B.2. Financial sector

The financial sector in many East Asia and Pacific (EAP) economies has been under considerable stress in the aftermath of the COVID-19 crisis. The global spread of the virus rattled financial markets around the world, reverberating through the developing EAP economies. This led to an abrupt tightening of the region’s financing conditions in March, with capital flying to safe heavens, equity prices declining, and interest rate spreads increasing (Figure B.2.1). Since then, unprecedented fiscal, monetary and financial policy actions in both advanced and emerging market economies, including in the EAP, have helped calm financial markets and partially bring capital back to the region. The main stock indices in EAP have rebounded but remain volatile. By July, equity prices in China had fully recovered earlier losses, but in other major economies, where losses were much larger, asset prices remain below their pre-pandemic levels, with Indonesia, Philippines, and Thailand still around 20 percent below their January levels.

Figure B.2.1. Financial markets have partially recovered but remain volatile

A. Dow Jones global index and U.S. CBOE VIX

B. Stock prices (index. January 2020 = 100. 3 month moving average)

C. Net non-resident purchases of stocks and bonds (cumulative)

D. Net non-resident purchases of stocks and bonds (cumulative)

\[\text{\smaller{\footnotesize\footnotesize\footnotesize\footnotesize This analysis was conducted to inform the October 2020 East Asia and Pacific Economic Update.}}\]
Source: Institute of International Finance; Haver Analytics; World Bank Global Economic Monitor.
Note: C-D. Developing EAP excl. China includes Indonesia, Malaysia, Philippines, Thailand, Vietnam. EM excl. EAP includes: Colombia, India, Korea, South Africa, Brazil, Taiwan, China, Turkey, Qatar, Sri Lanka, Pakistan, Saudia Arabia, Hungary, Mexico, Poland and Ukraine

**Initial conditions**

The EAP economies entered the crisis with relatively strong macroeconomic framework. Today most countries have greater exchange rate flexibility and more robust monetary, prudential, and fiscal policy frameworks than during past crises. Past reforms and macro policies have also increased the potential of the financial sector to absorb losses, although there are differences within and across countries. In many EAP economies, losses in the banking sector are low and financial institutions are well capitalized making the banking sector more resilient compared to past crises and to other emerging markets and developing economies (EMDEs) (Figure B.2.2). Some examples are Thailand, Philippines and Indonesia. Thailand’s tourism sector was severely affected by COVID-19 crisis, however its exposure to foreign exchange risk is limited given that most of the loans are expressed in local currency and government deficit and debt levels are moderate. Philippines and Indonesia also have deficit and debt under control as well as high levels of reserves in foreign currency which combined with mild contractions of real GDP along 2020 would mitigate the crisis. Nevertheless, at the same time, profitability and liquidity in the region remains below the levels found in other EMDEs.

Available data for 2020 suggests that non-performing loans and other measures of financial sector strength have deteriorated only marginally in recent months as countries deal with the COVID-19 shock. However, the losses may be larger, and it may take time to see the full picture. While many firms have been given moratoriums on their loan repayments, many central banks are not requiring financial institutions to regularly monitor these firms’ solvency. High levels of NPLs are problematic because they impair bank balance sheets, depress credit growth, and delay economic recovery (Aiyar et al., 2015; Kalemli-Ozcan et al., 2015); what is more, they
could affect countries’ policy space for post-crisis recovery. Vietnam, for example, it is likely to rise its NPLs levels mainly due to its weak fundamental and low capital adequacy.

**Figure B.2.2. Measures of financial sector strength are showing signs of detrioration.**

**A. Non-performing loans to total gross loans**

**B. Regulatory capital to risk-weighted assets**

**C. Return on assets**

**D. Liquid assets to total assets**

*Source: International Monetary Fund Financial Soundness Indicators*

*Note: Latest available data. For Panel B, patterned areas show estimates for NPLs based on equations developed by Jakubík and Reininger (2013) using a dynamic panel approach which incorporates macroeconomic fundamentals as determinants of NPLs.*
Monetary policy response

Governments have continued to support both the financial sector and the real sector through various policy measures. However, the policy space available for governments varies from country to country and the vulnerability of the financial sector depends on pre-crisis macroeconomic performance. In China, PBOC has announced massive liquidity injections besides reducing interest rates. In other EAP economies, the response has also been large, supporting the financial sector through monetary policy easing, liquidity injection and lowering reserve requirements (Table B.2.A1). Other measures to support businesses and provide guarantees have helped slow down non-performing loans and eased pressure from the banking sector (Figure B.2.3).

Figure B.2.3. Authorities in the EAP region have loosened monetary policy and implemented an array of measures to support the financial sector.

A. Monetary policy support measures

B. Financial sector support measures

Source. Haver Analytics; International Monetary Fund Policy Tracker; World bank staff elaboration

Notes. A. Red bars denote cumulative policy rate cuts since the outbreak. Green lines denote cumulative cuts in reserve requirement ratio. Orange diamonds denote recently announced central bank asset purchases expressed relative to respective 2019 nominal GDPs. Last observation is June 02, 2020. Right panel: Blue bars denote estimated direct fiscal support packages announced by fiscal authorities between late-January 2020 and late-May. Red bars denote other economic support packages announced by fiscal authorities since the outbreaks. Both are expressed as share of nominal GDP in 2019. B. Number of measures.
Risks to financial sector stability

The large-scale interventions in the financial sector could encourage risky lending, while the lingering macroeconomic shock puts upward pressure on losses to banks. The financial sector plays a critical role in mitigating this macroeconomic shock. But, as liquidity challenges give way to solvency problems, defaults on debt is expected to rise and the pressure on the banking system will grow. These problems can be compounded as relaxation of lending standards can encourage insolvent firms to continue to operate, masking the true extent of losses in the banking sector.

Figure B.2.4. Debt in EAP has been gradually increasing, driven by households and non-financial corporates

A. Drivers of debt in EAP

B. Total debt

C. Household Debt

D. Non-financial corporates debt

Source: Institute of International Finance.
Note: A. Data shown is for Q1 2020, with the exception of Vietnam that data availability ends in Q3 2019. EMDE countries included: Brazil, China, Colombia, Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico,
Poland, Russian Federation, South Africa, Thailand, Turkey, Argentina, Chile, Ghana, Hong Kong SAR, China, Israel, Kenya, Nigeria, Philippines United Arab Emirates, Singapore, Ukraine and Vietnam

In some countries, financial instability is likely to be amplified because of the rapid growth in private sector debt (Figure B.2.4). Dependence on domestic debt held by foreign investors, substantial debt denominated in foreign currencies, and the need to refinance debt in short time represent increase sources of vulnerability in several countries across the region (Figure B.2.5). Developing EAP economies are vulnerable in different ways, for example, through elevated domestic debt (China, Vietnam, Malaysia), private sector debt (China, Malaysia, Thailand), external debt (Lao PDR, Mongolia, Malaysia, Papua New Guinea, Cambodia); or heavy reliance on short-term debt (Malaysia and Thailand).

Figure B.2.5. Increased reliance on foreign investors, foreign denomination and short-term maturity of the debt could be sources of concern for some countries in the region

A. Foreign participation in local currency government bond markets

B. Non-financial corporate foreign currency denominated debt

C. Financial corporates foreign currency denominated debt

D. Debt service in the region
Increased reliance on foreign investors, foreign denomination and short-term maturity of the debt could be sources of additional vulnerabilities for some countries in the region (Table B.2.1). In credit markets, lending institutions relying more heavily on foreign deposits or foreign wholesale funding markets could face increasing funding pressures as a result of capital outflows from the region. At the same time, economies with higher exposure to US dollar funding tend to be more vulnerable to stress in the US dollar funding market. The revaluation of debt burdens causes higher default rates and a collapse in spending. These responses lead to a worse local recession, driven by a decline in local demand, and negative spillover effects on nearby borrowers without foreign currency debt (Verner and Gyöngyösi 2020).

This, in turn, can trigger nonresident investors to pull out their investments, raising concerns about financial stability in emerging market economies (Park, Rosenkranz, and Tayag 2020). In addition, EAP economies’ exposures to US dollar funding risks compound their external and financial vulnerabilities as a stronger US dollar increases the debt servicing costs of emerging market borrowers.
Table B.2.1. The region’s corporates have been prudent, but existing vulnerabilities coupled with the size of the shock are a cause for concern in some of the countries

<table>
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<th>2020Q1</th>
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<td></td>
<td>Corporate Debt At Risk (Altman-Z), % of Total</td>
<td>Corporate Debt At Risk (MDSCR), % of Total</td>
<td>FX non-financial corporation debt (%GDP)</td>
<td>FX financial corporation debt (%GDP)</td>
<td>Non-financial corporates debt maturing in 1 year or less</td>
<td>Non-financial corporates debt maturing in 2 years</td>
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<td>39.5</td>
<td>53.7</td>
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<td>-</td>
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<td>62.4</td>
<td>8.6</td>
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<tr>
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<td>-</td>
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<tr>
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<td>15.1</td>
<td>18.0</td>
<td>10.3</td>
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</tr>
<tr>
<td>Vietnam</td>
<td>28.3</td>
<td>46.9</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

*Source: Institute of International Finance; World Bank staff calculations*

*Notes: Gross external financing needs is defined as short-term debt, plus the amortization of medium and long-term debt, minus the current account balance. External debt data refers to 2018 for Lao PDR, Myanmar, Timor-Leste and Vietnam. Colors refer to comparisons with EMDEs:* | shows that country is in the bottom 25th percentile of the global distribution; | shows that country is between the 25th and 50th percentile; | shows that country is between the 50th and 75th percentile; | shows that country is between the 75th and 90th percentile; and | shows that country is in the upper 10th percentile of the world distribution.

There appears to be a disconnect between financial markets and economic prospects (IMF, 2020). As equity markets rally, rising debt levels combined with potential credit losses resulting from insolvencies could test banking sector resilience. Markets are betting that the support from central banks will lead to a quick recovery, but uncertainties are high. Some banks are already assessing how governments’ support for households and companies translates into borrowers repaying their loans. Some preliminary evidence suggests that expectations of further pressure on their profitability is reflected in the declining prices of their stocks. Financial stress indicators suggest that stress in the financial sector is elevated. At the same time, credit-to-GDP gap, defined as the difference in credit to GDP ratio and its long-term trend and a well-accepted warning indicator of banking sector distress, is positive in several EAP economies (Figure B.2.6).
Figure B.2.6 Financial sectors in EAP remain under elevated stress.

A. Household credit-to-GDP gap

B. Non-financial corporates credit-to-GDP gap

Sources: Institute of International Finance
Notes: Credit-to-GDP gap is defined as the difference in credit to GDP ratio and its long-term trend. EMDE countries included: Brazil, China, Colombia, Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russian Federation, South Africa, Thailand, Turkey, Argentina, Chile, Ghana, Hong Kong, SAR, China, Israel, Kenya, Nigeria, Philippines United Arab Emirates, Singapore and Ukraine

Nonbank financial companies could be an amplifier of stress in the financial sector and the real economy. While these entities now play a greater role in the financial system than before, their commitment to continuing to provide credit during a deep downturn is untested. A sharp correction in asset prices could lead to large outflows in investment funds (as seen early in the year), possibly triggering fire sales of assets (IMF, 2020). In addition, there’s evidence that corporate credit market has decoupled in many economies: bond issuance has boomed, but discretionary bank credit has stalled (Goel and Serena 2020). This leads to unequal access to credit between large firms and the rest.

Large firms use borrowing proceeds to meet short-term liquidity shortfalls and build precautionary buffers. Central banks expanded existing corporate bond purchase facilities or set up new ones (Cavallino and De Fiore, 2020). Some have purchased debt in both secondary and primary markets, and a few have included syndicated loans in their asset purchase programmes (e.g. the Federal Reserve). These facilities accommodated a surge in overall borrowing in global debt markets. Because monetary easing reaches bond markets directly whereas banks turn more cautious in an economic downturn, the increase in loan issuance is not likely to be matched by an increase in credit from banks. Large firms take the lion share of bond financing and there is evidence that the additional borrowing is used to build cash buffers (Goel}
and Serena 2020). Services firms, which operate in sectors most hit by the COVID-19 shock are small and not likely to participate in bond markets.

**Policy considerations**

**Countries need to strike the right balance between competing priorities in their response to the pandemic.** The financial sector plays a critical role in mitigating the macroeconomic shock. But governments need to be mindful of the trade-offs and implications of continuing to support the economy while preserving financial stability. The unprecedented use of unconventional tools has undoubtedly cushioned the pandemic’s blow to the region’s economies and lessened the immediate danger to their financial systems. However, policymakers need to be attentive to continued buildup of financial vulnerabilities in an environment of easy financial conditions.

**In particular, policy responses should be:** (i) be time-bound; (ii) have a clear exit strategy; (iii) targeted to ensure that only viable firms benefit as much as possible; and (iv) account for potential moral hazard in their design and implementation.

**Encourage restructuring of loans.** Supervisors should encourage banks to prudently restructure loans and maintain the flow of credit to the economy. But financial institutions should maintain transparency and provide, where necessary, additional guidance on risk disclosure. Experience with past crises shows that transparency is a precondition for maintaining trust in the system and for market discipline to work effectively, and thus limiting moral hazard. It is therefore key to disclose: (i) materiality of loan restructuring; (ii) the performance of the loan portfolio; (iii) any adjustments made to policies to assess borrowers’ creditworthiness; and (iv) the impact of these adjustments. When needed, supervisors should provide additional guidance to ensure that the policies used to deal with the crisis and their impact are disclosed.

**Use capital buffers.** Banks and other financial institutions should draw down on buffers to absorb losses arising from the pandemic and maintain key financial services to the real economy. Countries that have set the countercyclical capital buffer above zero should consider its release. Regulatory supervisors should suspend the automaticity of corrective supervisory action triggers to deal with the extraordinary circumstances of the current pandemic. In some countries, a fall in the capital adequacy ratios towards or below minimum requirements may automatically trigger the activation of corrective supervisory action. Authorities could temporarily suspend (to the extent legally permissible) the automatic activation of these triggers when banks are fundamentally sound and the decline in regulatory capital ratios is expected to be temporary. This should be reviewed on a case by case basis. In addition, a decline in capital ratios below minimum thresholds should be accompanied by a timely and credible capital restoration plan. Given the uncertainty and the impact of the crisis, capital restoration plans may have a longer time horizon than usual.
**Encourage the recapitalization of banks.** Supervisors should also ensure that banks temporarily limit capital distribution until the impact of the crisis becomes clear (e.g., dividend payouts, share buybacks, exceptional bonus payments) and that buffers are rebuilt over an appropriate timeframe. Banks must be well-capitalized to allocate credit efficiently and support the recovery (Acharya et al. 2020). Recapitalizations boost banks’ capital position and prevent them from gambling-for-resurrection, for example by shifting assets in their portfolios towards high risk investments and instead focusing on credit-worthy healthier borrowers.

**Ensure the securities clearing, settlement and payment systems, and assess financial market stability as digital payments rise.** Central banks and supervisory authorities should also monitor the functioning of retail payment systems to maintain confidence in the system given the system-wide impact of any failure. Weaknesses in these nodes and their interactions could tighten financial conditions and impact the provision of financial services, the execution and transmission of monetary policy, and potentially the stability of the financial system. The pandemic has decreased cash use and is likely to accelerate the move to digital banking. As private operators enter the markets, new risks arise. Several banks in the region are evaluating the feasibility of Central Bank Digital Currencies to be able to better adapt monetary policy to a world of digital payments.

**Purchasing of government bonds by central banks can facilitate debt accumulation by governments and endanger central bank credibility.** As some countries are expanding their set of tools to support the recovery, more government debt is being purchased by their central banks. Bank Indonesia, which already owns about 15 percent of tradable government bonds, may end up adding significantly to its holdings. Governments should make it clear that these measures are time bound and resist attempts to make it easier for governments to use central banks to finance their deficits. It can imperil the hard-won independence of monetary authorities that have struggled in the past to keep their distance from financing political cycles. Monetary indiscipline can lead to destabilizing runs on their currency. Meanwhile, interest rates are above 3 percentage points in about half of the developing East Asian economies, allowing central banks to ease monetary policy by conventional means.
References


Annex B.2. Monetary policy interventions

| Table B.2.A1: Select Monetary and Macro-Financial Policy Responses to COVID-19 |
|---|---|
| **Cambodia** | The National Bank of Cambodia improved liquidity in the banking system by delaying additional increases in the Capital Conservation Buffer, decreasing banks’ funding costs in local currency, encouraging banks to disburse loans, and (iv) lowering required reserves in local and foreign currencies for financial institutions. The Central Bank also provided guidelines to financial institutions on loan restructuring for borrowers experiencing financial difficulties (but still performing) in priority sectors. |
| **China** | The People’s Bank of China (PBC) increased liquidity into the banking system through open market operations, and an array of other measures including: lowering rates; cutting reserve requirements; and increasing liquidity and providing incentives to local banks to help small- and medium-sized enterprises. In addition, the government allowed delay of loan payments and eased loan size restrictions for online loans; increased the tolerance for higher NPLs and reduced NPL provision coverage requirements; supported bond issuance by financial institutions to finance SME lending, and increased fiscal support for credit guarantees. |
| **Indonesia** | Bank Indonesia (BI) lowered policy rates and reserve requirements, and implemented several measures to provide ample liquidity to the financial markets. A Presidential decree expanded BI’s authority by allowing BI to purchase government bonds in the primary market, and financing the deposit insurance agency (LPS) for bank solvency problems through repo transactions and purchases of government bonds owned by LPS. At the same time, BI is facilitating collaboration between the banking industry and Fintech companies, supporting digital payment in various sectors, and introducing Sharia-compliant instruments. |
| **Lao PDR** | Bank of Lao PDR (BOL) reduced the reserve requirements for both foreign exchange and local currency. BOL also cut its policy rates and made available LAK 200 billion through commercial banks for low interest rate loans to Small and Medium-sized enterprises. BOL intends to allocate additional LAK 1800 billion for low interest rate loans post-COVID as economic and business recovery strategy. To support businesses affected by the outbreak, a credit policy was implemented which grants regulatory forbearance on loan classification and provisioning to all those banks and financial institutions that implement debt restructuring and new loan provisions. |
Malaysia  Bank Nagara Malaysia (BNM) lowered the policy rates and the Statutory Reserve Requirement ratio (SRR). In addition, BNM increased its financing facilities and eased the regulatory and supervisory compliance on banks to help support loan deferment and restructuring, as well as announced measures to help business financing by both the private sector and public banks. The BNM announced a targeted loan payment moratorium extension and provision of repayment flexibility to borrowers affected by COVID-19. The beneficiaries are individuals who have lost their jobs in 2020 (extension of the loan moratorium for a further three months by their bank) and those whose salaries have been affected due to COVID-19 (reduction in loan instalment in proportion to their salary reduction). Banks have also committed to provide repayment flexibility to other individuals and all SME borrowers affected by COVID-19.

Mongolia  Bank of Mongolia (BOM) reduced the policy rate and the local currency reserve requirement of banks. It allowed existing consumption loan borrowers to defer their principal and interest payments by up to 12 months. The BOM and the Financial Regulatory Commission implemented temporary financial forbearance measures on prudential requirements, loan classifications, and restructuring standards.

Myanmar  The Central Bank of Myanmar (CBM) cut the policy interest rate halted deposit auctions to maintain adequate liquidity in the interbank market (deposit auctions are Open Market Operations that allow banks to adjust excess liquidity with the CBM using their excess reserves); temporary reduced banks’ reserve requirement ratio, revised the formula for calculating the liquidity ratio, increasing the weight of government treasury bonds with a remaining maturity of more than one year, and extended the deadline for compliance with four prudential regulations by three years to enable banks to support the economy cope with the impact of COVID-19.

Papua New Guinea  The Bank of Papua New Guinea (BPNG) reduced the main policy rate (Kina Facility Rate - KFR) and asked the commercial banks to reduce their respective Indicative Lending Rates. In addition, it reduced the Cash Reserve to provide additional liquidity to the commercial banks, announced a program to repurchase government securities in the secondary market to provide liquidity to the private sector, and increased the margin on central bank borrowing of both sides of KFR to encourage interbank activity. All financial institutions have agreed to provide relief of 3 months on loan repayments and interest payments to customers who have lost their jobs on a case-by-case basis. To cover for the 3-month loan repayment holiday for borrowers severely affected by the COVID crisis, BPNG suspended loan-loss provisioning for affected loans during this period.
Philippines  The Bangko Sentral ng Pilipinas (BSP) reduced its policy rate four times in and lowered the RRR for commercial banks. BSP purchased PHP 300 billion worth of government securities (about 1.5 percent of 2019 GDP) through a repurchase agreement with the government, made secondary market purchases of government securities, and remitted PHP 20 billion as dividend to the government. The BSP allowed a temporary relaxation of requirements on compliance reporting, penalties on required reserves, and single borrower limits, easier access to the BSP’s rediscounting facility, a temporary relaxation of provisioning requirements (subject to the BSP approval), and a relaxation of prudential regulations regarding marking-to-market of debt securities.

Thailand  In Thailand the policy rate was reduced as well as the contribution from financial institutions to the Financial Institutions Development Fund (FIDF). The Bank of Thailand (BOT) provided soft loans to financial institutions for on-lending to SMEs – the government covers the first 6 months of interest and guarantees up to 60-70 percent of these loans, relaxation of repayment conditions for businesses including a loan payment holiday of 6 months for SMEs, and suspension of principal and reduction of interest on the debts to supervised financial institutions. BOT also purchased government bonds in secondary markets to ensure the normal functioning of the government bond market.

Timor-Leste  The authorities extended micro-enterprises’ access to the Credit Guarantee System by increasing the type of economic activities eligible for the program, and introduced a moratorium on the fulfillment of capital and interest obligations arising from credit agreements, which delayed maturity by three months and reduced debtors’ interest payment obligation to 40% of the original amount with the remaining 60% financed by the government.

Vietnam  The State Bank of Vietnam (SBV) (i) cut its benchmark policy rates, issued guidelines to commercial banks to reschedule loans, reduce/exempt interest, and provide loan forbearance, and also asked Credit Institutions to not only channel credit to priority economic sectors, but also to accelerate consumer loans to meet legitimate demand of individuals and households. SPB provided concessional loans to affected eligible firms, with no interest for making salary payment to their workers who temporarily stopped working. SBV also instructed Credit Institutions (CIs) to reduce bonus and salaries, cut other operating costs, adjust business plans in a timely manner, and use the saved resources to reduce interest.

Source: International Monetary Fund,