The corporate-sovereign-bank nexus and future policy space - article by Rolf Strauch

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“The corporate-sovereign-bank nexus and future policy space”

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While strong national and European policy responses have contained the economic impact of the pandemic, there are spillover risks from corporates to banks and to sovereigns. Any exit strategy must consider both corporate revenues and debt dynamics.

The pandemic severely affected the corporate sector; many firms saw their revenues collapse while they still needed to pay their bills. This caused severe liquidity shortages with risks of corporate insolvencies, voluntary closures and defaults. While precise estimates are difficult, economic studies suggest a large increase of bankruptcies due to the economic restrictions that were imposed to contain the pandemic.

In response to these challenges, governments supported firms’ liquidity through direct subsidies, tax deferrals, debt moratoria and state loan guarantees. Short-term work schemes enabled workers to keep their jobs while others were supported with unemployment benefits.

EU monetary and fiscal policies complemented these government actions. Together, they considerably reduced the depth of the recession: there has been a high uptake of credit lines by firms to continue operations, default rates have been limited so far and unemployment has been substantially contained.

However, these strong policy responses resulted in a growing corporate and bank dependence on public policy support. This interconnectedness will carry risks when the temporary policy support is phased out.

The pandemic has exhausted firms' own reserves and capital and the necessary bank lending has resulted in higher levels of indebtedness - backed by explicit and implicit state support. We will likely see corporate defaults and non-performing loans (NPLs) increase with more firms facing solvency problems when the budgetary and regulatory support is phased out.

While a certain increase seems unavoidable, the question is how high it will be and whether viable firms, that would survive without the temporary impact of the pandemic, will also face these challenges.

So far, the impact on banks has been limited. Banks entered the pandemic crisis with larger capital buffers than during the financial crisis, and they have also been in a better position to absorb NPLs. Moreover, prudential and monetary policy as well as budgetary measures facilitate the extension of credit to firms during the pandemic crisis. But the expected increase in NPL rates will likely take a toll on banks' profitability and their ability to lend. The challenge is to sustain and phase out support measures in a manner that minimises the impact on viable firms, bank balance sheets and their ability to lend.

These developments in the corporate and banking sectors are occurring against a backdrop of a significant increase in sovereign debt due to the large fiscal expansion. While the government guarantee schemes have not significantly affected fiscal balances so far, the impact will become more sizeable in the coming years as guarantees are called. This will reduce fiscal space, particularly for hard-hit, highly indebted countries. Going forward, this government support, including the guarantee schemes, will therefore have to become more targeted.

Besides the fiscal implications, there is the crucial challenge of ensuring that viable firms as well as new firms have access to additional, new financing as we emerge from the crisis. A comprehensive, gradual and well-sequenced promotion of post-pandemic bank and capital market financing is critical for a strong and sustained recovery. This includes the narrowing of public support schemes to viable firms, restoring transparency, removing forbearance in bank operations and accounting, and remedying any capital shortfalls that may have emerged.

This will not only help protect public finances from further - potentially unsustainable - pressure, but will also reinstate the right incentives in the corporate and financial sectors which are essential for private-sector-led growth. In this context, the progress being made towards banking and capital markets union is also very relevant, as this will encourage risk-sharing and financing flows throughout the euro area.

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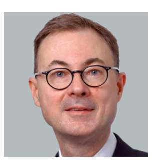

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