Introduction

The COVID-19 pandemic poses an unprecedented global public health crisis, resulting in a widespread loss of life and human suffering. The crisis has also posed a substantial threat to the global economy resulting from containment and other measures essential to address the health impact. As a result, companies desperately need funding in order to continue operations and keep their productive capacity intact. In this respect, financial institutions can play a vital role in supporting the economy to function normally by providing liquidity and channelling funding to where it is most needed. They can also underpin global value chains to produce vital goods, ranging from food to medical equipment and appliances. However, as significant turmoil in the global economy continues, an erosion of confidence, heightened uncertainty, as well as liquidity and solvency challenges are starting to cast a shadow on the ability of financial market actors to effectively and efficiently channel funding.

Meanwhile, there is the potential to recover and come out of the crisis more strongly. For example, workforces could become more productive as we work more flexibly, whilst saving energy on commuting. It also appears that the crisis enabled us to leapfrog several years of digital transition. Finally, building resilience based on structural reforms, improving public governance, cutting red tape and fostering greater international cooperation, possibly with novel solutions leveraging on digitalisation, bears significant positive potential for our economy and society.

How COVID-19 is stifling the global economy

In its June 2020 Economic Outlook, the OECD projects the deepest recession seen in peacetime over the past century. Notably, it stresses that the recovery is likely to be hesitant, and could be interrupted by another coronavirus outbreak. In its “double-hit scenario” assuming a second outbreak later in 2020, global GDP growth is expected to decline by -7.6% in 2020, while in an alternative scenario where a second outbreak is avoided (“single-hit scenario”), global GDP growth is projected to decline by -6.0%. The effects of the crisis are expected to leave long-lasting scars in many economies – by the end of 2021 the median OECD country will have lost more than 5 years of income per capita growth.

The negative impact on economic growth, alongside a substantial rise in the level of corporate debt over the past 12 years¹ and a decline in the quality of corporate bond issuance², introduce significant fragility in the financial system. One of the most severe economic impacts of COVID-19 is the abrupt interruption of business activities, leading to a major – and sometimes a complete – loss of income for firms of all sizes. This is the result of strong, negative disruptions in both supply and demand. A substantial number of companies are now facing cash flow and liquidity issues, with a considerable risk of insolvency for certain companies in the future.

While the virus has the potential to disrupt all businesses, small and medium-sized enterprises (SMEs) tend to be particularly vulnerable to the loss of income due to the containment measures. Most SMEs do not have sufficient cash to ride out the emergency period, with a recent OECD report warning that over 50% of SMEs may not survive the next few months.

¹ The issuance of corporate bonds doubled to a record-high of around USD 14 trillion since the financial crisis, according to OECD estimates.
² Over the last three years 52% of all new issues were rated BBB – the lowest quality in investment grade.
Should companies fail due to either weak corporate earnings or elevated credit costs resulting from increased risk pricing, the compounded impact may lead to a further weakening of market confidence, with a potential vicious cycle of further increases in the cost of credit and solvency issues for non-financial firms that can in turn weaken through direct and indirect impact the whole business ecosystem. Higher losses could have serious consequences for financial institutions. Even if solvency is not threatened, an increasing share of non-performing loans may constrain financial institutions’ willingness and ability to lend, resulting in a broader credit crunch.

Finally, it is important not to overlook that during the Covid-19 crisis, the credit standing of sovereign borrowers has suddenly worsened as governments have allowed their deficits to balloon. The crisis is fast moving, noticeable decreases in the probability of defaults have been observed in recent weeks, however this needs to be closely monitored in order to avoid a “sovereign debt crisis” that may result from a prolonged lockdown.

Policy recommendations to address the crisis

We recommend that public authorities take the following actions to help address both short-term economic factors and long-term underlying structural vulnerabilities in the financial system.

1) First, governments and central banks can support the economy with support programs related to the receipt of liquidity. These include:

- Maintain supportive monetary policies to ensure liquidity is flowing to intermediaries, and credit intermediation is reaching businesses and households to avoid a liquidity crunch. This includes the provision of immediate central bank liquidity to financial institutions that need short-term funding.
- Provide government guarantees to support credit flows to business, especially SMEs. In addition, overall state support, including other programs and measures, both in financial and other forms are of high importance to help enterprises tackle crisis-related challenges such as accessibility to finance.
- Support companies and banks with temporary liquidity challenges by implementing tax holidays. However, simple debt moratoria may result in more non-performing loans on the books of the banks, so its use should only be considered after all other means have been exhausted.
- Cooperate with financial institutions to find solutions that make liquidity support to business more accessible and improve transmission mechanisms.
- Create an enabling policy environment to help financial institutions to fulfil their duties of ensuring the circulation of funds. For example, interest payment support implemented in some countries can serve as a good practice to ensure that business can ride out the short-term revenue squeeze.
- Where necessary, regulators and supervisors could temporarily adjust underwriting standards guidance and encourage more flexible payment arrangements to allow for credit extensions to SMEs and high-risk borrowers. In particular, this can include increasing bank lending capabilities, and temporarily relaxing the application of IFRS 9 Principles in calculating expected credit loss (ECL) requirements, by defining clear and fair criteria to rate borrowers based on the COVID-19 impact on their businesses.
- Assess how the 2008/09 financial crisis reforms are holding up during the COVID-19 crisis, in particular by looking into whether all previous reforms are achieving their desired objectives, or whether some are witnessing the appearance of any unintended consequences that hamper lending.
- More generally, identify and leverage best country practices from the 2008/09 crises.
- Investigate as to why there was pronounced growth in bonds leading up to this crisis, in order to better understand whether this was driven by a generally increased...
appetite for debt, versus the potential drop of other forms of funding, and the relative forces driving such patterns.

Finally, a phased approach should be ensured when governments roll back support programs and regulatory measures so that both lenders and borrowers can have time to adapt.

2) Second, governments have a role to play in stimulating the output side of the economy. These include:

- Deploy targeted fiscal policy to stimulate the economy, including through investment in key areas such as R&D and innovation, digitalisation, infrastructure and transportation, and human capital (incl. education and health), which can not only play an important role in the recovery phase but also help economies improve their 'preparedness' going forward. Relatedly, the mobilization of private capital will be crucial, which, amongst others necessitates capital market development in general as well as PPP project enhancement.
- A closer look at the “quality of public spending” (i.e. its effectiveness and efficiency) across countries is merited. The crisis has shown that not just amounts spent (in relation to the size of the economy) matter for positive outcomes but also “how” public resources are spent.
- Ensure that building resilience is not misused as a vehicle for protectionism and unilateral action, but based on structural reforms, improving public governance, cutting red tape and fostering greater international cooperation.
- Consider the use of such loans where a certain portion may be turned into a grant upon successfully meeting pre-defined objectives, as already deployed by some countries. These can potentially help to address solvency concerns amongst small businesses.
- Promote and support innovative solutions in building up of business resilience through digitalisation. For example, the digital transformation of conventional industries would not only prepare business against a potential next wave of outbreak but also strengthen global value chains.
- Finally, it is clear that today's emergency and recovery policies will shape economic and social prospects in the coming decade. Policies that support the recovery should thus also take into account sustainability aspects in order to 'build back better'. As one example, governments should monitor how much of the public spending is targeted at creating infrastructure that enhances resilience and sustainability of our society. Policy implementation is of crucial importance to help economies and enterprises become more sustainable in long run.

As general principles, recovery packages should be implemented in a timely manner as well as flexibly adjusted according to new necessities. Accessibility to measures and instruments provided to overcome the COVID-19 crisis should last reasonable time after 2020 to help economies, firstly, overcome the crises, secondly, stabilize the economies, and, thirdly, to develop and grow. Last but not least, it is important to avoid “one-size-fits-all” approaches and governments need to act according to their best judgment depending on the legal framework and country-specific needs. One should bear in mind that economies differ in many aspects such as financial sector resilience, budget and fiscal policies, industry portfolios and economic structures.

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3 For example, one Canadian loan program to assist companies through COVID-19 includes a provision that if the business pays 75% of the loan off, then the remaining 25% is a grant – which addresses solvency concerns amongst small businesses.