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FINANCIAL STABILITY REPORT

1st SEMESTER 2021



FINANCIAL STABILITY COORDINATION COUNCIL

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FINANCIAL STABILITY COORDINATION COUNCIL

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LIST OF ACRONYMS, ABBREVIATIONS and SYMBOLS

ADB	-	Asian Development Bank
AEs	-	Advanced Economies
ASEAN	-	Association of Southeast Asian Nations
BSP	-	Bangko Sentral ng Pilipinas
BIS	-	Bank for International Settlements
CALABARZON	-	Cavite, Laguna, Batangas, Rizal, and Quezon
COVID-19	-	Coronavirus disease
CRE	-	Commercial real estate
DepEd	-	Department of Education
EMDEs	-	Emerging Market and Developing Economies
EO	-	Executive Order
FCY	-	Foreign currency
FSCC	-	Financial Stability Coordination Council
FSR	-	Financial Stability Report
FY	-	Fiscal year
GaR	-	Growth-at-Risk
GDP	-	Gross domestic product
GVC	-	Global value chains
ICR	-	Interest coverage ratio
ICT	-	Information Communication Technology
IMF	-	International Monetary Fund
IT	-	Information Technology
MaPST	-	Macroprudential Stress Test
NCR	-	National Capital Region
NFCs	-	Non-financial corporations
OSRM	-	Office of Systemic Risk Management
PCE	-	Personal Consumption Expenditure
PHP	-	Philippine Peso
PMI	-	Purchasing Manager's Index
POGO	-	Philippine Offshore Gaming Operators
PSA	-	Philippine Statistics Authority
RoRo	-	Risk-on-Risk-off
Sqm	-	Square meter
SRCM	-	Systemic Risk Crisis Management
UNCTAD	-	United Nations Conference on Trade and Development
UK	-	United Kingdom
US	-	United States
US Fed	-	United States Federal Reserve
WEO	-	World Economic Outlook
WHO	-	World Health Organization
YoY	-	Year-on-year
YTD	-	Year-to-date

MESSAGE FROM THE FSCC CHAIRMAN and BSP GOVERNOR

The economy is moving in the right direction. The financial market is liquid, and despite supply-side pressures, inflation is stable. Labor force participation is back to almost 65 percent, employment rate is at 92.3 percent, and the underemployment rate is down to 12.3 percent. The economy will revert to its growth path soon and the vaccine rollout is well underway.

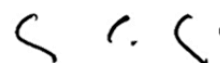
At the international level, there is convergence among financial stability authorities on what we have learned from this COVID-19-induced global recession and how managing systemic risks is central to our immediate and longer-term future. But there is also acceptance of the diversity across jurisdictions, suggesting that the transition to full recovery will have many elements that will be unique from one jurisdiction to another.

This is the key point that the Council has stressed from the onset: this is a once-in-a-lifetime crisis that requires innovative thinking to address the unprecedented market pressures, but we must still be fully mindful that helping out today cannot be at the expense of our collective future. COVID-19 then is as much about its disruptions as it is a story of our transition to the New Economy.

This FSR narrates parts of our transition. We look at the technical details of what and where are our pressure points. It is succinct but we do take a view on the current state of financial stability. We add granularity by discussing three specific industries which are central to the New Economy. We have been arguing that with the uncertainties created by COVID-19, it would be useful to paint what the future arrangements would be so that stakeholders can work backwards to identify what needs to be done today. Our discussion of the three industries manifests that thinking.

We complete this report by outlining how the Council will manage the financial stability agenda. We talk of what will be the focus of our surveillance and analytics, as well as the models that will be used in identifying possible pressure points. We end with a discussion of our messaging initiatives and our targeted stakeholders. This is our last mile because it is only by having a dialogue with stakeholders can we expect to influence individual risk behaviors that will redound to a more resilient system.

EO No. 144, recently signed by the President, puts all of the above in added context. The EO reflects the government's resolve to bring its weight on macroprudential policy and Financial Stability. The issuance of this EO is timely and strategic. While signs of stability are evident, market conditions remain fluid. The Council is then much more committed to enhancing the resilience of the financial system and we fully recognize the enormity of the continuing challenges.



BENJAMIN E. DIOKNO

FSCC Chairman and BSP Governor



Financial stability is the state when prospective systemic risks are mitigated so as to allow financial consumers, both individuals and corporate entities, to pursue viable economic goals while avoiding disruptions to the smooth functioning of the financial system that can negatively affect the rest of the economy.

– FSCC



EXECUTIVE SUMMARY AND FINANCIAL STABILITY ASSESSMENT

The rollout of vaccines has tempered the recent wave of COVID-19 surges. Although a new more contagious variant of COVID-19 is rampant, estimates from various institutions indicate a return to GDP growth. That the global economy will recover was never in doubt. What was at stake was the costs that will materialize during the transition and how far out into the future would it take before a state of normalcy becomes the norm.

A year into COVID-19, we know four things: (1) GDP will return to positive growth rates within 2021; (2) incomes will be permanently below its trajectory in the pre-COVID-19 period, with this permanent loss uneven across economic activities; (3) forecasts of the future are characterized by substantial uncertainty, and this caveat is causing risk aversion to remain noticeable in the domestic financial market despite considerable liquidity that has been released by the authorities; and (4) the recovery is happening at a different pace across jurisdictions which is causing spillovers that disfavor the EMDEs. The latter is evident in international financial prices which EMDEs cannot drive. Coupled with the loss in incomes, it is likely that some of the ensuing vulnerabilities have not been fully exposed. This supports the aversion of credit markets to take on new risks, and while this is rational for each market player, the resulting system-level outcome is prejudicial to the recovery into the New Economy.

This FSR reviews the broad effects of COVID-19 with a full year's worth of data already available. The story of divergence implies that current risks are nurturing a further round of risks, which need to be addressed before they become systemic. To provide some concrete discussions of what can be done, we highlight the stories of changed market environments in three specific economic activities. Each of these industries have their own unfolding story to tell but each one is intrinsic to the Philippine narrative: education provides the pipeline of talents, retail trade is key to a consumption-driven economy and the actions taken in commercial real estate provide a portal of the near-term future of the economy. The issue is not that there are disruptions in each of them. Rather, it is that specific action is needed to move forward because growth on its own does not resolve the underlying sources of the dislocations or how the scars of COVID-19 have likely changed their fundamentals.

Taken all together, a central theme of this FSR is that systematic risk has risen. This is the baseline risk in the market that can no longer be reduced further even with a fully diversified portfolio. If market players do not take this into consideration, we will be consigned to mispricing risks and/or providing solutions that kick the can down the road. This will spillover and develop into systemic risks, which are financial market disruptions that can adversely affect the rest of the economy.

We need to recognize and address these fundamental changes lest there be new systemic risks that arise. We then devote the last chapter of this FSR to talk about the FSCC story of acting early and deliberately.

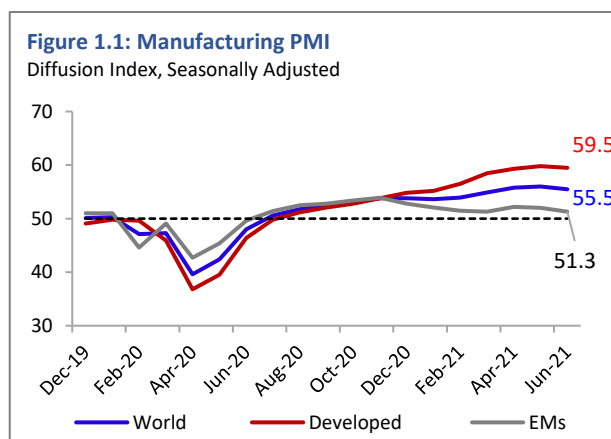


A STORY OF DIVERGENCE

One full year into the global recession, the economic damage from COVID-19 has been calculated. The structural changes that we mentioned in the previous FSR are now commonly referred to as “scars,” premised on uneven income loss and on heightened financial risks. As the rollout of the vaccines races against new variants of COVID-19, the divergent paths across borders and across economic activities within borders are laying the groundwork for second round systemic risks. As we argued previously, this sets us on a path, not as a “recovery” to the pre-COVID-19 world, but to market arrangements under the New Economy that are materially new. We look at these instances of divergence that matter for this New Economy as well as focus on issues for better management of systemic risks ahead.

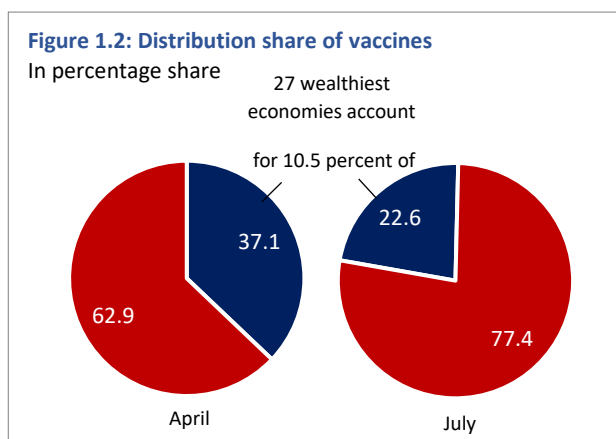
1.1. Divergence in the economic landscape

The most recent estimates from the IMF saw a sharper recovery in 2021 for AEs than for EMDEs. On average, EMDEs are still expected to post higher growth rates than AEs. However, it is the projected turnaround in 2021 for the AEs that is catching everyone’s attention. The April 2021 WEO estimated that the pandemic has caused a cumulative loss of over 20 percent for EMDEs (excluding China) while AEs have lost only 11 percent. This could provide EMDEs growth a “boost” via base effects, but there is evidence that the higher growth rates may not have much traction. For example, the Manufacturing PMI of Developed Markets continues to improve into 2021, bringing with it the estimates for the world economy (**Figure 1.1**). This is despite the fact that the PMI for the Emerging Markets is noticeably declining, although still above the critical 50-point threshold.



Source: IHS Markit

The vaccines are still key to the recovery. This is not particularly surprising. The WHO suggested that 65-70 percent of the population should be vaccinated to reach immunity (Burger and Kelland, 2020). Yet, meeting this immunity target is premised on a lot of ideal conditions, the most obvious of which is the supply of the vaccine. This supply had been tilted towards key markets (**Figure 1.2**), particularly those which are production hubs of the vaccines. This has since rebalanced further as the major economies had their populations vaccinated and more supply has been made available elsewhere.



Source: Bloomberg

For example, Moderna is made in the US, BioNTech-Pfizer has a supply chain that runs through the US and Belgium, while Oxford-AztraZeneca has production sites in the UK. In this sense, three of the most widely supplied vaccines throughout the world are produced in the US, UK, Belgium (and Germany, for Pfizer), whose combined population accounts for 6.31 percent of the world's population. Adding China into the mix, from where Sinovac and Sinopharm are produced, raises the tally to 24.30 percent of the world's population, but the point about supply remains evident.

EMDEs, on the other hand, face a different trajectory. Sentiments towards the EMDEs have not been as buoyant as their AEs counterparts. This is because they are coming from larger cumulative losses, but arguably a major concern is that they are more dependent on the global availability of vaccines before they can rollout in their home jurisdiction. In recent weeks, there has also been a resurgence of positive COVID-19 cases, made more complicated by virus variants that may be more resilient to the vaccines whose availability had not undergone the normal process and are on an emergency use basis.

1.1.1. Spillovers in the international economy

AEs and EMDEs face “divergent” paths, and this has consequences. Under more normal circumstances, improving conditions in the AEs would be taken as a “positive.” More cross-border activities would be expected, leading to higher growth. The challenge though is that the growth is, precisely, uneven throughout the world and, in the calculus of expected growth, it does matter with whom a jurisdiction transacts with.

In addition, the economies that regularly transact with AEs may not yet be in a position to re-ignite their economic engines, at least not in the context of pre-COVID-19 arrangements. While the pandemic affected every economy, the impact has been different across economies. For this reason alone, the path forward will mean a re-balancing of cross-border chains before we can reasonably expect growth acceleration.

Experts have also argued that this pandemic will surely invite a re-assessment of GVCs. By their nature, these GVCs create value, but their underlying supply chains are vulnerable to global risks (Seric et al. 2021). A surge in cases often leads to stricter border restrictions, labor and transport limitations, and weakened demand for non-essential goods. These

challenges, together with further technological changes, are likely to bring about a rethink of the GVC (UNCTAD, 2020).

Without a clear vision of what the post-COVID-19 world will be, it is difficult to fully anticipate these possible transformations. The thinking, however, is the move towards resiliency and not just efficiency. This may mean shortening supply chains and reducing dependencies on sole suppliers. Already, alternative arrangements are being considered (**Table 1.1**).

Table 1.1: Possible Trajectories for International Production

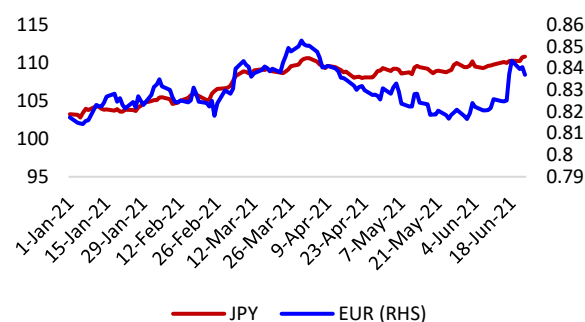
Trajectory	International Production Impact
1. Reshoring	Shorter, less fragmented value chains Rebundling of supply chain and production changes More concentrated value added Less offshoring, less outsourcing
2. Diversification	Continued fragmentation of supply chains Increased platform-based supply chain governance Increased offshoring and outsourcing of services More concentrated value added
3. Regionalization	Shorter physical supply chains, but not less fragmented More geographically distributed value added
4. Replication	Shorter, less fragmented value chains, rebundling of production stages Higher geographical distribution of activities, but more concentrated value added Increased outsourcing

Source: UNCTAD

Where there is more concrete manifestation of the divergence in financial markets. The USD, in particular, has been stronger in 2021 against other benchmark currencies (**Figure 1.3**) and the projected growth of the US economy for 2021 rival any traditional metric from EMDEs (**Table 1.2**). Although we discuss this more in the succeeding section, a portfolio rebalancing towards USD-denominated assets should not come as a surprise.

Figure 1.3: Euro and JPY FX rates

Currency to 1 USD



Source: Refinitiv

Table 1.2: IMF Growth Forecasts

In %

	October 2020		January 2021		April 2021	
	2021	2022	2021	2022	2021	2022
World	5.2	4.2	5.5	4.2	6.0	4.4
AEs	3.9	2.9	4.3	3.1	5.1	3.6
EMDEs	6.0	5.1	6.3	5.0	6.7	5.0
US	3.1	2.9	5.1	2.5	6.4	3.5

Source: IMF

1.1.2. Spillovers in the domestic economy

To state the obvious, mobility has been hampered. Google COVID-19 Community Mobility Report showed that the NCR had a reduction in the movement to workplaces by 48 percent, while movement to transit stations fell by 71 percent compared to the January-February 2020 baseline. Alongside this decreased mobility in public places is the increase in the movement to residential places of about 30 percent.

This simply reflects the community quarantine measures imposed on the NCR. Yet, this reduced mobility is not merely a physical restriction. The NCR accounts for 31.8 percent of the GDP and has 42.6 percent share in the Services Sector. This helps explain the sharp drop in GDP for the full year 2020. The same mobility problems also impacted economic activities in the nearby CALABARZON region, with the provinces of Cavite, Laguna and Rizal under stricter quarantine measures in March 2021. CALABARZON has a 24.5 percent share in the Industrial Sector where most of the workers are expected to work on site.

The already-vulnerable socio-economic sectors were the hardest hit. Employment prospects are slowly turning positive with the April 2021 Labor Force Survey reporting labor force participation rate increasing to 63.2 percent and employment rate increasing to 91.3 percent YoY. Despite labor market expansions in previous months, based on the reported estimates, slow recovery has been observed for those belonging in the structurally vulnerable labor sector composed of those working in the Services Sector, workers who are 15-34 years old, and workers who completed Junior High School. This was also reflected by the significant contractions observed in these sectors following the March-May 2021 lockdown.

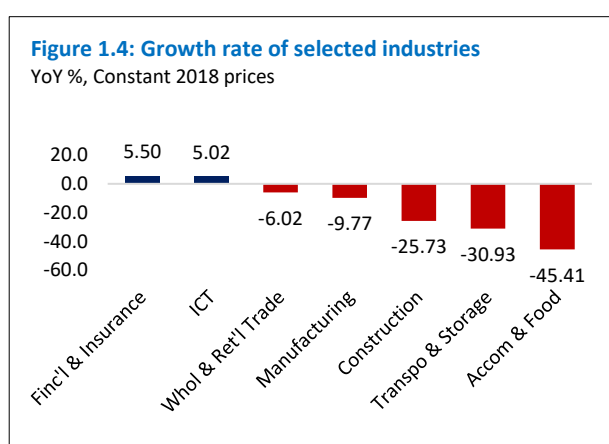
Job loss due to persistence of virus transmission and strict quarantine measures translates to an estimated 21 percent loss in income per capita (ADB estimates). Income loss has also been accompanied by the significant price increases since last year mainly driven by higher costs of production attributed to the African Swine Flu, increase in oil prices and supply-chain disruptions. Consequently, these weakened consumers' purchasing power especially for the already-vulnerable socio-economic pre-pandemic.

However, not all economic sectors experienced a contraction. Despite the significant losses across economic activities, two sectors stood out. Financial and Insurance Activities as well as ICT were the lone industries to see positive growth in 2020.

The resilience of the financial sector is evident from its 5.5 percent growth in 2020, one of only a handful of economic activities with growth in the year of a recession (**Figure 1.4**). This is notwithstanding heightened risk aversion,

reduced (often negative) operating income of its corporate borrowers, and the introduction of temporary-but-unconventional payment moratoriums. As is expected, banks prioritized liquidity over leverage, making their growth in a low interest rate environment more impressive (see **Section 1.2**).

The quarantine measures fueled the increased reliance on IT facilities under alternative work and schooling arrangements as well as the increase in online transactions. For the retail industry, this meant substituting brick and mortar stores in favor of online platforms. This increased online retail sales by 57 percent YoY in the first half of 2020 (see **Section 2.3**).



Source: PSA

These two industries contrast sharply with the others. The hardest hit was Transportation, followed by Storage and Accommodation, and then Service Activities. Social distancing guidelines, health protocols and reduced activity easily explain the drop in these sectors. The same explanations, though not necessarily in this order, can be made for the negative operating results in Manufacturing and in Retail Trade.

These have implications for the New Economy. This difference between Finance and Technology, on one hand, and the rest of the economic activities, on the other hand, is both stark and relevant for the path ahead. One can argue that the financial sector has held up because technology provided an alternative means of handling financial transactions. Technology not only will be a key element in the future but also bridges the physical space between transactors, the space that the COVID-19 virus has institutionalized. As discussed in Chapter 2, technology does help other industries such as education and retail trade, but these other industries are not yet fully fungible in technological terms. This flexibility to supply using technological platforms will be a key feature of the New Economy, which may pose a challenge to some other industries.

While the implications of this will be discussed further in Chapter 2, the different fortunes in the local market affect the financial landscape. We discuss this in the next section.

1.2. Divergence in the financial markets

1.2.1. Divergence in advanced and emerging economies

If there is a point that the COVID-19 pandemic has clearly established, it is how the global economy is intricately interconnected. While COVID-19 is a direct shock to the real economy, its impact on financial markets cannot be downplayed. In this context, the divergence that is being observed across

economies is also expected to be fully evident in financial markets, either through cross-border funds or through financial prices.

Versus year-end 2020, the USD has strengthened, the US long-term rates have risen, and the US economy is expected to grow at an EMDE-like pace of 6.5 percent this year. The world's biggest economy will always be in the narrative, and the numbers, thus far, strongly tilt the balance to its favor. The administration of US President Joe Biden has continued the release of “stimulus checks” but is also pushing for significant spending to boost the economy. The US Fed, for its part, has kept the Fed Funds Rate at between zero percent and 25 basis points, categorically stating that it intends to keep policy rates low until the inflation rate averages to two percent. However, the sharp rise in US inflation – previously argued by the US Fed as simply temporary – has now been formally acknowledged as more persistent than expected and has led to new signals of policy rate increases over the medium-term.

The immediate effects, though, are already evident. National government transfers to US households have seen PCE rise, a particularly notable development given the lockdown conditions in many states. It also bears

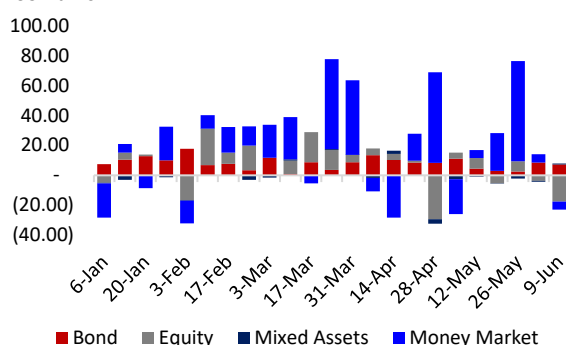
noting that the US Fed now projects US GDP to grow by 6.5 percent in 2021. This projection is significantly higher than the 4.2 percent estimate made in December 2020, further supporting the strengthening of the USD.

Rebalancing towards USD-denominated instruments and its policy dilemma. The elevated longer-term yields have been the subject of much discussion. This report does not offer a determination of the cause of the steepening US yield curve (which has more recently flattened), but we do point to its effect on EMDEs. Specifically, strong growth prospects, stronger USD and rising yields make the shift to USD-denominated assets a given. Portfolio flows, particularly in the US money markets, saw big jumps in March and April (**Figure 1.5**). In contrast, bonds flowed out of the ASEAN markets in March (**Figure 1.6**).

This puts EMDEs in a conundrum. Typically, GDP growth in EMDEs is higher than the US, creating the link between spot and forward rates. This is not the case today. With the damages caused by the pandemic, EMDEs may not be in a position to drive growth rates higher than the US in 2021. If capital

Figure 1.5: Flows to US funds by asset type

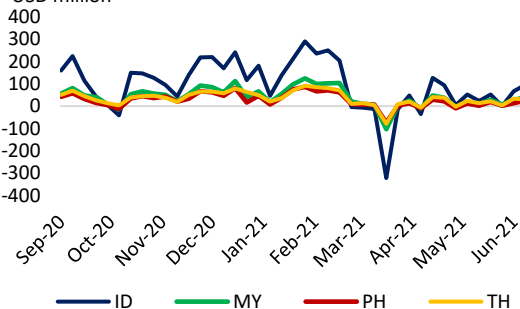
USD billion



Source: Refinitiv

Figure 1.6: Select ASEAN cross-border bond Flows

USD million

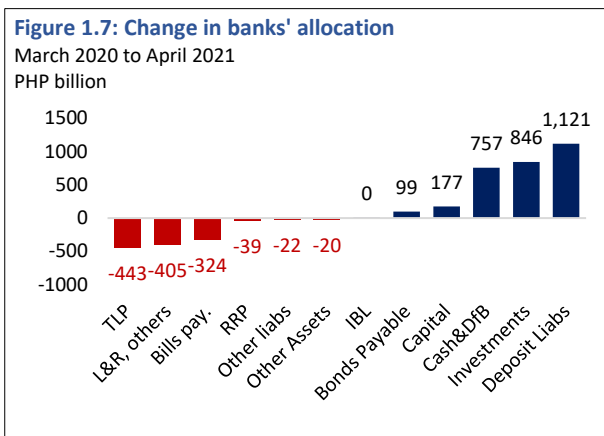


Source: EPFR

flowing out of EMDEs is an issue, this puts EMDEs in a difficult position to either raise onshore interest rates (which will make debt servicing even more expensive) or let their local currency revalue against the USD [making critical imports and repayment of FCY denominated debts more costly].

1.2.2. Divergence in the local markets

Banks remain risk averse. With the dislocations caused by the pandemic, one will expect risk aversion to rise, more so with lending institutions. However, there is a difference between not creating new loans (i.e., uncertainty over the prospects of borrowers) versus seeing the outstanding amount of loans decrease (i.e., a deleveraging). The latter has been the case with the overall loan portfolio declining point-to-point between March 2020 to the latest data (**Figure 1.7**). This decline in loans outstanding has occurred alongside a rise in investment holdings by banks, confirming the asset-liability rebalancing at a time of great uncertainty.

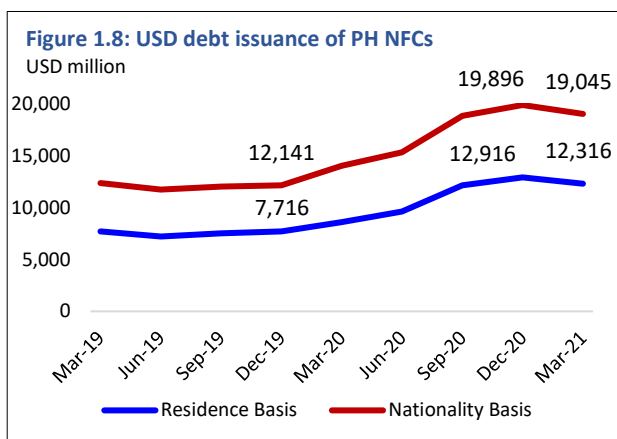


Source: BSP

On a per-industry basis, the largest YTD decline in loans outstanding is in Wholesale and Retail Trade, Repair of Motor Vehicles, Motorcycles, which contracted by PHP 60 billion from end-December 2020 to April 2021. Outstanding loans from Financial and Insurance Activities contracted as well, despite sustaining GDP growth in 2020. In contrast, outstanding loans of Professional, Scientific, and Technical Activities and the Information and Communication industry have increased YTD. Apart from these reductions, there is market talk that the demand for new loans has likewise decreased, reflecting the adverse effects of COVID-19 on potential borrowers.

Alternative sources of funding come at higher costs. The local securities market has served as a natural recourse for corporate entities, as evidenced by the steady increase in onshore issuances of NFCs and banks since 2017. The catch, however, is that risk premiums are rising in the corporate bond market. In particular, the gap between the coupon rates of similarly rated corporate issues and risk-free government bond yields has widened across time for a sample of 2Y and 5Y tenor bonds. This widening gap hints of pricing future risks, essentially translating to higher borrowing costs for firms.

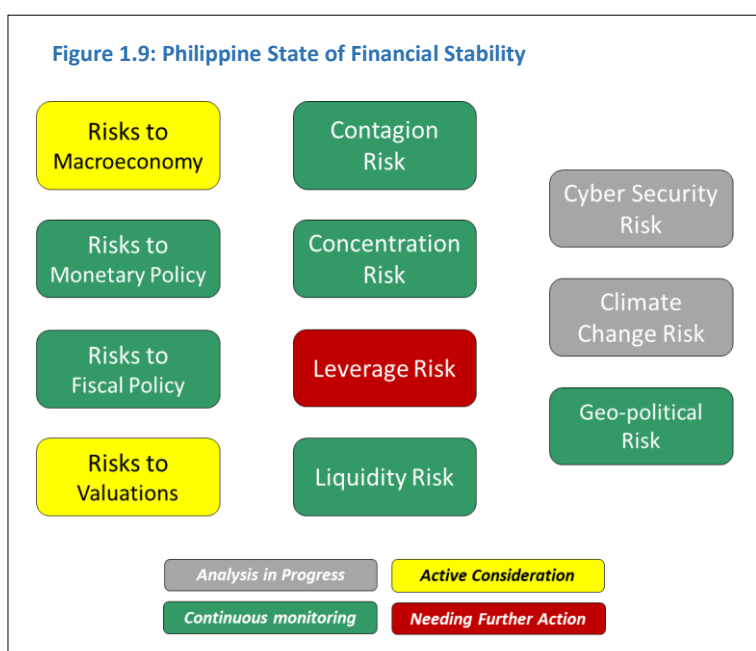
Some local firms are able to borrow abroad. The loan balances and the modest corporate bond market have not totally shut out borrowers from funding. Data from the BIS showed that Philippine private corporations have been borrowing offshore, a net increase of USD 731 million in 2020 (**Figure 1.8**).



Source: BIS

1.3. State of Financial Stability

As fluid as market conditions are, the Council has looked at 11 risks at this time. Based on various indicators, we have assessed the state of nine of these risks, while work is in progress on the remaining two risks. Schematically, this is presented in **Figure 1.9**. Debt servicing is the primary risk at this juncture, a combination of the incomes and business opportunities eroded by COVID-19 as well as the timing of debt repayment which was based on the pre-COVID-19 income projections. Growth will eventually be the norm which will alleviate the income compression, but the timing and terms of the debt repayment cannot be addressed by growth alone.



Source: Office of Systemic Risk Management, BSP

This growth must, however, be understood in light of the scars of COVID-19. Specifically, the growth over the medium term will arise from a lower income base and greater socio-economic differences. At the aggregate level, GDP may reach pre-COVID-19 levels as early as late 2022, but wider inequalities suggest that those who were vulnerable even before COVID-19 would now take much longer to recover. This is a slow-burn contagion that should be of concern.

In addition, it should be clear that getting back to pre-COVID-19 income levels is itself not the benchmark. This only brings us to where we were before the shock, but it does not make up what was lost because of such shock. Thus, the “full cycle” of recovery will take time, both because the effects of the pandemic-cum-recession are still unfolding and because more growth is needed to make up for what was lost.

The divergence between AEs and EMDEs also possesses a challenge to the macroeconomy and to valuations. As a small open economy, the Philippines is a price-taker in the global market and the current path of those global prices exerts added pressure on the Philippines and its recovery. If risk premiums rise, it makes it harder to stabilize from the disruptions of COVID-19. Debts will be more expensive to service (raising even further risks of default) and an abruptly weaker local currency makes the higher foreign currency exposures more costly to carry. All other risks are manageable at this juncture, but still require continuous monitoring and updating.



A STORY OF A CHANGED MARKET ENVIRONMENT

The uncertainty surrounding COVID-19 remains significant. If – as we have been arguing – risk behaviors have been changed in fundamental terms, forecasting the future will not be feasible. This is because the models that we have in place were all formulated based on the behaviors of the old normal. In order to reduce this uncertainty, our previous FSR suggested working backwards. This means setting the future market landscape and, from that, form a picture of what needs to be done today. We do that here for three specific market segments. Education is critical because it is the pipeline of future talents. Retail trade will necessarily mirror the prospects of our consumption-driven economy. Commercial real estate has the same feel for the future, but it also has important financial market angles to think about. All three are important in their own regard but they are commonly situated because the effect of COVID-19 is fairly similar across these three activities.

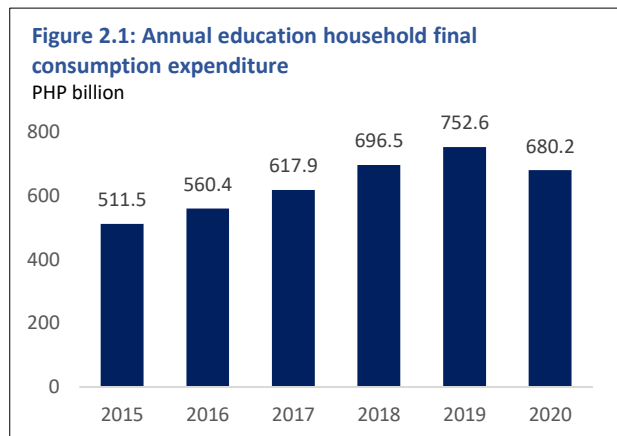
2.1. Education Sector

Labor is a key resource for the Philippine economy, both for onshore economic activities as well as in supplying the demands in offshore markets. The education system provides the pipeline for the needed skills, and the COVID-19 pandemic had a profound impact. The lockdown imposed to curtail the spread of the virus also closed schools, and while some have offered online classes, there were marked differences. It is not just the quality of future market entrants but also a socio-economic issue if the vulnerable sectors would not be at pace in the future, more digital, world of education. In addition, what industries will be viable in the future and their manpower requirements are issues that remain open for further discussion.

2.1.1. Where we are one year into COVID-19

Education expense and enrollment. COVID-19 had a profound impact on the education sector. At the aggregate level, household expenditure data showed that consumption for education in 2020 fell below 2018 levels (**Figure 2.1**). The drop itself is not a surprise considering the abrupt suspension of classes across all levels, but the magnitude of this decline does highlight the extent of the damage.

While several institutions resorted to delivering online classes, available micro data reflects a 53



Source: PSA

percent decline in enrollment reported in private schools.¹ Interestingly, the DepEd reported that there was no significant enrollment drop observed in public schools.²

These findings have deeper implications. If one assumes that students in private schools are from families with higher disposable incomes and wealth, then the drop in enrollment, both in absolute terms and relative to public school figures, seems to suggest that “time-off” can be made up by the stream of future incomes from employment. With public education largely subsidized by the government, steady enrollment is less surprising, but the efficacy of self-study learning through hardcopy modules is said to be a challenge. These two threads raise two issues: there may be an issue with the availability of manpower talents from the drop in private sector enrollment while the preparedness of graduates from the public school system may have added challenges from the lack of student-teacher learning interaction.

Alternative learning modes and its impact on schools. Responding to the immediate need to decongest schools, the government then implemented “learning delivery modalities” and “flexible learning” as alternatives to the traditional face-to-face instruction. This, however, presented at least three challenges. First, there are fields where the learning cannot be substituted by digital means. This covers a broad range from medicine to vocational courses, all of which require hands-on training.³

Second, several schools face the challenge of remaining viable under this new learning approach. Some of the established universities have very large physical footprint, designed to accommodate a rising student population. This may no longer be the business case. A 2020 study by the International Labor Organization showed that all the technical-vocational institutions they interviewed had to close down during the pandemic. While 99 percent were reported to have temporarily shutdown, around 34 percent mentioned the difficulty in continuing operations.⁴

Third, with the decline in education expenses and the physical closure of schools, it is not surprising that employment in schools has been affected. YoY April employment in the Philippine education sector declined 2.74 percent, as full-time employment fell by 79.1 percent. The PSA recently reported that the Education Sector had the largest decrease in employed persons from February to March 2021, with 274,000 workers taken out from the pool (PSA, 2021).

¹ The Coordinating Council of Private Education Associations said that only 2.0 million of the former 4.3 million students enrolled in private schools in 2020.

² The country’s Department of Education (DepEd) clarified that noted changes in enrollment figures in public schools could be attributed to geographical or physical migration of students, as well as movement from public to private school (DepEd, 2021).

³ Elsalem et al. (2020) also noted that remote electronic exams were more stressful for medical students as many of their assessments are practical in nature. This is also the case for vocational and practical arts-related schools, whose learning is based on a physical premise.

⁴ Others have resorted to delivering their courses online, but the practical portion of the training commencing when restrictions are loosened.

Ecosystem around schools. The negative effect on schools, although already significant, still underestimates the full dislocation. We cannot forget that institutions of learning are necessarily supported by a “community” around it. This includes food and beverage stalls, printing, binding, and computer shops. Restaurants, bookstores, room rentals, public transportation systems, as well as other recreational facilities are also adversely affected as they rely on the presence of students. This impact is nearly impossible to calculate but it is expected to be sizeable.

Institutions of learning are necessarily supported by a “community” around it (which) are also adversely affected.

2.1.2. Where are the systemic risks?

One can argue that if the dislocations above merely “suspend” economic activity in education and the sector can immediately revert to its pre-pandemic situation once the public health issue is reasonably handled, then these costs are painful but nonetheless more temporary in nature. Whatever systemic disruption there is would then be short-lived and could be recovered soon enough.

This does not seem to be a reasonable position. Two issues should be discussed.

First, the adjustments that students and schools had to make during the past year are likely to have longer-term consequences. The educational pipeline was effectively disrupted because (a) those who completed their education by end-2019 may not have good job prospects in 2020, (b) those who were supposed to finish in 2020 would now only have the chance to do so by late 2021 or by 2022, and (c) some students opted not to re-enroll prolonging their schooling timelines. From this perspective, there is at least a two-year delay in providing manpower to the market.

This supply-side adjustment needs to also consider that batch 2020 onwards will have to learn under a new regime where there is not much interaction between students and teachers, or between students and other students. Those batches which were trained with in-class experience and then completed with online subjects may feel the early brunt of the adjustment. Assuming that a new uniform approach to education is agreed upon by school year 2022, those graduating in 2026 will then be the first college batch to be completely under this uniform regime. All these would not be lost on the demand-side of the market who must not only absorb the graduates but may have to make their own adjustments to align with how goods and services will be produced and distributed in the future.

Second, the difficulty for producers in thinking about the future is that there is in fact still much uncertainty over it. There is a strong belief that COVID-19 has changed the landscape of the future market, and with it comes the changing viability of various economic activities. This presents a challenge to education because it is no longer clear what skillsets are needed and it is also not clear how the education system of the future can better match the talent demanded with the talent supplied.

It is not enough to point out that technology will increasingly define the future. For education, technology is the means to deliver the substance but how technology affects the substance of the learning is not evident. Courses such as economics, finance, business management, and accounting, for example, will benefit from more interactive visuals but the foundations of these fields (except for a discussion on technology itself), at first pass, would not seem to change much.

If these two points are a reasonable view, the broader economy may find a window of 2-5 years of disruptive effects from education. Labor supply may not be ready to meet the market needs, either because of the delayed availability of manpower or because efficiency has been modified by changing modes of teaching delivery. There are studies which suggest that COVID-19 has reduced a portion of one's lifetime learning. This is slightly different because we are looking at how the real economy would use labor that has gone through a different structure of academic training.

2.1.3. What do these mean for stakeholders?

The changes in the education sector, for the immediate term, will be profound. Adjustments are inevitable and given the structural changes that we are witnessing, it is now at an important fork in the road. We discuss below some salient points.

For education. There are studies on how COVID-19 has affected the sector. Our view is that it is too early to make a holistic determination. From our perspective, we must first see the first cohort of graduates who completed their college education under the “new arrangements” before an assessment is made. The point of comparison is between the face-to-face approach in the pre-COVID-19 years versus the blended onsite-offsite arrangements post-COVID-19. If these new arrangements can be agreed upon by the time of the incoming college freshmen of 2022, then the school year 2025-2026 would represent the first batch of graduates who completed their college studies under the new educational system.

Two issues come up. First, counting from end-2019, there is a cohort of graduates over a 7-year period who are directly affected by COVID-19. These include those who studied completely under the pre-COVID-19

structure but may now find the post-COVID-19 market requiring different skillsets or those who ended up completing their education with a mix of pre- and in-COVID-19 arrangements. The efficiency (in labor market terms) of this cohort is untested, both because the market that would absorb the manpower has changed and because the schooling of that manpower has been altered.

Second, the assumption that stakeholders would agree on the new educational structure by the next incoming college batch is not a foregone conclusion. It may not be because there are competing interests but rather because the dislocations from COVID-19 have put all education stakeholders vulnerable. If online classes are now a foundation of learning, how will we provide for gifted students whose families may not afford a laptop and continuing cost of connection through the internet? Is the internet sufficiently available and reasonably stable throughout the archipelago? Will a more digital world mean that what would have been the first two years of college will not be (significantly) compressed so that the focus is only on the major subjects? Are schools and educators prepared for this type of transition? If materials are available online, what distinguishes the learning from one school to another?

These are questions that can only be addressed in a dialogue, and every year that a framework has not been agreed upon effectively extends the term of the vulnerable cohort.

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For schools. As the vehicle for education, schools must enforce the new arrangements. Yet, this is not an easy transition. It will take time to execute and decisions are needed early.

The immediate task is deciding what to do with the physical footprint of the campus. This footprint was put in place to accommodate a large community of students who would physically be on campus. There is now an obvious conflict in the costly maintenance of such physical space if this would be replaced by cyberspace as the teaching norm. This decision though would require a clear consensus of the new educational system and this is central to the stakeholders' dialogue espoused above.

Technology-related upgrades will be necessary, even for schools which specialize in fields that are more aligned to physical training. This is the indispensable way forward, hastened by but not entirely because of COVID-19. In the private market, these upgrades will be amortized into the cost of

education. Nonetheless, for public schools, they may not readily afford to incorporate digital learning into their approach, both in terms of the typical market that they serve and the financial viability of the school itself. This viability is a systemic risk issue because it is a disruption to the economy through households and firms which expect to employ manpower.

The other strategic issue is the question of establishing a school's value proposition. If relevant teaching materials are available online, how does a school distinguish itself from another educational provider? If there will be no significant difference, will the distinction then simply be a segmentation by location? But technology-related expenses tend to be lumpy and the reasonableness of making such expenses has to be aligned with a specific market. Thus, what may be initially a branding concern will affect enrollment which then redounds to the viability of the school as a business going concern.

For educators. Educators are not passive players in this system and are being asked to make significant changes on their own. Preparing visual presentations and delivering multimedia lectures are a skill that does not always come easy for some educators whose fundamental task is to communicate and convey ideas.

This is no longer a question of knowing the subject matter but also being able to convey the messages through the medium of a slide show, sometimes conducting the classes from a remote location, and then testing knowledge retention through some technology-based method as well. Specific challenges will cover a wide range across the level of the education (elementary to post-graduate), across socio-economic factors (such as the distribution across income groups and across different locations), and across time (through the transition). Good mentors often add their personal experience or personal anecdotes when teaching but it is not clear if and how this can be done in this world of digitized learning.

For students. It would be an oversimplification to suggest that students have been affected by COVID-19 because it has extended the years for education, suspended completion dates and delayed the entry into the job market. The impact is just as pervasive on students and, arguably, with longer-term effects as well.

The unfolding situation puts a premium on the adaptability of students. There is an increased concern over mental health issues arising from the quarantines and the abrupt disruption in what is physically allowed. The shift to a blended form of learning then puts the onus on the student to learn the material in the absence of social interactions with classmates or in-class discussions with the teachers. This is disruptive to human well-being and it can have long-term implications on labor efficiency.

To be clear, the change is not about technology. Slideshows were used in tertiary and graduate courses even before the onset of COVID-19 and teaching materials (i.e., teacher’s notes, presentation slides, reference papers, previous editions of books, and even prior tests) could be downloaded off the web. These are the enhancements to the delivery of education.

What COVID-19 hastened – and likely changed more permanently – is the use of this technology for a larger reliance on self-study. Such self-study tends to be more targeted and more succinct because there is less opportunity to expound on the material in a face-to-face setting. Whether students are conscious of this new bar of learning is unclear. If we have to venture a guess, we take the view that the increased burdens on students are not clear to them as well, making it difficult for them to consciously adjust.

For the authorities. There is much work ahead for the authorities, not just to restart the educational system stalled by COVID-19 but more so to think about what the future holds. That there is a cohort of students who will be in transition is all but inevitable. This has an immediate impact on their readiness for the job market, which is a serious concern as it is. Yet, there is a much bigger longer-term issue because how we develop the skills of students as a preparation for the needs of the New Economy is also an issue. A blended approach may seem inevitable at this juncture but there are transition issues and sustainability concerns that need to be addressed. What is clear is that a common stance among stakeholders – school administrators, teachers, students, employers, and the authorities – is necessary, and absent this common stance, the costs of the transition will simply extend.

2.2. Retail Trade Sector

Consumption expenses of individuals make up roughly 75 percent of Philippine GDP. With the incomes suppressed by COVID-19, it is not a surprise that PCE declined by nearly 8 percent in 2020 vis-à-vis 2019. This contraction in PCE is mirrored by a related decline in both wholesale (YoY 10.1 percent) and retail trade (YoY 3.6 percent), factoring back into the economy which contracted by 9.5 percent in 2020.

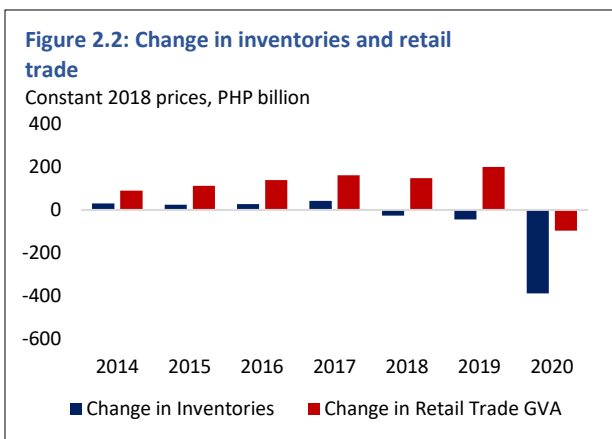
We then see the direct link from the public health crisis to disposable incomes, impairing private household expenditures (i.e., the demand side) and its related counterpart in trade (i.e., the supply side). However, the shock is not only in incomes. The distancing requirements and the lockdowns meant shifting the remaining activity through online channels. This is most obvious for the retail trade sector which must now find a way to continue to be in business while facing the prospect of reducing the in-store customer experience.

As the retail trade sector looks ahead, it has to recalibrate against consumer incomes that is at a lower base and with a greater dispersion across households i.e., the gap between the “haves” and “have nots” is likely to have worsened and will be so for some time. This wider dispersion though factors into the move towards online retail sales because this will not be the usual medium for many households and for certain products.

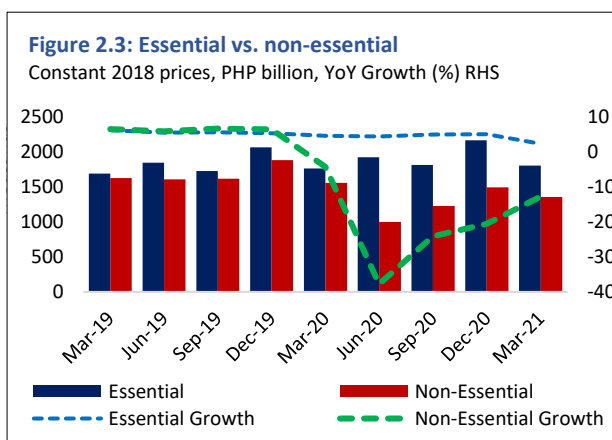
These premise the strategic decisions that retailers now face as they position for the post-COVID-19 world.

2.2.1. Where we are one year into COVID-19

The effect of COVID-19 on retail trade is clear cut since regular destinations such as malls and other leisure activities were cutoff to the public over extended periods. Even when these places were re-opened, there were still conscious efforts to keep the activity at below pre-COVID-19 levels.



Source: PSA



Source: PSA

From the official national statistics, the adverse effects are plainly visible. Household final expenditures fell by PHP 1.11 trillion (real terms) in 2020 versus 2019 levels. The income of retailers, in comparison, declined by PHP 96.45 billion on the same basis, which looks rather small for this PHP 2.7 trillion industry. This may reflect, however, how inventories cushioned the decline in income. This inventory is finite and income losses may still escalate once the inventories get depleted (Figure 2.2).

Behind the headline numbers though are the interesting micro patterns. Food and non-alcoholic beverages, health, and communication expenses all increased in Q1 2021 on a YoY basis. These are expenditures that are difficult to substitute and, as such, may be generally categorized as “essentials” (Figure 2.3).

In contrast, expenditures on restaurants and hotels, recreation and culture, transportation, clothing and footwear, as well as home furnishings are the five categories that have significantly declined. This reflects the lockdown itself, and these are expenses that families can postpone for a more opportune time. We loosely refer to these as “non-essentials.”

At least at the aggregate level, we can see a difference between essential and non-essential spending. Future data may provide better granularity, particularly on food expenditures, to give us a better view of the underlying spending patterns. For now, it sheds light on where there are vulnerabilities in retail trade (i.e., clothing and footwear, as well as home furnishings) and to household spending in general.

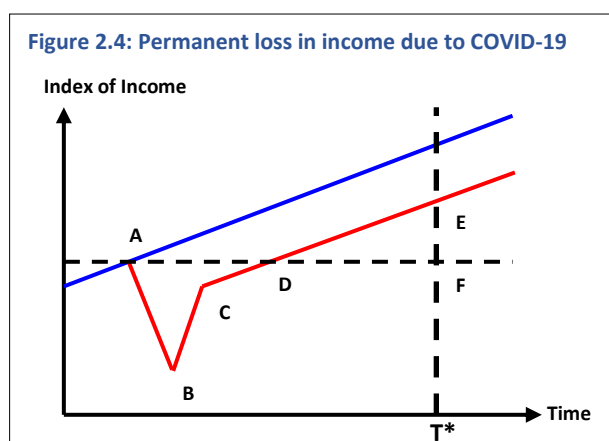
These aggregate data can also be appreciated vis-à-vis the developments in electronic payments. According to the 2020 Consumer Payment Attitudes survey of VISA, 52 percent of Filipinos used online platforms for the first time in doing their shopping activities in 2020 (Villanueva, 2021). In addition, fund transfer portals, InstaPay and PESONet, both report significant increases in the volume and value of transactions coursed through their systems. The conventional thinking then is that the in-store experience has been substituted by online purchases and the subsequent delivery via 3rd-party providers. We now see several establishments offering “personal shopper” services, and we see several established brands creating their “own store” via a much stronger presence on the web.

This rise in electronic payments may seem at odds with the challenging retail market in 2020. What it suggests, however, is that a sizeable proportion of transactions were previously paid for with cash and are now settled through electronic transfers and payments. Despite this substitution effect, the market suffered a contraction, nonetheless, because the income effect (demand side) and the suspension of business activity (supply side) combined had a far larger impact on the bottom line.

2.2.2. Where are the systemic risks?

This last point is the crux: if the negative impact of COVID-19 on incomes is transitory, then the adverse situation in the retail trade sector will be temporary. The economy picks up and retailers get back on track, likely armed with an enhanced tool of online facilities.

However, the most reasonable estimates thus far are that the incomes lost to COVID-19 are permanent. While we will eventually revert to positive growth, the trajectory of the underlying incomes is lower than what it was pre-COVID-19. This is the “lower income base” that comes out of the permanent loss in incomes, and we loosely recreate an IMF diagram in **Figure 2.4** to illustrate this point. The effect is that purchasing power is permanently lower relative to the pre-COVID-19 path and this directly affects the prospects of retail trade.



Source: IMF

In addition, the socio-economic divergence across income groups has likely worsened. The vulnerable sectors have been hit harder and this too will affect what can be bought and by whom. Visually, this can create a floor to retail spending. One can imagine that online purchases are a natural recourse for some income groups, others may prefer to take the in-store experience particularly for specific commodities, while the vulnerable groups would neither have the electronic card facilities nor have enough disposable incomes as they did before.

Both of these suggest that the retail trade sector may expect tempered activity, at least until we get back to end-2019 income levels. Some forecasts have put this threshold at 2022, suggesting three years of a transition. As new COVID-19 variants come out, this threshold may still be pushed back. It not only delays the point of the threshold, but it also extends the length of time “lost” to the ill-effects of COVID-19.

This last point is material. The challenge is that there are costs for remaining open throughout this transition. This will include the carrying cost of fixed assets, the costs of maintaining a workforce, the cost of shifting towards an online presence, and for those with debts, the cost of borrowed capital. As this transition is lengthened, then the carrying costs become more detrimental. Whether the retail trade sector has enough buffers to keep it afloat for this variable-length transition is ultimately the systemic risk at hand.

2.2.3. What do these mean for stakeholders?

Simply put, retail trade is reliant on the availability and the distribution of disposable incomes, both of which have been adversely affected by COVID-19. The catch-22 is that retail activity and the overall GDP feed off each other, creating a reinforcing loop that can build up gains or nurture losses. The conservative thinking is that it would take time to “neutralize” these adverse effects, which we use here in its narrow sense of getting back to end-2019 incomes at the aggregate level. This changes the retail trade market.

For the informal market. Limited timely data makes formal analysis difficult for this segment. One can only guess that the negative income effect would likely be strong. This is because this segment is more vulnerable to income shocks and they rely on other retailers (rather than wholesalers) for their supply of goods to be sold. This vulnerability comes with the silver lining that these retailers may not be as exposed to carrying costs. This may not be a material advantage if the income effect induces a forced shutdown, nonetheless.

For the formal market. In this segment, top-tier name brand items are less likely to be affected by negative income effects and can benefit from the substitution effect from cash to electronic payments. Retailers are then

more likely to sustain their online presence, but cash management, logistics and delivery services will have to level up as a consequence. These are not trivial transitions and the on-the-ground experience thus far is that timely delivery services, in particular, is a recurring challenge. The in-store experience would be for items that require more of a “look and feel” (i.e., clothing and footwear), but these too are items that are susceptible to adjustments for health-related concerns.

For the middle-market. Since this portion of the market depends on turnover and volumes, the challenge is that it may take a while for the public to get fully comfortable with crowded stores. There is admittedly a “cabin fever” aspect to the lockdown, and revenge spending is a distinct possibility. Yet, if turnover does not get back to where they were prior to the crisis, the carrying cost of the store footprint will increasingly be the marginal factor. Several boutique stores have already closed, and the pressure may be most telling for shopping malls.

A brewing in-between market. This is largely marginal but with the quarantine measures, there has been a noticeable increase in intra-community activity. This covers a very wide range of consumables as well as facilitation for other services. Transactions that were done previously in the formal market – and thus, visible in GDP terms – are now undertaken in a differently-defined informal market. These are not expected to materially bias the formal statistics, but they can influence behaviors moving forward, depending on whether inter-personal relationships can sustain these intra-community activities.

For the authorities. The re-boot of activity in the retail trade sector will be more than just opening up the economy. This is where the scars of COVID-19 matter. The authorities need to assess the impact of the income erosion and the distribution of such erosion across income groups to get a better sense of the emerging demand. Concerns over the spread of an invisible and mutating virus may also limit physical presence even for the vaccinated.

To the extent that behaviors have changed between “essentials” versus “non-essentials” as well as “in store” versus “online,” the adjustments in the New Economy will come more from how purchasing power is deployed, rather than how goods are supplied. There may be a strong upside to organizing the availability of essential commodities. This is a logistics problem that can be addressed as a collective issue. Even for commodities that may be beyond essentials, a broad review of distribution channels – from supply chains to store presence to end-user delivery services – can add value because it is in the interest of our recovery that retail trade is not hampered.



The re-boot of the retail trade sector will be more than just opening up the economy. This is where the scars of COVID-19 matter.



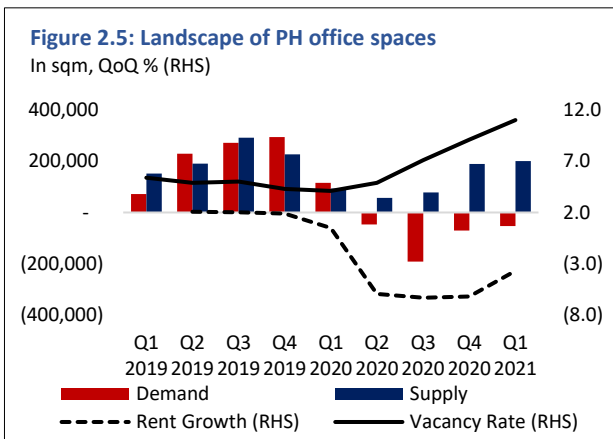
2.3. Commercial Real Estate Sector

Just as the impact of COVID-19 has been evident in education and in retail trade, so has it been for CRE. The community quarantine suspended business operations and put in place alternative working arrangements. Vacancy rates rose and the emerging “excess supply” brought down real estate prices. With real estate generally exposed to debt financing and/or used as the underlying collateral, the fortunes of this market will generally attract keen attention for any sign of systemic risks.

Moving forward, the prospects of CRE is linked to the economic recovery. Yet, there is more behind this than just derived demand. There may also be a need to retrofit existing spaces and improve ventilation, if the physical distancing and health protocols are to remain in effect. This may be an adjustment that may not be practical for older buildings. Also, it could be a consideration for the developments that are already in the pipeline but whose completion have been put on hold because of the unfolding crisis.

2.3.1. Where we are one year into COVID-19

Public health restrictions led to a rise in commercial vacancies. Rentals for office space were significantly affected by the suspension of business activity, inducing pre-terminations in leases. Data from Colliers International showed that average office rents dropped by 17 percent in 2020, from PHP 1,029 per sqm in Q1 2020 to PHP 851 per sqm in Q4 2020. With the reduction in demand and a seemingly high level of supply, landlords became more flexible in accommodating tenants' requests to lower lease rates, longer rent-free periods, fit-out allowances, delayed or waived escalation of rents, and other incentives to secure occupancy of their buildings.



Source: Colliers

This has been magnified by the introduction of remote work and telecommuting arrangements, further reducing the demand for physical space. Vacancy rates for office spaces have increased from 4.1 percent in Q1 2020 to 9.1 percent in Q4 2020 (Figure 2.5), with Colliers International projecting a further increase to 12.5 percent increase in vacancies for FY 2021. Nonetheless, there is a growing view from executives that these

work-from-home arrangements may still turn out to be more transitory since the lack of physical interaction appears to adversely affect productivity and team morale.

Vacancy rates have risen and burdened lessors with rising maintenance costs. Commercial rental prices have dropped by 6.2 percent as of Q4 2020, accounting for an overall 17 percent decline in FY 2020. Rent prices are expected to fall further by 15 percent in FY 2021, as the Philippines continues to grapple with the adverse impact of the pandemic-induced crisis. However, this does not mean that the only cost to lessors and landlords has been foregone income. Ironically, the maintenance costs for the upkeep of unoccupied spaces has risen as well (Sarino-Joson, 2020).

Also contributing is the exodus of foreign workers in the POGO industry. POGOs had been an active element of CRE demand over the recent years. However, they vacated a total of 314,000 square meters of office space as of Q4 2020, compared to 154,000 square meters in Q3 2020 (Colliers International, 2020). As POGOs tend to concentrate in certain locations, the impact of the vacated space is geographically amplified rather than broadly dispersed. This exacerbates the reduced prospects for CRE in the short-term.

COVID-19 has also caused massive delays and deferrals of construction projects. The construction industry was hard hit by COVID-19 and, as a result, there was a notable reduction in the supply of new office space in 2020. Completion of around 189,200 sqm was recorded in Q4 2020 versus the 294,400 sqm completed in Q4 2019.⁵ Moreover, a 70 percent reduction in the supply of residential space was posted, with 3,370 units completed in 2020 versus the 11,223 units recorded in 2019.

None of these are surprising data. Drawing from their experience during the regional (1997) and global (2007) crises, private developers suspended ongoing projects and avoided starting new projects. This “helps” manage the looming “excess supply” but it also has its consequences. Constrained operations today will create a domino effect, with all other developments pushed back. This can have financial implications, both on the borrower (the developer) as well as the lender (the banks). In transition, employment levels in the construction industry, particularly for casual and project-based workers, are adversely affected. These may be partly offset by the public sector, as the government pursues its sizable infrastructure spending program.

2.3.2. Where are the systemic risks?

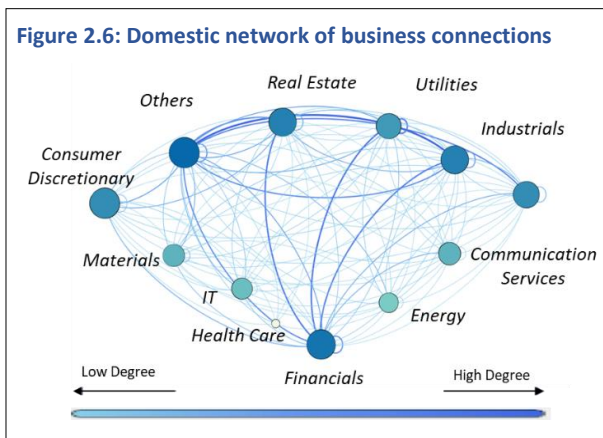
The real estate sector is key to the economy. In the national accounts, real estate (including ownership of dwellings) accounts for only six percent of GDP. Some may be surprised then why a relatively small part of the

⁵ Data from Colliers International, Q4 2020 full report

economy is often highly scrutinized by sovereign analysts and by the authorities. The simple answer is that real estate is seen as a barometer of the rest of the economy. When the economy is perceived to be doing well, demand for real estate – both residential and commercial – are expected to pick up. Yet by its nature, difficult times get mirrored quickly into the real estate market, and the effects can linger for some time. Two aspects summarize the key concerns.

Real estate (is) a relatively small part of the economy and yet often highly scrutinized by sovereign analysts and by the authorities.

The construction side is about time and getting different components in place. Much as we all want to avail of “just-in-time” production, this is not applicable to real estate. Homes, offices, and communities take time to build and require different elements to complete. Supply that is made available today is based on economic decisions by developers in the past and, as will be discussed below, based on a reading of future cash flows. Just as it is a barometer of confidence, these decisions are prone to time inconsistency problems in the sense that something unexpected can make a previously sound judgement suddenly look less viable.



Source: S&P Capital IQ, OSRM Calculation

It also requires different inputs from different related industries. Here, it should not be surprising to find that network analysis confirms that real estate in general is highly connected with other business activities (**Figure 2.6**). Under normal market conditions, these linkages are symbiotic. Once markets are distressed, they also provide the channels through which risks can be transmitted. Since there is an element of time involved, the transmission can also take several periods, creating a path-dependent shock across different market agents across several periods.

The financial side involves debt financing with paybacks well into the future. Financing is the other element that is intrinsic to real estate. Developers will need funding to complete their projects, whose repayment will depend on the cash flows from either earlier developments and/or the expected future cash flows from the object of the financing. The ICR is often followed by analysts for this purpose but as we show in **Table 2.1**, the ICR of real estate developers tends to be higher than other industries during normal times but fell drastically in 2020. This shows the variability of EBIT for this industry relative to others.

Users of the developments will also need financing (specially for mortgages) or depend on internal cash flows (for those who lease CRE). Again, with the element of time involved, changes that we have not anticipated or have simply underappreciated can alter the math behind debt servicing sustainability. This is a much harder aspect of risk for the authorities to monitor given the private data that this depends upon.

2.3.3. What do these mean for stakeholders?

The element of time is inherent to the real estate sector, arguably not just to CRE. Developers need time to build, the sequence and extent of which is dependent on the cash flows they expect to recoup from future economic activity.

Despite the deep scars created by COVID-19, the economy will recover and there will be renewed demand for CRE. That is not in dispute. The more relevant questions are “when” and “under what conditions.”

The former is more than a timeline. It sets a balance between the realized costs incurred by suspending CRE activities versus the potential costs of taking a view despite the uncertainties of tomorrow. The latter puts this balance in greater perspective because what will be required of CRE in the future – both technical and financial issues – have likely been modified by COVID-19. Stakeholders must then make a bet about the market arrangements in the New Economy, and this bet will dictate their behaviors today.

For creditors. Credit underwriting traditionally reviews the history of a potential borrower and its business prospects. Both elements will be difficult to read because of the impact of COVID-19. Pricing the uncertainties into the debt contracts may seem to be the prudent move, but this will also raise the cost of borrowing. This will raise the bar below which many activities may not be financially viable.

Credit risks fully borne by borrowers (only) may then result into less credit transactions consummated and/or more moral hazard/adverse selection problems in credit underwriting. This may not be the solution that we seek moving forward. Some form of risk-sharing may instead be needed, principally because systematic risk – the risk of the overall market that cannot be diversified – has essentially risen.

Debtors, creditors and the authorities should accept that there is more risk that is inherent in doing business over the immediate horizon, and not just more risks. Without this recognition, segments of the market can be rationed out rather than rebalance credit throughout the market. This can

Table 2.1: Sectoral ICR

Sector	2017	2018	2019	2020
Industrials	1.20	0.80	0.46	-0.70
Energy	0.63	0.29	1.06	0.68
Real Estate	2.09	1.07	1.33	0.89
Consumer Discretionary	1.48	1.14	0.54	0.93
Utilities	1.60	1.52	1.31	1.56
Information Technology	0.79	-0.37	-0.12	1.75
Materials	2.90	1.37	0.53	2.13
Communication Services	2.86	2.53	3.04	2.76
Consumer Staples	3.38	3.20	3.19	2.94

Source: S&P Capital IQ, OSRM Calculation

delay recovery or erode opportunities. Further regulatory relief eases some pressure today, but it does not recognize the rise in systematic risk. This misrepresents risks which can lead to rounds of systemic risks if left unmanaged. Out-of-the-box solutions are necessary and that requires a dialogue with all stakeholders.

For developers. Experienced developers know that this crisis will eventually normalize, and demand for CRE will recover. The new variable is how the health protocols – space, meeting collaboration, new ICT demands, and the reflow of enclosed ventilation – will affect the design of future CRE and require current ones to be retrofitted. The expectation is that the industry has agreed on these construction and engineering standards by now. It will thus be an issue of execution, one of finance (incremental expenses) and of viability (what can and cannot be adjusted versus the costs involved).

Experienced developers also know that this crisis is unlike previous ones. This is unlike the Asian Financial Crisis where the supply of new developments got ahead of demand, or that the financing of these developments relied heavily on the assumption of a stable exchange rate. COVID-19 is a disruption to the economy, and not of reckless borrowing or necessarily of “irrational exuberance.” That said, COVID-19 does affect the capacity of firms and industries to demand CRE and to service their lease.

Developers must decide on their pending/delayed developments in the context of the above. The delays would adversely affect cash flow projections and not taking any further action will formalize sunk costs. Added financing seems unavoidable. What the new terms may be in this emerging credit market will depend on the stakeholders’ dialogue we suggest above. But whatever that may be, developers need to be conscious that their product requires changes (engineering and construction) and needs to be repositioned in the New Economy (not all current activities may be viable moving forward, thus affect demand).

For users. The flipside of all of the above are the users of the CRE. Risk aversion has led to loans outstanding falling and it is thus not obvious that firms can access new debts to acquire or lease a CRE. It is also not obvious how each industry will be repositioned in the post-COVID-19 economy, and thus who will demand CRE is also in question. But just as developers need to make a bet on the future, users of CRE cannot afford to stay in the sideline as well. Some of these bets may not pan out.

For authorities. Already conscious of the wide ramifications of dislocations in the real estate market, the authorities must now prepare for higher levels of systematic risk which could translate into systemic risks. The credit market has been disrupted by COVID-19 and new arrangements are needed to transition the existing cohort of borrowers into the new market of higher systematic risks, as well as to induce new credit demand that translate into incremental (GDP) output, coursed in part through CRE activity. In this

context, labelling the interventions as “out of the box” may not fully represent situation if the risk intrinsic to the whole-of-market has risen, and done so more permanently.



A STORY OF ACTING EARLY AND DELIBERATELY

COVID-19 is a costly reminder of the consequences of systemic risks. While we continue to focus on healing from the dislocations, we recognize that there will be other such systemic risks ahead. To be effective in identifying vulnerabilities before they become actual disruptions, surveillance is key. But focus is essential, and this leads us to back to what we refer to as CL2 risks. Parallel to this, conducting macroprudential stress tests is important. We describe here how we have proceeded on this initiative, how our tests are the same and different from other tests. Finally, communication has always been a major initiative but there is so much nuance in conveying systemic risk that this is a field of expertise on its own.

3.1. What should we look out for?

COVID-19 has become the perfect metaphor for describing the workings of systemic risks. As is the case with the public health issue, we worry about vulnerabilities spreading within a community and across communities. These vulnerabilities need not be physically evident (i.e., asymptomatic) or, even if there are symptoms, they can often be dismissed as irritations of other (non-COVID-19) causes. Just like COVID-19, we cannot predict the exact sequence and the magnitude of the costs on the community when such risks are triggered. And, in the end, the corresponding treatment is only for the evident effects since it is no longer timely to unwind the cause and there is no known direct remedy for the root cause, once it is triggered.

All these show that it is better to prevent systemic risks from occurring rather than to react to them. The challenge, however, is that the coverage can be very broad since any trigger can eventually become systemic if there are enough amplifiers in the system. To maintain operational discipline, the focus of the FSCC is primarily on contagion, concentration, leverage, and liquidity risks which we collectively refer to as CL2 risks. In dealing with the after-effects of this recession and for future vulnerabilities, these four will remain key.

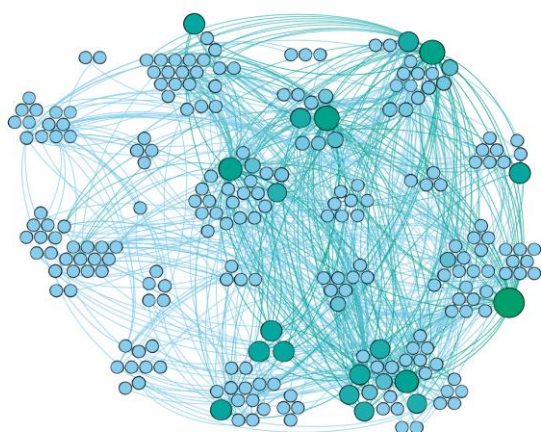
3.1.1. Contagion and concentration

Business linkages drive economic activity, but we have to be vigilant of the contagion and concentration risks that come with them. Business relationships are shaped because entities form a cost-effective supply chain or enhance a value chain. There is a natural steadiness to these relationships, in part because there is a distinct market for business relationships, and in part because cost structures and value propositions do not change instantaneously. Yet, by the same token, they provide

natural channels through which risks and vulnerabilities, once triggered, can cascade. These just highlight that business linkages are necessary for economic activity, but they also carry some risks.

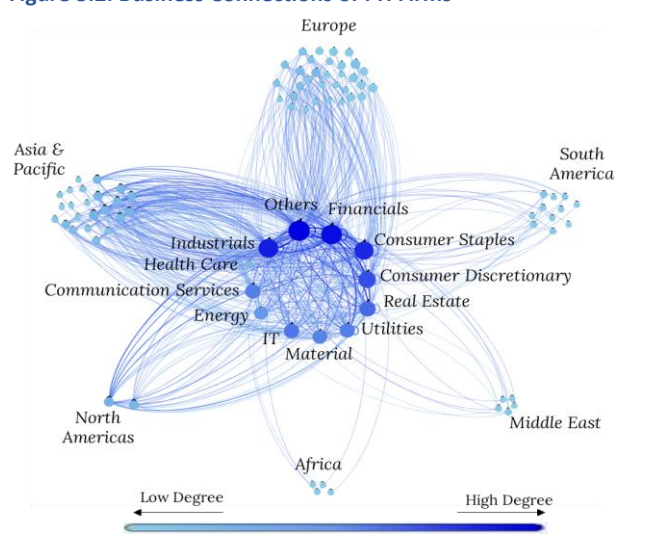
The add-on is that in a small open economy such as the Philippines, the market may not be deep enough to accommodate multiple players, each with a reasonable market share. Economic transactions would tend to gravitate towards businesses with established track record or with deep market connections. Market leaders then emerge, as they consolidate their position within a chain or diversify across chains. This may be seen as concentration risk. However, similar to business linkages, they reflect how risks, once triggered, can be amplified but, otherwise, these linkages are the engine that drive the economy under normal times.

Figure 3.1: PH Firm to Firm Business Connections



Source: S&P Capital IQ, OSRM Calculation

Figure 3.2: Business Connections of PH Firms



Source: S&P Capital IQ, OSRM Calculation

Networks provide the key for modelling systemic risks from contagion and concentration. Understanding these linkages is essential for market surveillance. We can visualize them through network models, and available Philippine data currently allows us to define such networks, either between firms (**Figure 3.1**), from industry to industry (**Figure 2.6**), and/or industry to other jurisdictions (**Figure 3.3**).

These are informative constructs for assessing which portions in the chains may be more susceptible to risk amplification. They can identify which firms and/or industries are more interconnected with the rest of the system and, in this context, their well-being is an important concern for the well-being of the system. They can explain why small initial shocks can escalate into large final effects (i.e., financial fragility) and show why vulnerabilities in the real sector create financial market pressures that introduce a negative feedback to the real economy (i.e., financial acceleration).

When and what actions may be needed? As has been repeatedly argued above, the presence of linkages and the emergence of market leaders themselves are neither unexpected nor absolutely undesirable. The network models give us a tool to visualize and take numerical readings. Authorities introduce prudential standards to manage the

excessive exposure to risks, such as when anti-trust laws rely on concentration limits for operational guidance.

Contagion, though, is a harder policy issue. Should policy impose limits to interlinkages on the possibility that contagion might occur? If we accept that systemic shocks occur but do so only with significant time in between, what does this imply of our going-concern approach? What costs are implicitly embedded by such regulations during the times when contagion has not materialized?

These questions presume that we have a clear intervention in mind to contain contagion pre-emptively. This is not obvious. Does the state rely on private decisions, hoping that no shock will ensue? Does the public sector have more information than the private sector such that it can intervene with precision and purpose?

Here then lies another challenge to managing systemic risks: the health of the system is a benefit to the public but there are many cases where private decisions (such as business linkages) are best for the counterparties but turn out (when some shock is triggered) to be not in the best interest of society.

Taking all considerations, the authorities must be concerned with contagion and concentration risks. These risks are inherently benign but will, at some point, become real. The policy task then is to have a view of the “point,” mitigate its occurrence, and/or build resilience should we find ourselves reaching that point. Here, network models offer insights that we would not have from traditional data or mainstream models. As the section on testing below will further describe, network models should play an integral part in assessing our resilience to the cascade of contagion and concentration risks.

Digitization represents a new facet of the network. Before leaving this discussion about networks, we should at least raise the question of how digitization affects the network, the business linkages, and thus contagion and concentration. Truthfully, this should require a more in-depth study because there seem to be a lot of possibilities. Off the top, one can argue that digitization would not fundamentally modify the production side of the chains. What is likely more affected is the flow of funds aspect, client to bank, or the payment between parties through their respective banks. The extent of the connections may not necessarily be altered but if digitization of finance increases turnover, then the intensity of the connections between parties (involving banks, directly or indirectly) will be affected. How all these should be accounted for in the network is a work-in-progress.

3.1.2. Leverage and liquidity

Leverage and/or liquidity are stereotypical core elements of any crisis. While contagion and concentration tell us how risks are cascaded, it is material risks in leverage and/or liquidity that often underpins crises. This

alone underscores the need to continuously monitor these risks, not just from the lenders point of view but more so from the borrower's side as well. This is why the networks and systemic risks cannot be limited to banks. Instead, the authorities need to cover NFCs as well as financial institutions.

However, despite being obvious candidates for sources of risks, there are challenges in the surveillance of leverage and liquidity. Three aspects stand out: (1) leverage or liquidity at any point in time are indirect measures because they can only be understood relative to their use, rather than of themselves, (2) there is a slow-burn element because any risk from these two takes a long time to develop, and (3) risks that do materialize will have both of these feeding into each other.

Measurement is not as straightforward as we think. These three points add an extra challenge to the risk analysis. We have to find a (visible) policy target for which leverage and liquidity contribute to, accept the limitation that this may be an aggregate target rather than the ideal-but-untenable per use measure, have this target be sensitive to different segments of the market, and do so across changing market conditions through different market sectors and through time.

As high a bar as this sets, GaR models can be valuable, with growth as the ultimate target, aided by the availability of credit and the support of liquidity. These models provide a range of outcomes and would therefore be more sensitive to tail risks. But experience tells us that these are very sensitive to changes in data such as the deviations introduced in 2020 by the pandemic.

More importantly, GaR is a model for an aggregate target, quite distinct from the firm or industry level linkages provided by the network analysis. This is not a fatal flaw since we can benefit from the insights from the two (presently disjoint) approaches. One can surmise – as we do in our work-in-progress – that measures of centrality (from the network) are inputs to GaR: possible upside growth is improved as the interlinkages drive the economy in good times but the downside risk is worse if the economy gets into crisis situation.

There is the added challenge of changing market sentiments. We typically look at indicators over a period of time to assess changed market conditions. The challenge is that this is an after-the-fact view of the market. There is a need for some threshold to signify “excessiveness” but the fact that it is a measure over time raises issues related to stationarity of the data series. For the authority, however, the biggest downside for these over-time indicators is that they would generally not be able to tell us how to inflect and reverse course.

This is where RoRo indicators could better survey the market. They reflect actual market risk decisions and, given the high frequency of these indicators, they provide some reasonable measure of real-time market sentiments. This is important for leverage and liquidity. We expect leverage to rise in a risk-on stance while the preference shifts to liquid, safe, low yield assets when investors take a risk-off position.

Leverage and liquidity risks can then take a broader view. As formulated, the level of leverage and liquidity can factor into the GaR model while market sentiments pick up the change in the direction of leverage and liquidity. Debt servicing issues – which will affect leverage and liquidity – can be incorporated into the GaR and network models to capture the pressure points on the NFCs as well as the creditors. In addition, the relevant liquidity measure would be that which is already deployed in safe assets or ringfenced in the balance sheet, rather than the outstanding aggregate amount measured, for example, by M3.

All of these will require data, both granular and timely, to monitor. As discussed below, this is not an easy constraint, but it is an issue that needs to be addressed if we intend to effectively monitor and anticipate brewing systemic risks.

3.2. How do we test for vulnerabilities?

The models discussed in the previous section tell us what we will be looking out for but all of them (network models, GaR, RoRo) require a trigger to assess potential systemic risk. We need to test for how the network fares when you have an unexpected external shock that can put pressure on the servicing of debts, increase the preference for liquidity, shift from risk taking to risk avoidance, and worsen downside tail risks.

This is an assessment of vulnerabilities in the way market participants interact with one another and it is a measure of resilience. This section discusses an aspect of these tests, specifically our first MaPST.

We anchor our MaPST on NFCs. The prevailing practice in systemic risk analysis is to focus more on the financial market and less on – but inclusive of – the real economy (Anderson et al., 2018). The COVID-19 pandemic reminds though that “systemic-ness” can be triggered by varied shocks. As we argued above, if there is systemic risk over leverage and liquidity, it will be driven by the ability of the borrowers to service their debts. Creditors will be affected by defaults, but the trigger is primarily from the side of the debtor with subsequent second round effects in the financial market.

From this perspective, our MaPST is anchored on the NFCs, using the network model at the centerpiece of the real economy. This reflects our judgement that the key risk over the medium-term is the health of the NFCs, both in terms of their viability in a New Economy and in settling maturing obligations which were contracted even before SARS-CoV-2. This is not to suggest that there are no vulnerabilities with any single financial institution, or does it suggest that no financial institution is important enough to the system. The former is a microregulatory concern, with safety and soundness well within the remit of the microregulator. The latter is not prejudiced as it is covered in the network model.

The model is modest and is meant to develop over time. While we capture the interaction between institutions, both financial and non-financial, our MaPST is a modest start. Ideally, what we want to assess are the behavioral responses to stress, allowing portfolios to rebalance and interlinkages to recalibrate. The intention then is to ultimately connect the MaPST with the GaR and RoRo models, providing behavioral triggers through macrofinancial linkages.

We can partially excuse this absence by arguing that the pandemic has caused fundamental changes in behaviors that puts the mathematical stability of prior models in question. The same is true for why there is no macroeconomy component to the stress tests. In the absence of these behavioral linkages, we instead simulate income impairment directly into the balance sheet of firms to assess the network effect of a given shock. The shock in this case is a percentage of the actual loss from the first year of COVID-19.

Where the model is most wanting is the need for a liquidity-related response. This is necessary between the NFCs and their banks, and within financial institutions themselves. This follows from the RoRo principle which should affect the distribution of growth potentials.

Notwithstanding these limitations, the MaPST should generate unique results from the bank stress test that is already well-established. Including NFCs is a critical add-on because this wider coverage shows the impact on the real economy. The fact that the network model is used in the stress tests ensures added depth via forward (customer) and backward (supplier) linkages. These differences are expected to be more distinct once the enhancements mentioned above are embedded into the models.

For better management, the MaPST is conducted in two phases. The first phase focuses on assessing corporates' capacity to service financial obligations through an ICR-based test and their ability to maintain productive capacity through a cash flow deficit approach. Through the use of the NFC supply chain network, the stress test captures the reduced demand of intermediate goods (upstream), as well as the decline in supply of primary inputs due to diminished production cuts (downstream) that arise from impaired earnings of firms.

The second phase specifies which among the linked financial agents are most adversely affected by NFC income shocks and measures their resiliency through credit, liquidity, and market risk stress tests. Nothing is lost with this bifurcated approach because the networks used in the first phase would allow for the amplification of risks and their spillover into the financial market.

3.3. Communication: what can be said, to whom and when?

Effective policy execution requires good communication, and financial stability is covered by this mantra as well, even though there are added challenges with financial stability. While inflation can be assessed against a target band, banks are evaluated against capital adequacy, and the costs of failed execution in the payments system can be measured, the concept of financial stability does not have an equivalent universal technical measure. This has never been a deal breaker since a part of this absence is more illusory than real: the definition of financial stability across jurisdictions are more alike than they are different.

The practical issue is that the benefits to society of “stability” is typically not considered in private decisions. It is then impossible to shape future behaviors if we cannot explain what it is that we are trying to address or achieve, something that is itself unique from other policy objectives. The fact too that financial stability is all about managing systemic risks adds to the challenge because talking about – much more confirming – vulnerabilities is not the typical communication of authorities.

None of these challenges change the fact that the authorities cannot shape behaviors and anchor expectations relative to systemic risks if it cannot strategically communicate and do so across varied stakeholders. Something must be conveyed to market players, analysts, students, the executive branch of government, among others, if they are to make informed decisions and for the system to enhance its resilience.

What then can be done?

Build familiarity. Managing the build up of systemic risks – and being resilient to such risks when they do arise – is a nascent but still nuanced policy area. There is a significant amount of technical detail that is the object of the messages and yet the current messages remain to have this non-specific high-level pitch to them. This is reflective of the limited familiarity that most stakeholders have about systemic risks, not just as a concept but as part of the factors that affect their own private choices.

To be more effective, systemic risk communication must be precise in its narrative of how issues are to be addressed. Stakeholders must be made aware of what are the issues, why they matter, and to whom they matter. This communication is very much of the nature of market surveillance and

its corresponding analysis, but it needs to be conveyed differently to different stakeholders.

Defining the foundations. Ideally, the what-why-when-for-whom issues should be in place so that the authorities can focus instead on communicating the execution (“how”) of the identified macroprudential interventions. In practice, however, there is still a lot that has yet to be appreciated about systemic risks and why this is different – and not simply a bigger version – of existing risks.

To make systemic risk policy effective, it must first be relevant to stakeholders. This is the groundwork that must be developed, and on this point, the FSCC builds its communication around the following key messages:

- The whole is greater than the sum of its parts – this quote from Aristotle describes why system level risks are different from the risks faced by the individual players in the system. This difference comes from the interlinked behaviors of the stakeholders and those interlinkages create a market dynamic that will not be captured by simply summing the situation of each stakeholder.
- What makes a risk “systemic” is its ability to disrupt and affect the rest of the system – systemic-ness is defined by how the well-being of the whole economy can be affected by the interlinkages between stakeholders. COVID-19 is a systemic risk, even if it did not originate from financial markets, because of its ability to spread to create larger outcomes than the separate individual shocks.
- Systemic risks are not obvious and difficult to anticipate – black swan events represent situations that do not occur with high frequency, but they do occur, and the dislocation is typically both deep and widespread. The real risk is that we prepare only for what is deemed usual. The objective is to be more resilient to what may happen and not just to what is likely to happen.
- Systemic risks impact different stakeholders differently – distribution matters in assessing the impact of systemic risks. The vulnerable benefit more from protecting against the occurrence of systemic risks than those who are already resilient. This highlights that gains and losses in the system do not naturally offset each other and the resulting inequity is why we build resilience for the whole system.
- Not all risks are systemic and not all systemic risks involve banks or inflation – this just reminds why managing systemic risks is a different policy objective. While the labels for the risks may sound familiar, what is different is the objective itself, the issues that arise, why they matter differently for the system than for individual stakeholders, and the way they are handled.

These are not separate messages but are building blocks. They should be calibrated when conveyed to different stakeholders and it is also understood that the task is not just to articulate but rather to explain why each message is important and what society gains from knowing them. All these foundational messages are ultimately to converge our core message that:

Financial Stability improves the current and future welfare of society by:

1. Assessing the risks to stakeholders, the choices they make, and how these choices affect other stakeholders.
2. Measuring the gains that accrue to some and the costs borne by others, a balance which factors into determining the health of the society.
3. Crafting policy interventions to strengthen the capacity of our financial system to manage risks so that society is better off today and in the foreseeable future.

Keeping to the discipline of transparency. Beyond the foundational messages are the interventions that make up the policy response to brewing systemic risks. These will tend to “look and feel different” but that is the nature of systemic risk interventions. They can, at times, differ with previous messages from other policy objectives (i.e., different objectives, different assessment, different interventions) or these can be actions that one does not usually take under normal market conditions (i.e., out-of-the-box thinking in line with the needs of the situation).

As significant is the task of delivering on the foundational messages, conveying macroprudential policy is likely the bigger challenge. While the established best practice is to instill transparency even under stressed market conditions, the execution of this remains at its early stages. Credibility is the most important currency of authorities but for those with multiple mandates, there will be instances when the minuses outweigh the pluses. This is a difficult narrative under any condition but COVID-19 has hastened the value of speaking clearly and speaking “with one voice.”

Challenges aside, the objective remains that of shaping expectations and providing guidance to risk behavior. Credibility is critical but it is also the intermediate step for signaling the prudent path ahead. For systemic risk, this means that the messages add value rather than cause new panic. This is where credibility circles back to transparency: systemic risk communication must take the longer-term view but mindful of near-term unintended consequences. This will require deliberate handling.

Working with and through our stakeholders. Communication does not happen in a vacuum and is a continuing relationship between the counterparties. Different stakeholders will have different reasons for “listening” and it is up to the macroprudential authority to convey such messages. It is then important to be clear about with whom we are communicating with, and what may be their interest in a systemic risk discussion.

- **Market players** – Risk taking is a private decision with private gains. Systemic risk is not typically in the calculus of private agents because “stability” is essentially a public good, to be enjoyed by all collectively but difficult to price individually. But as history has repeatedly confirmed, actions in the best interest of private agents may not be in the best interest of society. When system-level risks materialize, everyone is affected. In this context, the smooth operation of markets depends on such systemic risks not causing disruptions. Familiarity by the private agents of systemic risks helps contain self-imposed shocks to the system.
- **Analysts** – Different stakeholders have different views, and analysts are not an exception. Providing the facts to analysts is an important task so that they can form their views which will influence the behavior of others. It is these different views that create markets and for as long as the facts are well presented, we expect a balanced view of the so-called “pluses and minuses”. This balance avoids the sharp corrections which is key outcome of responsible analytics.
- **Academe** – The benefits of communicating with the academe cannot be overstated. Developing the foundations of Financial Stability as a policy objective deepens the discussions and supports further research. This focuses the discussion on the prognosis itself rather than on explaining the basis of the prognosis. And by escalating the level of familiarity from “why” to “what then”, we take a more progressive tack in this policy area. Influencing the development of minds early on also provides the authorities the pool of talent for those interested to specialize in this field.
- **Media and the Public** – It is ultimately the risk choices of the public that we would want to shape, thinking about the effects on the whole and not just its parts. This system-level thinking requires time to develop and continuous reinforcement. This is itself important so that the public can make well-informed decisions in the face of changing market conditions, rather than increasingly stay averse to the risks. The media plays an important role in conveying the messages to the public.
- **Local authorities** – System-level risks must be managed by the designated authority, but the consequences of the risks permeate throughout the rest of government. It is important to keep all stakeholders informed so that the actions of other authorities

already consider the systemic risks being monitored. Just as we espouse a well-informed public, macroprudential policy depends on a coordinated approach from all authorities.

What the FSCC is trying to do and how COVID-19 changed everything.

The above reflects the direction and substance of what the FSCC is doing to communicate the nature of systemic risks and its macroprudential policy interventions. Aside from this FSR, another key step forward was the recent public statement on the state of financial stability. This has not been done before in the country, but it is an initiative that we look forward to building upon. Other initiatives to convey differentiated messages are in the pipeline, including the communication element that is inherent in the forthcoming release of our SRCM framework.

EPILOGUE: WHAT IS NEXT?

All multilateral agencies talk about a recovery in 2021, completing the V-shaped resurgence from the global recession. This recovery is understood to mean that GDP growth rates will revert to being positive. This is indeed the case, with some jurisdictions already reporting as much early on, and many other jurisdictions expecting no less than the same.

What is less talked about is that systematic risk – the overall market risk of doing business – has risen. The permanency of the loss in incomes affects purchasing power and debt servicing over the longer-term. This will feed into risk aversion which is currently already elevated. The credit market, thus far, is impaired by this risk aversion, nurturing a risk-off market situation which serves to self-validate the initial aversion to new risks. What we see is the vicious cycle of disruptions that have created risks which can cause further disruptions. And while GDP growth is fully expected to turn positive in 2021, different income groups face different conditions. With this, some segments of society are moving forward while others require a longer and more nuanced path towards recovery.

These define the transition out of the COVID-19-impaired market and into the New Economy. Different cohorts are facing different circumstances. This divergence is an important element of what lies ahead, and unless we recognize all these, higher systematic risks can lead to new systemic risks. Already, debt servicing is an issue, not because of any overt recklessness from borrowers but rather because of the opportunities lost to or altered by COVID-19. This is a structural impairment that the authorities must consciously address because time alone is unlikely to repair its underlying cause.

The three sectors reviewed in this FSR are similarly affected by structural impairment in the sense that the status quo was disturbed, and the future would not see a return to the old norms. COVID-19 and the lockdowns may have instigated it but the effects on these sectors will linger. Blended education is not just another option. This has consequences on the readiness and efficiency of the future labor force. The income shock and distancing requirements drew sharper distinctions between what was being purchased, by whom, as well as how the goods would end up with the end-user.

Footprint issues need to be addressed. This is true for schools which had been designed to accommodate the physical presence of a high volume of students, and this is true of the in-store experience for retail trade. The increased use of cyber space leaves questions about these footprints and the resulting carrying costs of physical assets. Space and flow concerns are also important for CRE since health protocols will have their construction and engineering requirements. Design changes for future developments can be readily expected but it is also conceivable that retrofitting may be too expensive and thus impractical for some existing structures.

The scar of income impairment has lasting implications on financial markets. Creditors must now consider what the future market will look like and the underlying ability of obligors to service debts. As all forecasts carry the caveat that the numbers should be treated with a fair amount of caution, the reality is that the future is much more fluid than we are usually accustomed. Stakeholders need to accept that future market activity now carries more uncertainty. This epitomizes our point about heightened systematic risk. This is not on regulators or market players. This is all on COVID-19 and the scars it is creating.

What do these mean for systemic risks?

All these suggest that we are at the point of a reboot. The market is in the midst of a transformation and we argue that we are better off resetting from a common starting point. By this we mean that the stakeholders need to agree on what are the next steps and why these steps are even being pursued. This is a mindset shift that involves agreeing on what we want to see of the future market landscape and forming a consensus on how we are going to manage the transition. Absent these agreements and consensus, there would be unintended consequences from a transition made “disorderly” by several components that individually look to be the best choices but, taken collectively, may be adverse to the system. This is systemic risk at its core and the interlinked behaviors of stakeholders will almost certainly ensure the amplification into system-level concerns.

The commitment of the government to managing systemic risks has only been reinforced by the issuance of EO No. 144, signed by the President on 6 July 2021. This EO gives the Council the authority to intervene with regulations, set guidelines, as well as collaborate with various parties to generate needed data, among others.

This strengthens the work of the Council in preventing a further escalation of the unfolding risks and actively anticipating potential new rounds of systemic risks. We took the opportunity of this FSR to outline the direction of the FSCC. Enhancements to the network models can better flag concentration and contagion risks. Revisiting the previous work on GaR and RoRo is critical for a firmer view of liquidity and leverage. Finding ways to merge changing risk behaviors into the networks would be the ideal state.

The MaPST would be completed. Even at its modest formulation, there are already significant insights which will be useful for our surveillance work. The broad principles for the SRCM should also be in place, and this will be an important platform for pursuing other collective actions. Finally, we have outlined how the Council will strengthen its messaging initiatives to a broad array of stakeholders. This will ensure that stakeholders make well-informed decisions with systemic risks being considered and for the authorities to focus on mitigating these systemic risks.

The hovering clouds are not as dark as they were two to three quarters ago, but there is still much work to be done towards complete recovery.

ANNEX

EXECUTIVE ORDER NO. 144, 6 July 2021

**Office of the President
of the Philippines
Malacañang**

BSP JUL 7 '21 9:55 AM
OSRM 7JUL21PM1:38

MALACAÑANG RECORDS OFFICE

Manila, July 6, 2021

GOVERNOR BENJAMIN E. DIOKNO
Bangko Sentral ng Pilipinas
Malate, Manila

Sir:

I have the honor to transmit for your information and guidance, a certified copy of Executive Order No. 144 dated July 6, 2021 entitled **"INSTITUTIONALIZING THE FINANCIAL STABILITY COORDINATION COUNCIL."**

Thank you.

Very truly yours,



ATTY. CONCEPCION ZENY F. FERROLINO-ENAD
Director IV

M-128 Mabini Hall, Malacañang, Manila Trunkline 784-4286 loc. 4029/ 4123/ 4153

06 07/06/21



MALACAÑAN PALACE
MANILA

BY THE PRESIDENT OF THE PHILIPPINES

EXECUTIVE ORDER NO. 144

INSTITUTIONALIZING THE FINANCIAL STABILITY COORDINATION COUNCIL

WHEREAS, financial authorities have learned from the Global Financial Crisis of 2007-2009 that financial stability is a distinct and over-arching policy objective that sustains the health of the entire financial system;

WHEREAS, driven by their mutual interest for a well-functioning and resilient financial system, the *Bangko Sentral ng Pilipinas* (BSP), Department of Finance (DOF), Securities and Exchange Commission (SEC), Insurance Commission (IC) and the Philippine Deposit Insurance Corporation (PDIC), voluntarily convened in October 2011 to pursue financial stability;

WHEREAS, on 29 January 2014, the BSP, DOF, SEC, IC and PDIC signed a Memorandum of Agreement to create the Financial Stability Coordination Council as a voluntary inter-agency body which shall collaborate and cooperate to pursue, sustain and enhance the health of the financial system under the objective of financial stability;

WHEREAS, under Republic Act (RA) No. 7853, otherwise known as "The New Central Bank Act", as amended by RA No. 11211, the BSP is mandated to promote financial stability and is directed to closely work with the National Government, including, but not limited to the DOF, SEC, IC and PDIC; and

WHEREAS, in recognition of the importance of financial stability to the overall health of the country's financial system, there is a need to formalize the creation of an inter-agency body on financial stability in order to institutionalize its powers and functions, and strengthen the ability of the Government to collectively address systemic risks, which may arise in different segments of the financial market;

NOW, THEREFORE, I, RODRIGO ROA DUTERTE, President of the Republic of the Philippines, by virtue of the powers vested in me by the Constitution and existing laws, do hereby order:

SECTION 1. Policy of Financial Stability. Consistent with the objective of the National Government to safeguard the welfare of Filipinos through a well-functioning financial system, the government hereby reiterates its policy of enhancing the stability of the financial system by mitigating systemic risks through timely policy interventions.

THE PRESIDENT OF THE PHILIPPINES

SECTION 2. Institutionalizing the Financial Stability Coordination Council. The Financial Stability Coordination Council (FSCC) is hereby institutionalized as an inter-agency council composed of the BSP, DOF, SEC, IC and PDIC, as its member agencies.

SECTION 3. Purpose and Objectives. The FSCC shall enhance the stability of the financial system by mitigating systemic risks through timely macroprudential policy interventions. Towards this end, the FSCC shall formulate a Macroprudential Policy Strategy Framework, which shall guide its policy interventions. The Macroprudential Policy Strategy Framework shall be made publicly available and shall be updated periodically, as may be warranted.

SECTION 4. Powers and Functions of the FSCC. To the extent consistent with the respective mandates of the member agencies, the FSCC shall have the following powers and functions:

- a. Issue directives or policy regulations in the pursuit of its objective of financial stability;
- b. Align various policies, regulations, supervisory frameworks, programs and initiatives on financial stability;
- c. Coordinate with foreign regulators on financial stability and macroprudential policy;
- d. Collaborate with public and private organizations for data collection and research to facilitate informed policy recommendations; and
- e. Formulate and adopt its governance and operational guidelines, as may be necessary.

SECTION 5. Executive Committee (ExeComm). The affairs of the FSCC shall be governed by an ExeComm which shall be composed of:

- a. The BSP Governor – Chairperson;
- b. The Secretary of Finance – Member;
- c. The Insurance Commissioner – Member;
- d. The President of the PDIC – Member;
- e. The SEC Chairman – Member;
- f. One senior official from each of the five (5) member agencies, as formally designated by the head of the agency, shall serve as non-voting members.

The ExeComm shall promulgate rules for the conduct of its internal procedures, issue Resolutions relating to the implementation of its functions, and create Technical Working Groups and/or Sub-Committees, as necessary.

The National Treasurer may be invited to the meetings of the ExeComm as a special non-voting member.

SECTION 6. FSCC Secretariat. In performing its purpose and objectives, the FSCC and its ExeComm shall be assisted by a Secretariat. Unless the FSCC declares otherwise, the Office of Systemic Risk Management of the BSP shall serve as the Technical Secretariat to the FSCC.

SECTION 7. Meetings. The FSCC Execomm shall meet periodically, without prejudice to the discretion of the Chairperson to call meetings, as may be necessary.

SECTION 8. Funding. The funding requirements for the operation of the FSCC shall be charged against the budget of the BSP.

SECTION 9. Repeal. All other issuances, orders, rules and regulations inconsistent with this Order are hereby repealed or modified accordingly.

SECTION 10. Separability. If any provision of this Order is declared invalid or unconstitutional, the remaining provisions not affected thereby shall continue to be in full force and effect.

SECTION 11. Effectivity. This Order shall take effect immediately.

DONE in the City of Manila, this 6th day of July, in the year of our Lord, Two Thousand and Twenty One.




By the President:


SALVADOR C. MEDIALDEA
Executive Secretary



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