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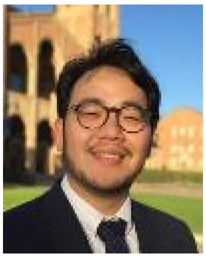
Is This Time Different?

The Coronavirus Crisis and Its Impacts on the Financial Market



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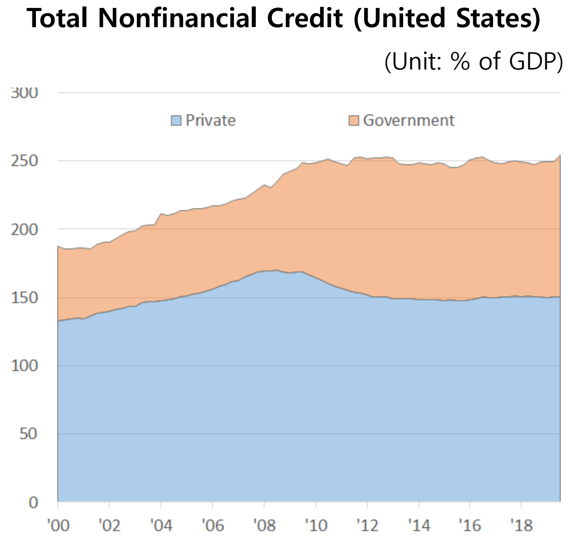
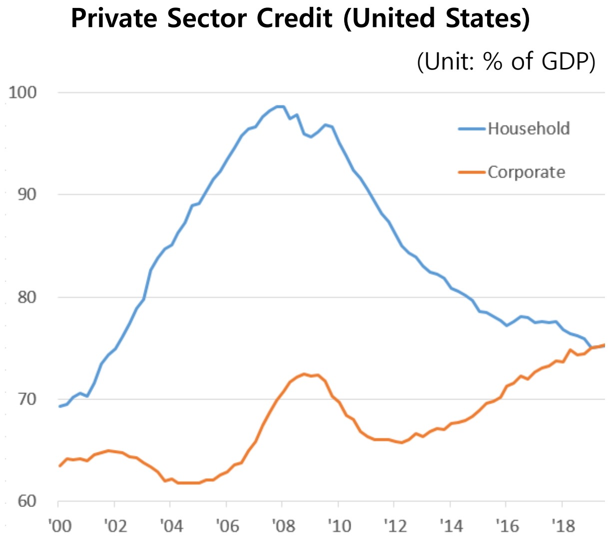
The coronavirus outbreak has rapidly spread out around the world. Since the first case reported in the United States on January 20, 2020, the United States has become one of the most severely infected countries by the virus with the numbers of confirmed cases and deaths reaching more than 360,000 and 10,000 in the first week of April 2020. These outreach the official numbers of confirmed and deaths in China, which are around 80,000 and 3,300, respectively.

It is the worst pandemic episode that is leading to a severe deterioration in the real economy, which we have not experienced for the last several decades. Also, we haven't encountered such a situation where real shock influences the financial market and could potentially lead to a financial crisis. The financial market is more volatile than ever before. The VIX volatility index reached 82.7 on March 16, 2020, exceeding the highest level (80.9) at the time of the global financial crisis.

Every financial crisis has two components: trigger and background. At this point, the trigger is obviously real demand and supply shock caused by the coronavirus. What is the background? Many experts point out the vulnerability of corporate bonds.

After the global financial crisis, total credit on the US economy has not changed that much, even though interest rates have remained at a low level for the decade. There are, however, dramatic changes in the composition of credit: household credit has decreased whereas corporate credit has increased (see figure below). One of the reasons behind this phenomenon is tight bank regulation adopted after the global financial crisis. Because of this bank regulation and surveillance system, bank loans, which are typically related to household credit, cannot be increased. Meanwhile, corporate bond issues have escalated in the low-interest rate environment.





Source: BIS.

The increase of global liquidity makes it easier for companies to issue bonds, which not only expands the level of bond issuance but also increases lower credit rate corporate bonds proportionally more. According to the Moody's credit rating, low-risk (Aaa, Aa, A) bonds issuance in 2019 has increased 115% compared to 2008, whereas medium-risk (BBB) and junk (Ba1 below) bonds have increased 335% and 211%, respectively. Besides, some US companies have increased treasury share through increased debt by issuing bonds. Moral hazard problems will arise if these movements bear relation to bailouts.

Corporate bondholders have been changed since the global financial crisis, which may amplify the financial vulnerability when the economic slowdown becomes visible, and the possibilities of default of firms and downgrading of issued bonds are realized. The share of insurance and pensions and investment banks has increased significantly, whereas that of banks has decreased (OECD, 2020). Insurance and pensions are known as long-term investors, but they have to liquidate high-risk corporate bonds to satisfy the risk-based capital requirements. Investment banks are sensitive to their returns and liquidate corporate bonds quickly as the liquidity of corporate bonds is relatively low.

The US government and monetary authority adopt several policy tools that prevent turmoil in the financial market that can potentially escalate into financial crisis, concerned that the feedback loop effect of the collapse of the financial market can lead to disastrous amplifications on the real economy. At this point, it is hard to predict whether those policy tools will be sufficient to prevent a financial crisis as we are still unclear about the magnitude and persistence of the shock yet. It is clear, however, that the burden and the subsequent side-effect on the financial sector will be aggravated if the pandemic is prolonged and requires more aggressive policy responses. It is no doubt that the most crucial thing for policymakers is to give first aid to keep the economy to survive, but they should also think of the economy after the disease is gone. KIEP