times their capital, households debt soared to 100% of GDP in the US, volume of derivatives market ballooned with notional value reaching \$516 trillion (10 times the world GDP), and global debt was 260% of world GDP.

The combination of a dizzying array of new and risky products, such as collateralized debt obligations and credit default swaps, with excessive leverage in almost all sectors of the economy in an environment of light regulation and permissive monetary support from the central bank, was the perfect cocktail for a financial implosion. The dyke eventually broke in 2007/2008 and the financial contagion spread throughout the world. Many major banks and financial institutions became insolvent and had to be bailed out by government costing trillions of tax payers' money.

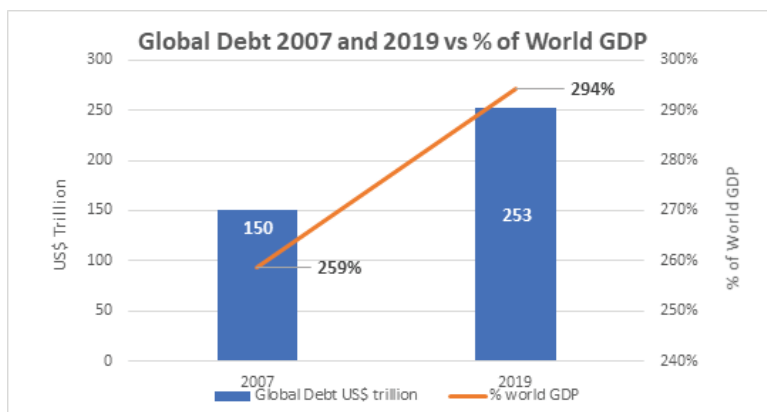
In a desperate effort to avoid a severe recession, major central banks all over the world embarked on unconventional policy of quantitative easing, essentially injecting liquidity into the financial system with objective of encouraging lending and investments to resuscitate the economy. While the economy averted a severe recession, growth continued to be desultory and uneven. It was like pushing on a shoestring. Households that were living on a shoestring and trying to repair their balance sheet reduced borrowing and increased savings. Banks instead of lending to small medium size companies and households that needed credit, lent to financial industry and investors who speculated in the stock and bond markets driven by low interest rate.

Interest rates became negative in several European economies so that today the global financial markets are sitting on \$16 trillion of negative interest rate bonds (Wigglesworth, 2019) Economists are still unsure of, or divided, on the impact of this phenomenon. One thing is clear, when interest rates rise there will be huge capital losses.

Corporations borrowed more for financial transactions like mergers and acquisition, private equity investments, leverage buy out and share buyback than for productive investments. The stock and bond market went on a tear and enjoyed the best bull run for a decade scaling new heights that surpassed pre GFC levels. All these created asset inflation and asset bubble which have been the main triggers for financial crises. Global investments on the other hand stagnated as percentage of GDP.

Irrespective of the causes of financial crises, of which there are many, the one constant condition is excessive debt - companies and individuals borrowing in excess of their ability to generate the income to pay off debt. The quantitative easing monetary policies of central banks after the GFC have exacerbated the debt problem. Twelve years after the GFC, world debt at US\$253 trillion (294% of world GDP) is 69% higher than pre GFC debt at \$150 trillion. See Figure 1. What is even more foreboding is that global debt is rising 50% faster than global GDP between 2007 and 2018; and this trend is unsustainable.

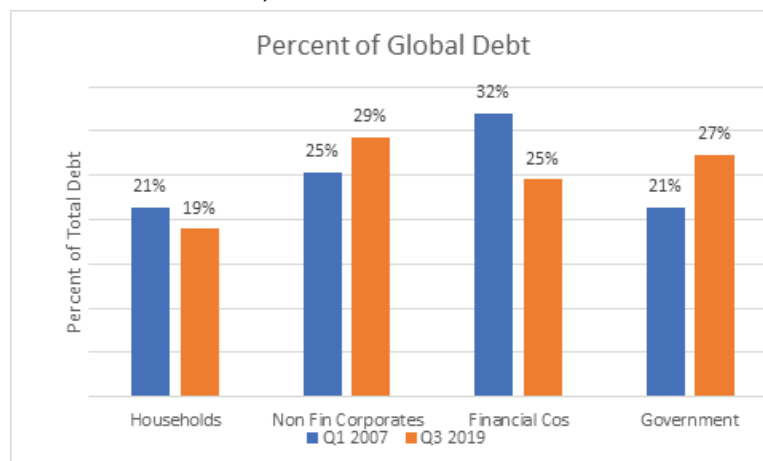
Figure 1: Global Debt, 2007 and 2019.



Source: IIF
https://www.iif.com/Portals/0/Files/content/GD-M_Aug2019_vf.pdf
https://www.iif.com/Portals/0/Files/content/-Global%20Debt%20Monitor_January2020_vf.pdf

There has been a shift in composition of global debt. Non-financial corporate debt and government debt have risen while financial and household debt has declined. However, more than half of the debt in 2019 were still accounted for by non-financial corporations (29%) and financial corporations (24%), followed by government (27%) and households (19%). See Figure 2

Figure 2: Composition of Global Debt, 2007 and 2019



Source: Ibid

Another disturbing trend is debt in emerging economies (EE) has risen significantly and a large part of it is denominated in foreign currencies making these economies highly vulnerable to currency depreciation and capital outflows.

Emerging economies' debt has risen more than two fold since 2010 to \$72 trillion with sharp build up in non-financial corporate sector (up from \$20 trillion to over \$31 trillion) with dollar debt accounting for 85% of the increase (IIF, Jan 13, 2020).

One of the positive outcomes of the GFC was the changes made to strengthen the banking sector. Banks were required to hold higher levels of capital buffer as well as liquidity ratios, to undergo stress test more frequently, to put in place a living will. There were attempts to regulate banking activities under Dodd-Frank initiatives and the Volcker Rule that restricted banks from speculating and trading securities for its own account. However, push back by the banking industry eventually saw these efforts substantially watered down especially under Trump regime. Nevertheless, the banking industry is ostensibly stronger compared to the pre GFC period.

However, the same cannot be said for the non-banking financial sector, or what is sometimes known as the shadow banking industry which is not regulated like banks. This has grown twice as fast as banks between 2012 and 2017 (see Table 1). These include money market and fixed income funds, hedge funds, private equity funds, securitization vehicles, mortgage companies, finance companies, collective investment vehicles, brokers-dealers, insurance companies, pension funds etc. At \$184 trillion, they hold more financial assets than banks with \$148 trillion in 2018. If pension funds and insurance companies are excluded, they form \$115 trillion (30%) of global financial assets. The total global financial assets at \$379 trillion is 4.5 times global GDP.

Table 1: Growth of Global Banks and Shadow Banking Industry

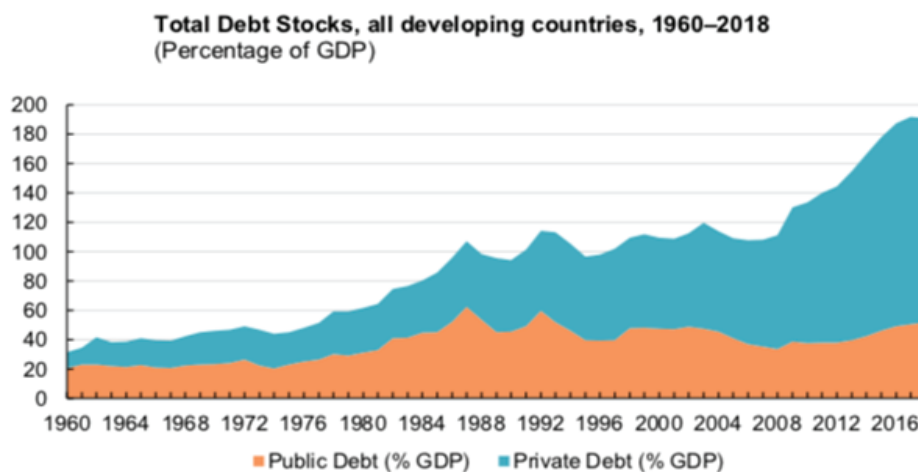
Total Global Financial Assets			
US \$ Trillion	2012	2018	Annual Growth
Banks	130	148	3.4
Central Banks	25	30	8.5
Public Financial Institutions	10	17	4.7
Bank Financial Institutions	165	195	
Insurance Cos.+ Pension Funds	50	66	5.5
Pension Funds			6.3
Other Fin Institutions	75	115	9.0
Non-Bank Financial Institutions	125	181	7.8
TOTAL	250	379	

Source: FSB, Global Shadow Banking Reports 2013, 2019

Global financial risks and vulnerabilities have become more complex and nuanced since the GFC and have shifted in terms of sectors and region. In advanced economies, particularly the US, centres of risks have migrated to shadow banks and non-financial corporates that gouged on cheap debt. Chasing for high yields in a low interest rate environment investors bought high risk, high yield bonds. This problem was clearly evidenced in March when markets in normally safe assets like money market funds and US treasuries froze. Highly leveraged asset managers and other non-bank financial institutions facing margin calls in a collapsing stock market were forced to sell safe securities into a market with no buyers. The Fed had to step in as the buyer of last resort in order to save the market. Credit spreads in riskier assets like corporate bonds and high yield bonds spiked. The Fed stepped in to purchase private and high risk debt, something that was unprecedented.

Another sector or region with huge vulnerabilities post GFC are the developing economies. Just as in the Asian Financial Crisis of 1998, and the GFC of 2008, low interest rates sent huge waves of money flowing into Asia and other developing economies that eventually led to financial crises. With even more deregulation, financial liberalization and deeper integration into the global financial system, the total debt stock of developing economies, domestic and external, doubled from 100% to 191% of their GDP between 2008 and 2018. See Figure 3.

Figure 3: Total Debt Stocks of all Developing Economies, 1960-2018

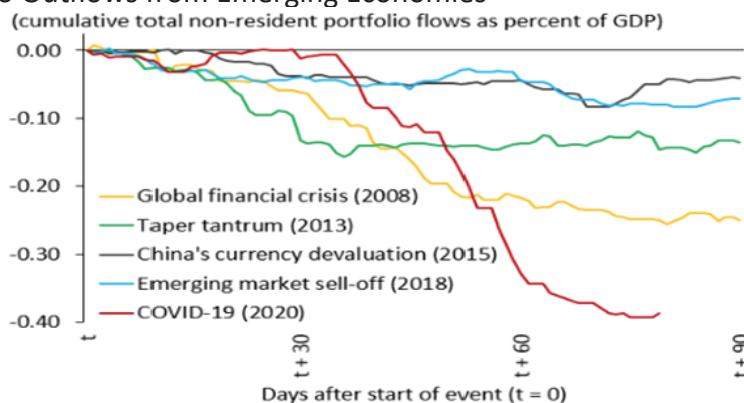


Source: UNCTAD, 2020.

In terms of ownership of public debt, as high as 80% of it was held by private non-resident parties in high income developing economies exposing them to sudden outflows in times of crisis.

Figure 4 depicts the volume of portfolio outflows from emerging economies during different periods of financial disruptions. The outflows during the COVID-19 crisis at \$100 billion over a three months period were even larger than during the GFC. Risks are further compounded when a large chunk of external debt is denominated in hard currencies exposing debtor countries to currency risks. The health and debt problems facing developing economies could not have come at a worse time with exports and commodity prices collapsing even before the pandemic crisis, and credit spreads widening for developing economies with the crisis.

Figure 4: Portfolio Outflows from Emerging Economies



Source: Adrian and Natalucci, 2020

Financial crisis can lead to recessions and recession can lead to financial crisis. The 2008 recession was a direct result of a financial meltdown originating from the US. Today, a health crisis has led to a recession with unprecedented speed and scope since the 1929 Great Depression. In the first quarter of 2020, the U.S. economy slid 4.8% and the EU economy 5.8%. Unemployment claims in the US reached 30 million, wiping out all gains since 2008. In EU unemployment is also expected to surpass 10%. Second quarter 2020 numbers will be even more dismal. Not only is non-financial corporate debt at historic high, a significant portion (16% in the US and over 10% in Europe) are zombie companies, i.e., unable to service debt even before the pandemic crisis.

Will this lead to a financial crisis? Central banks and governments all over the world have spared no effort to prop up the real economy. While this has led to a rally in the financial markets, is it able to prevent a financial crisis? Markets are grasping at every straw of “good news”- from flattening of infection curve, to rumours of discovery of new vaccine, to relaxing of lockdown - to hope for a quick V shape recovery before the end of 2020. But signs are that the virus will stay with us longer, may mutate, and change our lifestyle. This will mean that at best it may be a U shape, or a rounded bottom W shape, or even L shape recovery. For sure, the tourism, hotels, air travel, restaurants, recreational and other services industries which form a huge chunk of our economy will not be bouncing back to their pre-COVID levels anytime soon. And most of the jobs created in the US economy over the last decade are in low-paying service industries that are at greatest risks. Far from being an equalizer as some have claimed, the pandemic has hit hardest the lower income people with no health insurance, low paying or/and temporary jobs. With loss of income for many households and firms which can lead to mass defaults and bankruptcies, are banks able to hold the dyke?

Conclusion

Covid 19 is the equivalent of a category 5 storm – its intensity and scope are frightening; the only unknown variable is the duration. The longer it lingers the greater the destruction. It is hitting at a time when the world health, economic and financial systems are vulnerable and fragile. Some parts of the systems are stronger and others are weaker. In terms of health, developing countries especially the poorer ones lack the least resources to cope up with the pandemic. However, even advanced countries are experiencing the same fate as evidenced in Italy, Spain and the U.S.

In terms of economy, advanced countries with hard currencies, possess the luxury of massive even unlimited monetary and fiscal interventions to rescue the real economy from total collapse, though the consequences of such measures are still uncertain and a subject of great debate among economists. Developing countries do not have the same monetary and fiscal space to unleash the same level rescue measures without currency debasement, capital flight and inflation. This is particularly true for countries with weak macro-economic fundamentals, like current account and budget deficits, high external debt and dependence on commodity exports, and weak currencies. These include countries like Argentina, Brazil, Turkey, South Africa.

In terms of financial sectors, while banks are relatively stronger after the GFC, non-bank financial sectors, and non-financial corporations in most advanced economies, particularly in the US, are more vulnerable and fragile. Global debt today is 73% higher than before the GFC and is concentrated in the latter two sectors. Much of the debt is used for financial speculation such as share buybacks, mergers and acquisition and high yield high risks bonds. High yield, leveraged loans and private debt markets reached \$9 trillion globally (Adrian and Natu- lucci, 2020). This could amplify shocks if companies defaulted or decided to reduce their debt by cutting investment or firing workers.

According to the IMF 2019 Global Stability Report, “In a material economic slowdown scenario, half as severe as the global financial crisis, corporate debt-at-risk (debt owed by firms that cannot cover their interest expenses with their earnings) could rise to \$19 trillion—or nearly 40 percent of total corporate debt in major economies, and above post-crisis levels (Chapter 2). In the event of this happening, it is unlikely that the banking sector will be able to escape a major financial crisis. It is unlikely that the stress testing scenarios of banks had anticipated

a downturn of such magnitude with all reports pointing to the most severe recession since the Great Depression of 1930s.

Finally, there are differing views on the economic prospects going forward. Many economists see deflation as the more likely scenario. With demand collapsing and not about to return to pre COVID19 levels anytime soon, most evidenced by the historic decline in oil prices, and the massive rise in unemployment, deflation will increase the risk of insolvency. This is exacerbated by interest rates at near the zero level thereby leaving little, if any, room for central banks to wiggle, leading to the classic liquidity trap. With historic proportion of global debt and weak debt servicing capacity, the line separating between deflation and debt deflation is razor thin. Woe betide, if the world slips into debt deflation.