Macrofinancial Considerations for Assessing the Impacts of the COVID-19 Pandemic

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Phakawa Jeasakul, Purva Khera, and Heedon Kang
Macrofinancial Surveillance and Review Division
Why should we care about “macrofinancial” analysis?

1. Comprehensive assessment of the macroeconomic impact of the pandemic in the short and medium run
2. Early signs of warning: emerging risks and avoiding unintended build-up of risks
3. Device and calibrate policy responses appropriately and in a timely manner
4. Exit strategy
Agenda

1. What is the COVID-19 crisis?
2. Macroeconomic impact
3. Financial market volatility and stress
4. Impact on the financial sector and credit intermediation
5. Spillovers and amplification through structural macrofinancial linkages

Transmission Channels of the Macrofinancial Impact of the COVID-19 Pandemic

1. COVID-19 Pandemic
   - Global surge of confirmed cases and deaths
   - Medical emergency
   - Lockdowns, quarantines, and border controls

2. Supply
   - Disruptions of global supply chains
   - Capacity utilization
   - Due to morbidity and mortality, labor supply
   - Supply contraction

3. Financial Market
   - Extreme volatility (e.g., equity prices, FX rates)
   - Credit spreads
   - Market liquidity
   - Capital outflows
   - Tighter domestic and global financial conditions

4. Financial Sector
   - Liquidity strains
   - Solvency problem with defaults of borrowers
   - Operational risk
   - Disruptions to the provision of financial services

5. Public Finance
   - Increase in healthcare and social welfare expenditure
   - Reduction in fiscal revenue
   - Fiscal deficits

6. External Position
   - Capital outflows
   - Exchange rate depreciation
   - Impact on net exports
   - BOP difficulties

7. Commodity Price
   - Breakdown of negotiations among OPEC
   - Sharp drop in demand & shortage of storage capacity
   - Oil & commodity prices plunge

8. Property Price
   - Pressures on real estate markets with aggregate shock
   - Property price correction
What is the COVID-19 crisis?

- A pure health shock
- Exogenous to the economy and the financial system
- Containment measures are imposed
- Unprecedented repercussions for the global economy

→ Morphing from a health crisis to an economic crisis

**COVID-19 Pandemic**

- Global surge of confirmed cases and deaths
- Medical emergency
- Lockdowns, quarantines, and border controls
Macroeconomic Impact of COVID-19

- Supply-side disruption
- Demand-deficient economic contraction
  - Severe impact on firms in retail, leisure, hospitality, and travel sectors
  - Falling household income and rising unemployment
  - Broad-based reduction in private consumption and investment
- Potential output loss due to impaired human capital and reduced productivity

→ It is important to reflect the transmission of these effects in the baseline outlook and risk assessment.
Financial Market Volatility and Stress

- Sharp tightening of financial conditions at the onset of the COVID-19 crisis
  - Rising risk premia and falling asset prices with an increase in risk aversion
  - Market liquidity pressures and capital outflows from EMDEs

- Substantial easing of financial conditions in recent months with central bank support
  - Disconnect between asset prices and the economic performance

→ Useful to assess downside risk to economic growth with the growth-at-risk framework
Impact on Financial Institutions

- Credit events: bankruptcies and higher default on debt
- Low profitability: low for long, increase in provisioning
- Liquidity pressures
- Nonbank financial sector: sharp correction in asset prices and fire sales of assets

→ Forward-looking analysis of FIs’ solvency and liquidity (e.g. stress tests), considering “lower-for-longer” recession scenarios
Impact on Credit Intermediation

- Prior to the pandemic, corporates and households have become more leveraged on the back of low interest rates.

- Sharp tightening of financial conditions + income shocks
  - Credit demand: short-term ↑, medium-term ↓
  - Weakening debt-service capacity of firms and households

- Financial institutions (FIs) would take a significant hit
  - Credit supply ↓

→ Debt-at-risk analysis for corporates can give insight about their financial distress
Amplifications through Structural Macrofinancial Linkages

- Structural macrofinancial linkages:
  - Sovereign-financial nexus;
  - Reliance on external financing;
  - Dependence on commodity exports amid falling commodity prices; and
  - Exposure to real estate markets.

Financial System

Real Economy

Vicious Macrofinancial Feedback
(e.g., financial accelerator effects, wealth effects)

<table>
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<tr>
<th>Public Finance</th>
<th>External Position</th>
<th>Commodity Price</th>
<th>Property Price</th>
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<tr>
<td>• Increase in healthcare and social welfare expenditure&lt;br&gt;• Reduction in fiscal revenue&lt;br&gt;→ Fiscal deficits ↑</td>
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Macroeconomic and Financial Sector Policies So Far

COVID-19 Pandemic

- Increase in health-related spending
- Containment measures
  - Massive testing
  - Patient isolation and quarantine
  - Social distancing and lockdown
  - Border controls

Financial Market

- System-wide liquidity support
- FX interventions
- Bilateral swaps among central banks
- Temporary capital flow management measures

Financial Sector

- Term funding
- Macroprudential relaxation
- Regulatory and supervisory responses
- Resolution and recapitalization
- Contingency planning (e.g., business continuity)
- Credit guarantees

Demand

- Monetary and exchange rate policies
- Fiscal policy (e.g., tax deferral and relief, transfers, wage subsidies)

Supply

- Tax deferral and relief
- Subsidized and guaranteed credit
- Equity injection

Financial System

Real Economy

Vicious Macrofinancial Feedback

Monetary and macroprudential policy
Conclusions

- Policy priority: saving lives.
- Be careful: The reopening should proceed carefully.
  - Threat of second-round outbreaks remains a main risk
  - Approach: large-scale testing, case tracing, quarantines of infected and suspected cases, social distancing, and public participation
- Be supportive: Policy actions should be supportive to the most vulnerable businesses and households.
  - Macrofinancial policy measures should mitigate liquidity and solvency stress
  - Mitigate moral hazard with adequate safeguards
- Be ready: Policymakers should stand ready to do whatever it takes to safeguard macrofinancial stability in the post-pandemic era.
Disconnect between financial markets and the evolution of the real economy

Figure 1. Global Financial Conditions Indices
(Standard deviations from mean)


Figure 1. Quarterly World GDP
(2019:Q1 = 100)

Source: IMF staff estimates.