The coronavirus is set to sharply cut global growth and also risks sparking substantial levels of financial distress among both businesses and households, potentially cascading into the banking sector. The challenges this poses for policymakers is formidable.

Financial vulnerabilities were evident in the corporate sector in many economies even before the virus struck, with rising debt, declining credit quality and worsening liquidity positions. Consumer-facing sectors especially at risk from the impact of the virus tend to have weaker financial positions.

There are also household fragilities. A large fraction of households - often 40%-50% - have limited liquid assets to tide them over if they cannot work. Access to sickness and unemployment benefits varies widely across economies.

High levels of bad loans in some banking systems, most notably in Italy, could be exacerbated by the virus impact, threatening financial stability. High dollar debts in many economies outside the US are another risk factor.

As well as containing the virus, policymakers need to consider imaginative approaches to prevent financial distress worsening the economic downturn, potentially including a need to rapidly backstop banks, firms, and households.

The abrupt slowdown in growth resulting from the coronavirus outbreak risks sparking a sharp rise in loan delinquencies. But how bad will this be? The extent of loan defaults in downturns varies and may not just be a function of the depth of the downturn.
Corporate sector risks

Steep drops in output usually lead to rising corporate loan delinquencies and defaults, but the link isn’t completely predictable. In the last, very deep, recession, defaults in the US soared but those in the UK were contained. However, in the early 1990s recession UK defaults rose more sharply than in many other economies (Figure 1).

There are a number of reasons why defaults and delinquencies might rise more than expected as a result of the coronavirus-driven downturn:

- **Limited policy space.** With rates already so low, scope for policymakers to ease the debt burden on firms using rate cuts is much less than a decade ago.

- **High debt.** Corporate net debt/equity ratios are now above pre-crisis levels in most regions and interest coverage has dropped despite low rates.

- **Worsening credit quality in the corporate sector.** There are dangers from heavy issuance of low-grade bonds and leveraged loans and from a high and rising share of BBB-rated credit within investment grade credit (Figure 2). Large-scale downgrades of BBB-firms into ‘junk’ status could disrupt credit markets.

- **Weakening liquidity positions.** Liquidity positions of firms (e.g. the cash/debt ratio) have also been worsening. But the picture is even worse if we exclude a small group of cash rich (mostly tech) firms. Cash-to-debt ratios for investment grade firms in the US outside the top 1% are no better than in the pre-financial crisis period and for speculative grade firms are somewhat worse (Figure 3).

- **Sectoral impacts.** A number of sectors face particularly extreme challenges due to the coronavirus. Firms linked to ‘discretionary’ consumption, large chunks of which are being lost or postponed in the near-term, face massive revenue losses. Moreover, these consumer-facing sectors are often among the most financially vulnerable – with lower cash ratios and higher debt than average (Figure 4).

For these reasons, the coronavirus outbreak could reveal underlying financial fragilities and leave large numbers of firms facing serious cashflow problems as revenues slump and liquidity buffers rapidly dwindle.
Fragilities in the household sector

The coronavirus is leaving many workers unable to work due to illness, quarantines, and closures of schools and workplaces. Many workers will have very limited liquidity buffers to tide them over if they cannot earn. Across the OECD, around 40% of individuals typically have liquid assets insufficient to support themselves at the poverty line for three months. Unemployment and sickness benefits have a part to play in this situation, but access to these varies considerably across economies (Figure 5) and among individuals within given economies – coverage is often poor for the self-employed, particularly.

As a result, there is a risk of rising consumer loan defaults and delinquencies, adding to the likely rise in corporate loan distress. This in turn poses a potential risk to bank balance sheets. In general, banks are in better shape now than a decade ago, but there are some significant weak spots in the global banking sector, where bad loans were already high – such as Italy, India, and some other EMs (Figure 6). In these cases, a further rise in bad loans would risk economy-wide credit crunches and could threaten financial stability.

A final danger area relates to international dollar debt. In the 2007-2009 period, shortages of dollar liquidity were an important factor propagating the financial crisis. But dollar borrowing outside the US is actually much larger now than then (Figure 7). Dwindling dollar liquidity and negative balance sheet effects as currencies weaken against the dollar (especially in EMs) could add to the global default risk.

What should policymakers do? Policies to fight the medical impact of the virus may imply worsening short-term output losses and creating financial distress. There is a pressing need, recognised by governments, to backstop vulnerable firms, workers, and banks.

Some moves are underway, such as Italy’s suspension of mortgage payments, and offers of payment holidays by banks elsewhere. Schemes to provide cheap loans to affected firms also make sense but need to be well-targeted. For households, and as many governments are doing, it makes sense to loosen restrictions on unemployment and sickness benefits or allow firms to keep paying idled workers and reclaim the funds. The authorities need to be imaginative and accept that short-term costs may be very high. Critically, the speed with which funds reach those who need them is as important as the generosity.