BUSINESS at OECD

Business at OECD (BIAC) Policy Note – *Financing the Recovery: The Need for a Long-Term Strategy and the Role of Financial Markets*

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Context: Ensuring that financing does not become the bottleneck for recovery

A particular challenge related to the COVID-19 crisis is to ensure that sufficient financing is put in place to allow the real economy to recover. This note looks into how we can ensure that financing does not become the bottleneck for a sustainable economic recovery to take hold. It thereby focuses on the specific role of financial markets and related institutions. In particular, it highlights the important role that the private sector, from banks to asset managers and insurers, can play as key enablers of financing the recovery.

The longer-term challenges of the crisis: recovery is marathon, not a sprint

First, while public fiscal support and stimulus programs implemented as a response to the crisis are necessary to address the immediate fallout and to avoid the destruction of physical and human capital and the concomitant reduction in growth potential, they, together with the impact of automatic stabilizers and lower output levels, have significant implications for public finances. Government budget deficits and debt are set to see sizable increases in many countries. For example, the OECD estimates that if the virus surges again, headlines fiscal balances could deteriorate by about 9 percentage points (pp) of GDP in the median OECD economy, i.e. around three times as much as in 2008-09, whilst the median debt ratio could increase by almost 15 pp of GDP in 2020, compared 10 pp in 2009.[1]

Already now there are signs of a deterioration of the credit standing of sovereign borrowers. While sovereign ratings published by ratings agencies and developed internally by financial institutions provide slow-moving perspectives on country credit quality, default probabilities' analyses performed on 1 and 5-year Credit Default Swap (CDS) spreads show that at the peak of the pandemic's first wave, the average rating decline for Europe is 2.0 notches, for Middle East 3.1, for Asia & Pacific 2.6, for South & Latin America 2.9 and for Africa 4.3.[2] There is a risk that the enormity of the funds needed to recover will overwhelm the public sector's current capacity. This underlines the critical role of the private sector during the recovery efforts as public sector finance alone will not suffice.

Second, a key medium- to long-term risk relates to corporate insolvency and the potential implications of debt overhang of non-financial corporations as the OECD highlights in a recent report.[3] For one, the COVID-19 crisis has diminished actual and expected sales and profits of firms, thereby potentially putting downward pressure on the value of firms' assets. For the other, whilst preserving access to credit is critical for companies' survival at the current juncture, the absorption of more debt through credit-based support programs could pose problems for non-financial firms in the longer-term given leverage constraints. There is a risk that a sizable portion of firms will start the recovery period with deleveraging pressures and heavy debt-servicing costs, which in turn may impede them from making productive investments in the future and generating jobs. Should liquidity concerns morph into a solvency crisis this could lead to negative feedback effects in

[1] OECD, June 2020 Economic Outlook.
[2] "Real-Time Sovereign Ratings in the COVID-19 Crisis", Risk Control Limited, London, May 2020.
[3] OECD, Working Party No. 1 on Macroeconomic and Structural Policy Analysis, "Insolvency and debt overhang following the COVID-19 outbreak: assessment of risks and policy responses", September 2020.

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corporate bond markets and market-based financing of corporate debt. An increase in non-performing loans (NPLs), alongside weaker bank earnings in a low-growth and low-interest environment, would likely constrain bank lending despite strong monetary policy support, with negative feedback effects for the economy.

A key policy challenge is thus to prevent widespread insolvencies, while avoiding excessive leverage across firms. Additional complexity arises in identifying the prevalence of non-viable firms (or "zombie firms") as locking in resources in less productive firms would undermine the pace of a sustainable economic recovery. A balance must thus be found between the risk of supporting potentially non-viable firms and that of prematurely liquidating productive firms.[4]

Third and related to the previous point, there is also a clear danger over the medium-term that once government stimulus recedes and the underlying nature of the economic damage becomes more visible, financial institutions are led by regulators or markets' expectation to go abruptly into a "risk off" mode, i.e. by attempting to reduce risk by selling existing risky positions and moving the funds to cash or low/no-risk positions.[5] This may have severe negative consequences for our economies which, as the OECD rightly notes,[6] depend on well-functioning, resilient financial markets and financial intermediation, and could set in motion a vicious circle between weak growth prospects and insufficient financing. This means that a key priority will be to limit potential procyclical effects of the crisis with serious repercussions for the real economy.

Finally, a particular challenge posed by the crisis relates to developing countries and emerging market economies, which typically have fewer fiscal capacities, less deep capital markets and more limited room for monetary policy action than advanced economies to mitigate the adverse effects of crisis on their local economies. These challenges can be exacerbated by capital flight as investors start to seek 'safe havens', which is what happened during the early phase of this crisis and subsequently abated thanks to external financing due to strong monetary policy action globally acting as a shock absorber. Still, as the crisis persists, weaker long-term fundamentals, changes in relative demand, and declines in important sectors such as tourism can pose particular challenges to developing countries and emerging market economies, which may in cases require support from external finance sources.

Policy recommendations

Ensuring private finance supports a long-term economic recovery and addressing the risk of procyclicality

- In order to ensure that financing does not become the bottleneck for a long-term sustainable economic recovery, access to private capital, including via the capital markets, is necessary but must be facilitated and coordinated through an extraordinary effort at collaboration between the public (IMF, MDBs, Paris Club, ECAs, large bilateral government lenders, etc.) and private sector. These extraordinary efforts are essential in re-establishing capital market risk taking, liquidity, price stability and market functionality.

- To further leverage private finance, actions such as reprieves, standstills, forbearance, public sector guarantees, and more blended finance should be considered. These would require regulators and supervisors continued flexibility in terms of accounting, loan-loss

[4] A further complicating factor in this respect is that some sectors may see rapid restructuring due to changing behavior following the crisis (e.g. with regards to e-commerce, e-learning and e-meetings), making it more difficult at the current juncture to predict the prevalence of zombie companies.
[5] In fact, even if banks apply the same risk levels, lending could go down as companies are more in debt and turnover forecasts are more uncertain. Thus, only if banks are taking more risks lending would be upheld.
[6] OECD Ministerial Council Meetings (MCM) key issues paper 2020.

management and capital buffers. In particular, regulators should consider regulatory reform to enable private sector companies to deploy their capital to support infrastructure projects that will enhance economic activity. Other possible tools to incentivizing private finance are measures aimed at increasing non-financial corporate solvency (e.g. equity and quasi-equity injections, temporary loss carry-back schemes, increased deduction possibilities).

    - Notably, evidence on public programs supporting businesses with equity or hybrid financial instruments is currently still very scant as only very few companies in a very small number of sectors such as airlines or tourism have so far tapped those programs. It remains to be seen whether the corporate sector will manage through the pandemic without recourse to public support programs addressing equity, ownership and control issues. In countries with strong and recurrent problems of containing the pandemic, a medium-term engagement of the state in a larger set of companies may be the only option of avoiding long-lasting damage, while contingent on adequate safeguards that minimize the risks of distortion with other private companies, or between countries and that limit moral hazard issues. At the same time, other options should be explored such as the issuance of convertible bonds, which was thriving in the early phase of the crisis.

    - For SMEs, however, such public capital injections are extremely difficult to implement due to a lack of the right vehicles and structures to recapitalize SMEs with public funds. Consequently, more efforts should be made to design special-purpose vehicles and schemes to inject capital to viable SMEs, which cannot or should not borrow more funds to avoid over-indebtedness and insolvency issues. Even specific-purpose investment funds, with blended finance and public funding or guarantees for certain tranches, merit consideration by governments and regulators to support the SMEs fabric. Such initiatives could also aim to draw in private/household investments to achieve greater impact.

- No financing and funding initiative in support to the private sector can, however, ever be properly effective if accessing it is cumbersome and firms have excessive costs in complying with administrative measures of bureaucracy. This even more true for trade and cross-border compliance burdens. We thus strongly encourage regulators and policy-makers to look at the "cumulative regulatory burdens" to firms rather than a limited focus on the impact of each individual policy. In this context, we encourage a look also at alternative solutions as those jointly proposed by the B20 and *Business at OECD* with the "GVC Passport on Financial Compliance".[7]

- Throughout the recovery phase, policymakers and financial regulators should make efforts to support the stability of financial markets and the real economy, so that potential investors feel more comfortable in investing in firms with otherwise attractive business models.

    - Should sharp increases in NPLs hinder already fragile banks from new lending, governments could, where needed, explore the possibility of developing distressed debt markets to facilitate the disposal of NPLs, such as "bad banks" to guarantee that viable lenders maintain adequate access to funding. Moreover, quality-based and transparent insolvency frameworks are critical to resolve distressed assets, so that business activity can continue or assets can be redeployed to more productive uses. The time is opportune for countries to assess

[7] "GVC Passport on financial compliance, a pragmatic concept to strengthen inclusive and sustainable growth" – B20 and *Business at OECD* Joint Policy Paper to G20.

their related frameworks and adapt if necessary. More generally, the crisis may provide a window of opportunity to embrace ongoing structural changes and foster the adoption of digital and IT tools, with the potential to boost the productivity of laggard firms across all sizes.

  - It is in particular critical to address procyclicality by relaxing the application of IFRS 9 principles in calculating expected credit loss (ECL) and classification of borrowers into Stage 2 if businesses are impacted by COVD-19 and by defining clear and fair criteria to rate borrowers based on the COVID-19 impact on their businesses.

- As transparency of government policy measures addressing these issues is particularly low for businesses being engaged in many jurisdictions, establishing a structured set of descriptive categories or indicators of government response measures would be useful. This could be structured along the lines of suggestions of equity, debt restructuring and efficient insolvency procedures as outlined in the OECD working paper on "insolvency and debt overhang" referenced above. Also, some modelling on the desirable degree of equity injection and debt restructuring, perhaps along OECD member state and sectoral lines, i.e. focusing on the policy issue for the highest affected countries and/or the highest affected sectors, would be useful for designing government equity schemes and for delineating the size of the problem for creditors.

- Finally, the timing of exit strategies must be carefully evaluated. For instance, in the area of finance, regulators and policy makers need to take a gradual, phased approach in scaling back economic support programs. A key concern from members is the prospect that support programs would cease at a single point in time, which could create a sudden economic shock with ripple effects through the economy and across the financial sector. A gradual phase out will instead allow borrowers and lenders the necessary time to adapt. Next, a phased exit also applies to government fiscal measures that assist business. A phased approach needs to allow for continued targeted support for sectors that are unduly disadvantaged by containment measures. In light of the renewed wave(s) of the pandemic and restriction issues, a quick restart of such schemes appears warranted in many countries.

Ensuring the sustainability of public finances

- In order to ensure the long-term sustainability of public finances, strong economic growth is key as it helps lowering the debt-to-GDP ratio. To foster long-term growth, fiscal and monetary policy needs to be accompanied by ambitious and well-designed structural reform efforts, both at national level and, where applicable, at supranational level (e.g. in case of the European Union (EU)). Also, it is critical that recovery programs focus on productive public investment and help leverage private investment.[8] Such measures could also help to address challenges related to weak productivity growth already present pre-COVID-19. As aforementioned, in the event of a continuation of the pandemic, fiscal support and accommodative monetary policy should, where needed, be further extended or scaled up.

- A closer look at the "quality of public spending" (i.e. its effectiveness and efficiency) across countries is merited to ensure high-quality spending on the right areas, boost long-term economic growth and ensure debt sustainability. 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. Regarding stimulus programs, we agree with the

[8] Here it is essential to maintain a level playing field and prevent unfair competition through public capital injections in national and/or private companies of national interest.

OECD that these must thus be designed in a transparent, time-limited, targeted manner, consistent with longer-term objectives in order to ensure a sustainable recovery. In this regard, the OECD could look into developing a scorecard – benchmarking exercise – of stimulus programs (including the EU Recovery Fund) in order to make sure that funds are used effectively and to promote best practices.

- Ultimately, the need for a restoration of public budgets and compensation of crisis and recovery measures will be paramount to regain a balance. Globally aligned fiscal solutions for multilateral application, which avoid potentially harmful unilateral actions that could pose obstacles to global trade have the highest chance to achieve this goal, and the OECD is the right organization to lead such effort. Projects that ensure fair but growth-oriented taxation according to value creation and guarantee tax certainty to all stakeholders involved will ultimately have the highest impact for companies and tax administrations.

- In some highly indebted OECD countries, issues of fiscal sustainability in the medium-term will have to be managed carefully once the pandemic is under control, output has recovered and fiscal and monetary policy are recalibrated.

Supporting developing countries and emerging markets

- Supporting developing countries and emerging markets in times of crisis is not only essential from a humanitarian and ethical perspective, it is also necessary to defeat the pandemic on a global scale and to eventually fully overcome the COVID-19 economic crisis. Several key policy measures are highlighted in our Development Committee COVID-19 response paper. [9]

- With regards to finance, the following measures could be explored:

    - Market Stabilization Mechanism – such a mechanism could for example be undertaken by G7 central banks in support of central banks in emerging markets. An asset support program for such banks could backstop their securities, extend and in some cases, amplify swap lines. This would also have a beneficial effect on secondary market trading for such sovereign securities.

    - Financial Credit Lines And Rapid Financing Instruments – should be expanded. This could be facilitated by developing a mechanism that more adequately values guarantees provided by Multilateral Development Banks (MDBs) for collateralized loans.

    - Partial Risk Guarantee Programs – should be modified to allow for new exposures and to allow banks utilizing such programs to sell, hedge or decease uncovered risk.

    - Full Guarantee – extend their use to minimize risk for private capital and to leverage MDB and other official guarantees to have a multiplier effect in tapping private funding as well as to reduce spreads on emerging market sovereign debt.

    - For some least developed countries and overly indebted emerging markets, a structured approach to over-indebtedness may appear increasingly likely and urgent, possibly necessitating debt restructuring and debt-equity swaps.

[9] It should be noted that risks born by developed nations in providing financial support to emerging economies should be analysed and articulated in a transparent manner, since domestic financing institutions' balance sheets and financing facilities may be negatively affected by an emerging debt solvency crisis.