Overview

The COVID-19 pandemic is causing significant strains in the global financial system

The COVID-19 pandemic brought to an end an extended period of stable (but only moderate) growth, low inflation, and low financial market volatility. Prior to the pandemic, the prices of a broad range of risky assets had been at high levels, underpinned by low risk-free interest rates and low risk premiums that presumed very little possibility of adverse outcomes. The outbreak of the virus, which was not even a feature in the outlook at the start of the year, has changed this.

The exceptional measures taken to contain COVID-19 are having a major effect on economic activity and the global financial system. The high level of uncertainty surrounding the size and duration of the economic downturn is accentuated by the uncertainty around the effectiveness of the various measures in containing the spread of the virus. Financial market uncertainty is also elevated because of the difficulty of pricing risk given the correlated effect of the virus on a broad range of assets globally. This heightened uncertainty related to the pandemic is compounding the usual volatility in financial markets that occurs as economic and financial conditions turn down.

The various regulatory reforms since the 2008 financial crisis have increased the resilience of the global financial system, with banks having more capital and liquidity than previously. Banks also have less complex business structures. Even so, the COVID-19 pandemic is putting the spotlight on a number of pre-existing global financial vulnerabilities, including: areas of high leverage in some non-bank financial institutions; weak banking systems in Europe that are intertwined with high sovereign debt; high debt in some corporate and household sectors; and investment vehicles that offer a high level of liquidity, despite their underlying assets being illiquid. It is also noteworthy that the market for US Treasuries has been dislocated, partly due to leveraged accounts selling their most liquid assets in order to increase their cash holdings. Financial dislocation has also spread to emerging market economies, with a sharp reversal in capital flows.

Central banks have responded to the developments by rapidly easing monetary policy and implementing a range of policies designed to support the functioning of the financial system. But monetary policy cannot address the driver of the economic contraction. Rather it can only serve as a bridge, while substantial fiscal stimulus is being implemented to offset the economic contraction and, most importantly, authorities attempt to stop the spread of COVID-19 and respond to the health crisis. The economic policy actions seek to ensure businesses, households and financial institutions are well placed to resume activity when COVID-19 is contained.

Australia's financial system faces increased risks, but is well placed to manage them

The economic downturn resulting from the pandemic is changing some of the risks facing the Australian financial sector.

In Australia, the spread of COVID-19 has slightly trailed other advanced economies, but financial markets have moved with their global counterparts. The Australian government debt market has at times been severely dislocated, reflecting the same forces affecting US Treasuries. Equity prices have fallen sharply and corporate term debt markets have been significantly impaired.

With many staff working from home and from different locations, financial institutions face increased operational risks and may have less capacity to take on and manage market risk. It has changed the nature of some IT and cyber risks.

As discussed in previous *Financial Stability Reviews,* the level of household debt and elevated housing prices are longstanding risks for the Australian financial system. In the period ahead, many households will find their finances under strain due to efforts to contain the virus. Some of these households will be able to draw on significant financial buffers, including large mortgage prepayments, although many highly indebted households have only small buffers and so are more vulnerable to lost income. Repayment deferrals ('holidays') being offered by the banks and the Government's recently announced wage subsidy should both help avoid large increases in arrears. More generally, tightened lending standards over the past five years or so have improved the quality of outstanding household debt while Government income support policies and access to superannuation balances for the worst-affected households will cushion falls in household income.

Australian businesses generally have low levels of gearing and most have significant liquid assets which will help them to weather the economic contraction. Government and bank support will assist those businesses with sharp reductions in revenue, particularly those for whom income has completely dried up and small businesses with few assets that would otherwise be in a perilous position. Commercial property prices have risen faster than rents in recent years given the decline in risk-free interest rates. Owners who are more highly leveraged could struggle if tenants are unable to pay rent, particularly in retail property given the very weak retail sector.

The turnaround in housing markets in the second half of last year reduced the risk that falling housing prices would result in widespread negative equity and larger potential losses for lenders. Most households now have substantial equity in their homes. The economic downturn, uncertainty and social distancing are likely to result in very little turnover in the housing market. It remains unclear how this will affect residential property prices.

The Australian financial system enters this challenging period in a strong starting position. Capital levels are high and the banks' liquidity position has improved considerably over recent times. This strong liquidity position combined with slow credit growth means that banks have limited need to issue debt in the period immediately ahead. The Australian banks also enter the downturn with high profitability and very good asset performance.

The regulatory authorities have been working closely together to minimise the economic harm caused by the pandemic, to avoid the impairment of household and business balance sheets and to support financial market functioning. These measures, along with the strong starting position of the banking system, increase the financial system's ability to absorb, rather than amplify, the effects of the pandemic.

It is important that financial institutions remain strong so that they are able to support households and businesses during this difficult period and during the recovery once the health crisis has passed. ✠