Securities and Exchange Commission
PHILIPPINES

FINANCIAL STABILITY REPORT

APRIL 2020

FINANCIAL STABILITY COORDINATION COUNCIL

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LIST OF ACRONYMS, ABBREVIATIONS and SYMBOLS

AE	-	Advanced economies
AFC	-	Asian financial crisis
bpd	-	Barrels per day
BIS	-	Bank for International Settlements
BSP	-	Bangko Sentral ng Pilipinas
BTr	-	Bureau of the Treasury
CB	-	Central bank
CDS	-	Credit default swap
COVID-19	-	Coronavirus disease
EBIT	-	Earnings before interest and taxes
ECQ	-	Enhanced community quarantine
EME	-	Emerging market economies
FCY	-	Foreign currency
FX	-	Foreign exchange
FSCC	-	Financial Stability Coordination Council
FSR	-	Financial Stability Report
FWA	-	Flexible work agreements
GDP	-	Gross domestic product
GFC	-	Global financial crisis
GS	-	Government securities
GVC	-	Global value chain
IATA	-	International Air Transport Association
IATF	-	Inter-Agency Task Force for the Management of Emerging Infectious Disease
IC	-	Insurance Commission
ICR	-	Interest coverage ratio
IEA	-	International Energy Agency
IIF	-	Institute of International Finance
IMF	-	International Monetary Fund
InsCos	-	Insurance companies
MSME	-	Micro, small, and medium enterprises
NDC	-	National Development Corporation
NG	-	National government
NEDA	-	National Economic and Development Authority
NFC	-	Non-financial corporation
NPL	-	Non-performing loans
OFW	-	Overseas Filipino worker
OPEC+	-	Organization of the Petroleum Exporting Countries
PD	-	Past due loans
PDIC	-	Philippine Deposit Insurance Corporation
PHP	-	Philippine peso
PMI	-	Purchasing Managers' Index
PSEi	-	Philippine Stock Exchange Index
Repo	-	Repurchase agreement

SARS	-	Severe Acute Respiratory Syndrome
SEC	-	Securities and Exchange Commission
SPV	-	Special purpose vehicle
TARP	-	Troubled Asset Relief Program
UK	-	United Kingdom
US	-	United States
USD	-	US dollar
VaPI	-	Value of Production Index
VoPI	-	Volume of Production Index
WEO	-	World Economic Outlook
YoY	-	Year-on-year

MESSAGE FROM THE FSCC CHAIRMAN and BSP GOVERNOR

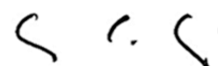
The global economy saw growth moderate in the second half of 2019 although financial markets remained generally calm. The emergence of the coronavirus disease (COVID-19) at the onset of 2020 dramatically altered the market situation. What sets COVID-19 apart from the most recent crisis, the global financial crisis (GFC), is the speed at which it has spread throughout the globe, imposing significant human and economic costs in a matter of months. The International Monetary Fund (IMF) has judged the global economy to be in recession and, more importantly, that they expect the full extent of the dislocations to be close to those of the 1929 Great Depression.

As countries focus their efforts to containing the pandemic, government interventions have supported the reflow of incomes, particularly to the most vulnerable sectors of society, while financial authorities have been implementing measures to sustain funding and re-ignite stalled economic activity. That human lives have been lost in this pandemic while measures to contain the virus have compromised household incomes and suspended business activity only highlight the great costs that have been borne by society thus far. Yet, there are still many challenges in front of us, as the country — as with all other economies in the world — goes through the process of stabilizing the public health shock and then making up of lost ground with an economic recovery.

At this juncture, we continue to believe that the financial system is stable, even if it is necessarily reacting to the uncertainties from COVID-19 and to the instabilities brought about by a recession on the macroeconomy. In this challenging time, the Financial Stability Coordination Council (FSCC) remains steadfast in our commitment to maintain a system-wide view of present and emerging risks, with the goal of preserving financial stability both today and in the future. Our end-goal has always been to maximize the benefits of finance while minimizing the costs of instability for the public.

This April 2020 Financial Stability Report (FSR) is our maiden report that shifts from an annual to a semestral calendar. We hope that, by doing so, we provide a timely analysis of the fast-changing market developments and be more effective in proposing pre-emptive interventions. This should also help our readers so that they are well positioned to make better-informed decisions.

We wish for everyone's good health as we share this FSR and we welcome any inputs so that we can enhance future reports.



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 ongoing public health crisis has escalated into a pandemic with severe human and economic costs. World growth was already slowing since 2018, but the emergence of the COVID-19 pandemic has put the global economy into a recession. That the virus emanated from China (the world's factory) and specifically from Wuhan (a transportation hub with direct access to five continents) underscores the interconnections that define the world order.

Compared with the Severe Acute Respiratory Syndrome (SARS), COVID-19 is more contagious, with over 3.3 million confirmed cases[1] (as of this writing) in 187 jurisdictions and a mortality rate of over 7 percent. Measures to contain the spread of the virus, however, necessitated restricting cross-border travels and suspending domestic economic activities, both of which effectively erode household income flows. The social and economic costs have been high thus far, but one should expect more difficult times ahead before the overall situation gets better.

In the Philippines, COVID-19 has put a strain on the public health infrastructure, and the stay-at-home preventive measure has disrupted people's usual day-to-day practices. The government has responded with an income augmentation and subsidy program, supported by the early action of Congress in crafting the Bayanihan to Heal as One Act (Republic Act 11469).

As adversely affected as the economy has been, there are no indications that the financial market is in peril. Risk behaviors have shifted though, as risk aversion has been heightened, asset prices have fallen, and risk premiums have increased. Across borders, a rebalancing of portfolios has been noted towards safe-haven, liquid, and often US dollar (USD)-denominated assets, just as there is evidence that shifts in asset holdings have transpired within jurisdictions.

For the Philippine financial market, the preference for money market instruments has been notable although one cannot say that this has been "funded" by withdrawals in other asset classes. There is also no evidence of a liquidity squeeze, either in Philippine peso (PHP) or dollar terms, and the PHP/USD rate has remained relatively stable.

Yet, risk premiums have risen and the impact of the recession on financial markets will depend on how (and how quickly) the country can resolve the public health issue, bolster family incomes, and re-ignite business activity. Over the near term, it is reasonable to expect increased difficulty with debt servicing in the formal market as business activity has been put on hold and, arguably, in the informal market as household cash flows have been disrupted. The regulatory reliefs on credit are critical and important, but authorities also have to look ahead as the business and income dislocations may take time to normalize.

What is to be avoided is a financial accelerator type of amplification. On this point, authorities should manage risk premiums to eliminate as much of the panic add-on, which is the antithesis of stabilization and recovery. In parallel, there is value to pricing risks off forward markets and then back to spot rates, rather than rely on spot rates that price-in an unanchored future.

[1] Based on 30 April 2020 data from the Johns Hopkins University & Medicine Coronavirus Resource Center.

Soon, authorities will have to think of the post-COVID-19 environment. At this juncture, it is difficult to imagine returning to the old status quo. The economy has to be re-fitted into the social distancing guidelines, as well as preventive measures that rely less on face-to-face interactions. While governments are in the best position to absorb the current burden of the relief efforts, sooner or later, the potential overhang of increased national debt may require fiscal policy adjustments.

CHAPTER 1

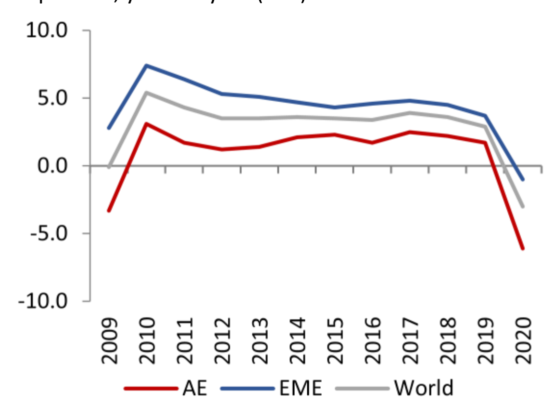
GLOBAL AND DOMESTIC DEVELOPMENTS

A public health crisis that started in one of the key jurisdictions of the world — China — has now unanimously led to a global recession. The only remaining issues are how sharp the contraction will be and how long will it take to get the economy back to a path of normalcy. Since various jurisdictions are differently vulnerable from the fallout of COVID-19, the disruption is a cause for heightened global apprehension.

1.1 Global and regional developments

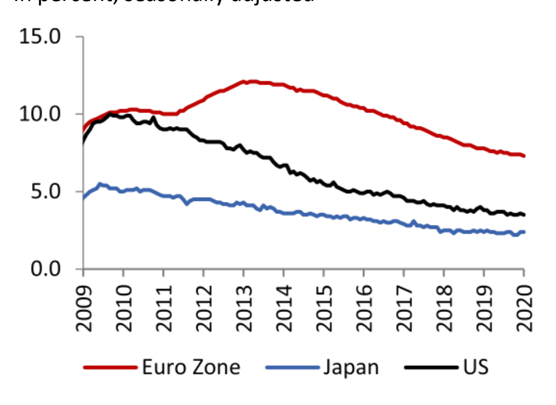
Global growth was already decreasing because of structural factors in advanced economies (AEs). A study by the IMF has argued that structural factors — aging population, demographic shifts, and the subsequent decline in potential output and the transition to a service-led economy — are slowing economic activity in AEs (Bakker, 2019). As a result, global growth has been declining since 2018, with the decline turning out more than what was expected over the last two years (**Figure 1.1**).[2] Unemployment, for instance, has declined very rapidly over the last five years even though growth was itself modest (**Figure 1.2**).[3] Unemployment rates in AEs, particularly in Japan, Europe, and United States (US), are falling because of a decline in the working age population rather than due to improving labor force participation. Investments have been slowing for a time now as well, following the declines of the working age population.

Figure 1.1: Real GDP growth rate
In percent, year-on-year (YoY)



Source: IMF

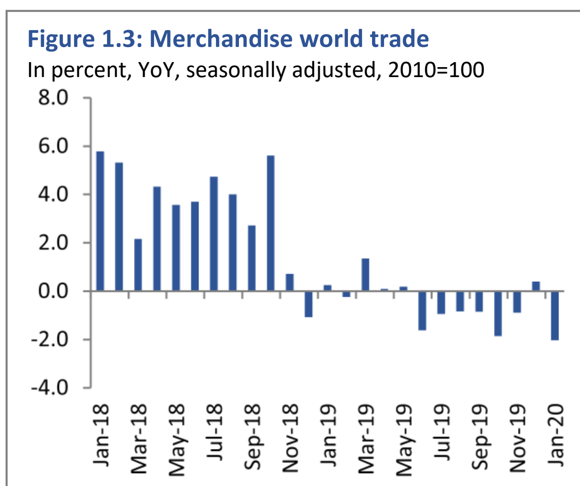
Figure 1.2: Unemployment rate
In percent, seasonally adjusted



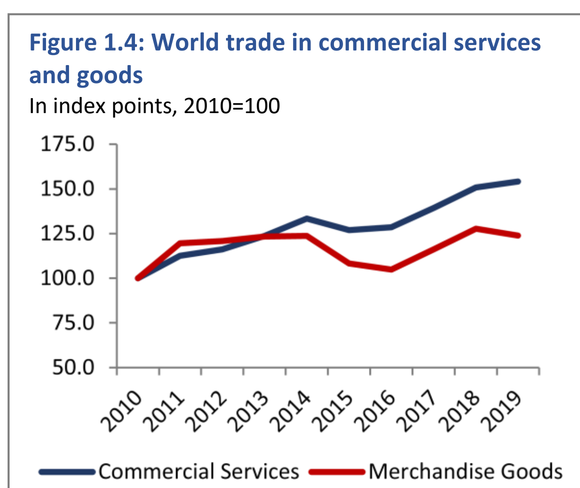
Source: Refinitiv

This structural shift in AEs affects emerging market economies (EMEs) through trade. The global economy is much more integrated with global value chains (GVC)[4] now accounting for more than two-thirds of world trade (WTO, 2019). China, US, and Germany continue to be the most important hubs for global production chains, connecting factories in Asia, Europe, and North America (ADB, 2018). Hence, changes in demand and supply in one country, sparked by updated technology,

[2] Growth declined by 0.7 percentage points between 2018 and 2019 alone (IMF, 2019 and 2020).
[3] Gopinath, G. (2019). The World Economy: Synchronized Slowdown, Precarious Outlook. IMF Blog.
[4] GVCs deal with the cross-border trade of intermediate materials for the production of a final good.



Source: CPB World Trade Monitor, staff calculations



Note: World trade is calculated as the average of world exports and world imports.
Source: World Trade Organization, staff calculations

economic developments, resource availability, and political shifts, have spilled over to trade relationships, reinforcing the interconnectedness of countries.

There was not much trade in global goods in 2019, leading to a 0.4 percent decline for the entire year (**Figure 1.3**). This decline reflected global trade tensions and affected both EMEs and AEs (Romei, 2020). On top of the trade war, the automotive industry was also in a slump because of higher taxes and tighter financial conditions in China, which led to a decline in car demand, whereas new car emission standards in Europe disrupted the automobile production in Germany.[5] These were material because the gross output[6] of the automotive car sector is around 5.7 percent of global output. Meanwhile, vehicles and its related parts remain to be the world's fifth largest export product (IMF, 2019).

In comparison, global services trade grew by 2.0 percent in 2019, mostly driven by non-transport and non-travel related services (UNCTAD, 2020). While services still account for a small share of total cross-border trade, it has expanded faster than trade in goods since 2011 due to digitalization (**Figure 1.4**). In particular, the digital revolution in the 21st century transformed the services sector from non-tradable to highly tradable[7], giving rise to a globalized services market (WTO, 2019).

Trade, together with other cross-border movements (such as investment, information, technology, and people), has made economies more integrated. This landscape has provided aggregate benefits to the global economy, such as increased productivity and efficiency (Bloomberg, 2020). The established linkages, however, also amplify the risks, and any shock to this interconnected world can quickly cascade from one economy to the rest of the world.

[5] The production schedule was disrupted due to the requirement to certify different automotive models leading to bottlenecks at testing agencies (IMF, October 2019).
[6] Gross output is the sum of its value added and intermediate consumption.
[7] Due to digitalization, the internet and low-cost telecommunications, services — such as finance, software development, outsourced business processes, education, healthcare, entertainment, and retail — can now be delivered remotely over long distances and at more affordable prices in lieu of being done face-to-face in a fixed location (WTO, 2019).

The marked moderation in global growth can only be expected to worsen with the spread of the COVID-19. What initially was considered a pneumonia outbreak in the Chinese city of Wuhan has been officially declared by the World Health Organization as a pandemic. The resulting fallout was immediately seen in the travel industry. In February 2020, the International Air Transport Association (IATA) revised their December 2019 growth projection to a contraction in passenger volume in 2020. Data from IATA as of 07 April 2020 indicates a 70 percent drop YoY in the second quarter for revenue per kilometer (their standard measure of demand) and an estimated full-year revenue loss of USD252 billion (Pearce, 2020). In their 06 March 2020 report, IATA likewise noted that airline share prices worldwide have fallen 17.1 percent month-on-month and 21 percent YoY, when the comparative Financial Times Stock Exchange All World index are only 8.2 percent and 1.9 percent, respectively (IATA, 2020). Counting from the date of the first case reported outside China, the decline in airline prices in this COVID-19 period (data updated 06 March 2020) is 26 percentage points lower than the effect of SARS at a comparable point in the outbreak.

This last point is telling in part because present-day China is very different from what it was during the SARS outbreak in 2003.[8] Today, China is the second-largest economy, accounting for 16.4 percent share of the 2019 global gross domestic product (GDP) while about one-fifth of global trade in manufacturing intermediate products originates from China (Sim, 2020). Though the Purchasing Manager's Index (PMI) for China has improved in March 2020 after a record slump in February, the outlook is still gloomy as new export orders may not be replicated in the succeeding months (IHS Markit, 2020).

As the epicenter of the virus shifts from China to Europe and now the US, it has triggered a global supply-chain disruption and demand shock. With more than 180 countries with confirmed cases of COVID-19, it is clear that the world is facing a global shock (Baldwin, 2020). Moreover, the seven nations (USA, Spain, Italy, France, Germany, United Kingdom (UK), and China) most affected by the virus account for 55.8 percent of global GDP in 2019 and their shares to the value added of selected economic activities are also significant (**Table 1.1**). Hence, the freeze in economic activity in these jurisdictions will substantially influence the direction of world supply, demand, and, in turn, growth.

Table 1.1: Top-7 COVID-19 infected economies

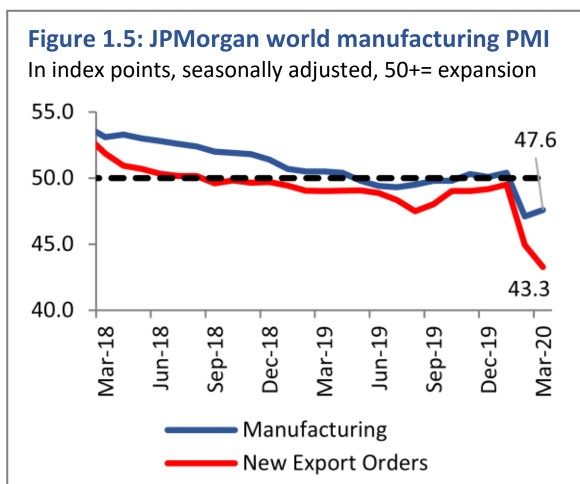
Cases in actual number of individuals, shares in percent

Country	Total Confirmed COVID-19 Cases[a]	Share to 2019 world nominal GDP[b]	Share to 2018 world value added[c]		
			Mfg.	TRH*	TSC+
US	1,039,909	24.8	16.6	25.9	30.1
Spain	236,899	1.6	1.1	2.1	1.5
Italy	203,591	2.3	2.3	2.6	2.4
Germany	166,543	4.5	5.8	3.6	4.5
France	166,441	3.1	1.9	2.9	3.4
UK	161,539	3.2	1.8	3.0	3.9
China	117,589	16.3	28.4	13.2	8.6
Top 7	2,092,511	55.8	57.9	53.3	54.5

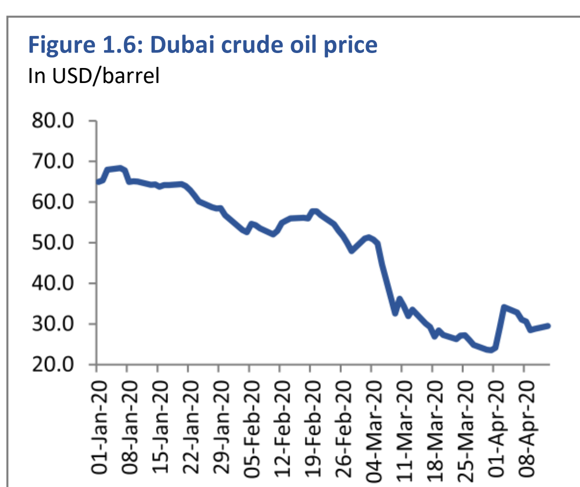
Note: *wholesale and retail trade, restaurants, and hotels; +transport, storage, and communication

Source: [a]Data as of 30 April 2020 from Johns Hopkins University; [b]IMF October 2019 WEO; [c]UNSTAT, staff calculations

[8] In 2003, China was less-integrated to the world, accounting for only 4.2 percent of the global economy and the outbreak SARS already led to a USD40 billion reduction in global GDP, equivalent to a 0.1 percent growth reduction (Feuer, 2020).



Source: Refinitiv



Source: Refinitiv

Latest trade figures have already captured the fallout in economic activity. Manufacturing PMI moved a little to 47.6 while new export orders further contracted to 43.3 in March 2020 (**Figure 1.5**).[9] In addition, analysts are already expecting a slump in auto sales this year, with global auto manufacturers announcing production shutdowns and switching to liquidity protection mode (S&P Global, 2020).

The supply disruptions and depressed demand caused by COVID-19 have aggravated the price war in the oil market. Even prior to the outbreak of COVID-19, the International Energy Agency (IEA) had already raised the possibility of an oil market glut in 2020. With China being the world's biggest importer of oil, the economic turmoil in China will certainly reduce oil demand. At the onset of the outbreak, the IEA predicted oil consumption to decline by 435,000 barrels per day (bpd) YoY in the first quarter of 2020, the first quarterly contraction since the GFC (Cunningham, 2020). Moreover, the impact of delayed or missed production in China will have direct knock-on effects on oil demand elsewhere in the supply chain.

The supply glut is not helped by the failure of the Organization of the Petroleum Exporting Countries (OPEC+) jurisdictions to adhere to their agreed production cuts. Saudi Arabia and Russia were at a stand-off, with the former announcing a further increase in oil production. A market imbalance is now evident in the drastic drop of oil prices (**Figure 1.6**).[10] In their latest report, the IEA (2020) says that there are 5 million barrels produced each day whose costs are higher than USD25 per barrel market price of Brent oil. Fortunately, the OPEC+ finally agreed to cut production by 9.7 million bpd starting 01 May 2020, which has provided temporary relief for the energy industry (Stevens, 2020).

The confluence of events has inevitably pushed the global economy into a recession. In end-March 2020, the IMF declared that the world has entered into a recession – worse than 2009. This follows after the pandemic triggered a standstill in global economic activity and many advanced and developing economies are already entering downturns. The IMF further stated that recovery is possible in 2021 but is dependent

[9] The PMI is a composite indicator of the manufacturing sector's performance, with 50.0 as the threshold. A reading above 50 indicates growth, while below 50 is a contraction.

[10] The IEA said that the oil market was already heading into the first half of 2020 with a bit of a supply surplus.

on the governments' response to contain the virus and implement economic policies to avoid a further slowdown (IMF, 2020).

1.2 Domestic developments

Throughout 2019, forecasted full year growth was revised downwards repeatedly for the Philippines like most jurisdictions. The downward revisions that began in 2018 continued into 2019 as multilateral agencies updated their forecasts (**Table 1.2**). This was not unique to the country as even the IMF was revising their estimates of world growth (**Figure 1.7**).

With the COVID-19 pandemic, 2020 growth estimates have been revised sharply. In their April 2020 World Economic Outlook (WEO) report, the IMF projected world growth to contract sharply by -3.0 percent in 2020 while the Philippines is expected to grow by only 0.6 percent (**Table 1.3**). The National Economic and Development Authority (NEDA) likewise forecasted a low growth between 0 to 2.0 percent for the full year and a contraction in the second quarter of 2020 (Aguinaldo, 2020). This followed after the enhanced community quarantine (ECQ) in Luzon was extended for another two weeks.[11]

Tourism, which is also a large contributor to the overall economic growth of the country, is expected to take a considerable loss this year. In 2019, the expected direct contribution of travel and tourism to GDP was 12.4 percent (WTTC, 2019). Meanwhile, the top three tourist arrivals came from Korea, China, and the US, which totaled to 58.1 percent of total tourists (**Figure 1.8**). In order to contain the spread of COVID-19, the government has imposed travel bans specifically to and from China, South Korea, US, and other countries with COVID-19 local transmission.[12] These measures limit tourism-related expenditures such as accommodation,

Table 1.2: 2019 growth estimates of multilateral agencies for the Philippines

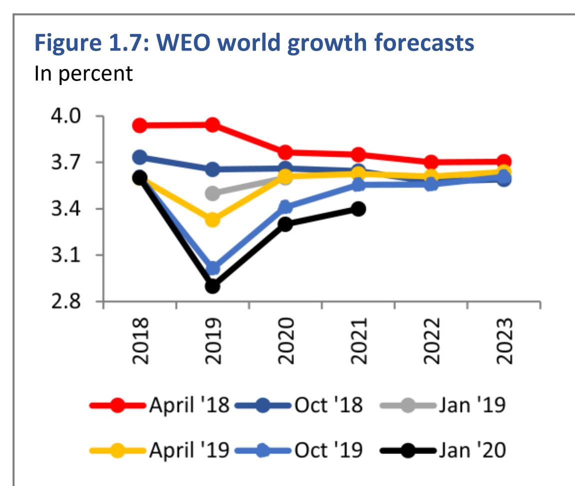
Growth in percent, change in percentage points

Report	Earlier Version	Latest Report	Change
Asian Development Outlook [a]	6.9	5.9	1.0
Global Economic Prospects [b]	6.7	5.8	0.9
World Economic Outlook [c]	6.8	5.9	0.9

[a]April 2018 vs. April 2020 update
[b]January 2018 vs. January 2020 report
[c]April 2018 vs. April 2020 report
Source: Asia Development Bank (2018 and 2020), World Bank (2018 and 2020), World Economic Outlook (2018 and 2020)

Figure 1.7: WEO world growth forecasts

In percent



Source: IMF

Table 1.3: April 2020 IMF economic projections

In percent

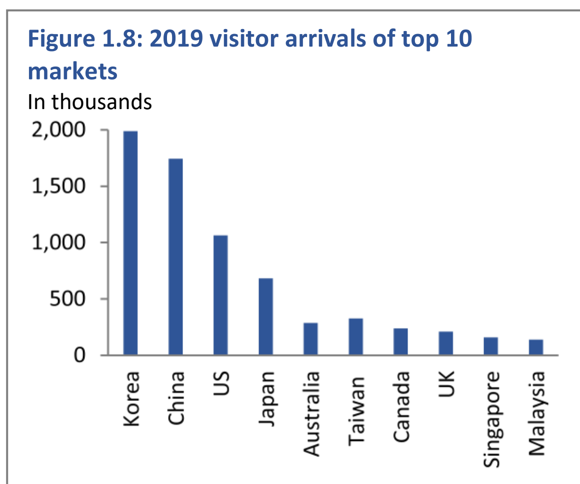
	2020	2021
World	-3.0	5.8
Philippines	0.6	7.6

Source: IMF

[11] The entire island of Luzon was placed on a month-long ECQ to contain the spread of the virus. It was due to end on April 12 but was extended by the President up to April 30 as recommended by the Inter-Agency Task Force for the Management of Emerging Infectious Diseases (Ibanez and Noble, 2020).

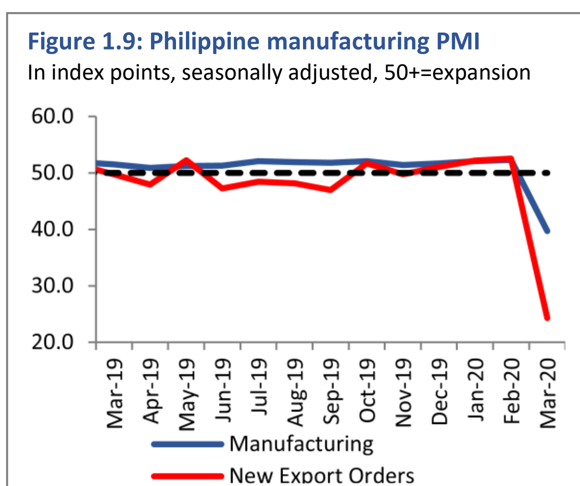
[12] The travel ban period for China began on 5 February 2020, Korea on 3 March 2020, and the US on 12 March 2020. The exceptions to the ban are Filipino citizens, their foreign spouse and children, permanent residents and holders of diplomatic visas (BI, DFA & CNN, 2020).

Figure 1.8: 2019 visitor arrivals of top 10 markets
In thousands



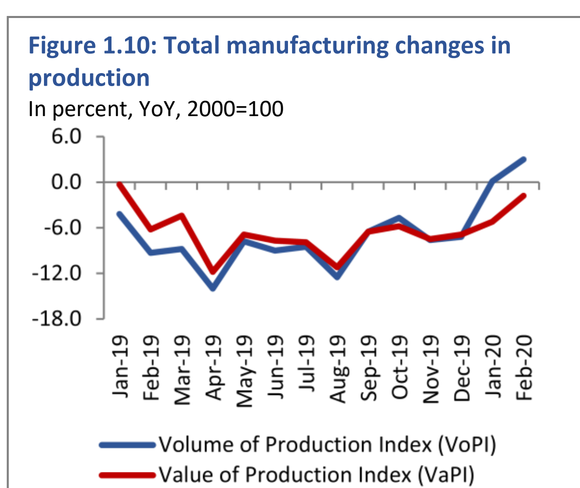
Source: Department of Tourism

Figure 1.9: Philippine manufacturing PMI
In index points, seasonally adjusted, 50+=expansion



Source: Refinitiv

Figure 1.10: Total manufacturing changes in production
In percent, YoY, 2000=100



Source: Philippine Statistics Authority

transportation, shopping, and food and beverage, among others. In fact, the NEDA estimated a loss of PHP23 billion a month for the tourism sector (Laforga and Espedido, 2020).

The manufacturing sector is already challenged given recent developments. The global growth slowdown, trade war, and now supply disruptions due to COVID-19 can further affect the domestic manufacturing sector due to its inherent exposure to the global supply value chain. With the sharp drop in volume of inbound shipments coming from China, this will further create frictions among manufacturing firms.[13] Maritime shipping through China's ports was reported to have contracted by 20 percent since January and several globally-integrated firms have warned of growing disruptions across their supply chains (WB, 2020).

In addition, the country's PMI for manufacturing new export orders, an indicator for global demand, contracted substantially, down to 24.3 in March 2020 from previous month's 52.6 (**Figure 1.9**). The sharp drop was due to the work stoppage and lockdown in the Luzon area, which affected the orders from both domestic and international clientele (IHS Markit, 2020).

Meanwhile, the value of production index (VaPI) for the sector has maintained its declining trend since January 2019, posting a negative 1.8 growth in February 2020 (**Figure 1.10**). In terms of the volume of production index (VoPI), however, the sector has rebounded as it posted a 3.0 percent growth in February of this year. Despite this, the NEDA expects that the global supply chain disruptions as well as the ECQ will weigh on the overall production of manufacturing output starting in March 2020 (Ordinario, 2020).

The services sector is also affected by the ECQ in Luzon. In particular, transportation, retail trade, and service activities that are not part of the food and health-related supply chains are affected. Given that Luzon accounts for 73 percent of the country's GDP, the ECQ will have a significant

[13] For the period of February 1 to 18, 2020 inbound shipments from China dropped by 62.2 percent in volume.

economic impact across various sectors, amounting to as much as PHP28.7 billion to PHP1.355 trillion in foregone revenues (Cordero, 2020). There have been numerous cancelled flights, stalled water and mass transport services, and inactivity in non-food and non-health-related manufacturing and services activities. The revenues of malls and gaming establishments are certainly expected to decline in the first quarter of 2020 (Gonzales, 2020).

Meanwhile, micro, small, and medium enterprises (MSMEs) are experiencing great difficulties due to market conditions. The MSME sector serves as the backbone of the Philippine economy as 99.5 percent of business enterprises in the country fall under this category and it contributes 62 percent and 25 percent to the country's workforce and exports, respectively (DTI, 2020). Like large businesses, the ECQ has affected the operations of MSMEs, but these firms have less financial space than their larger corporate counterparts.

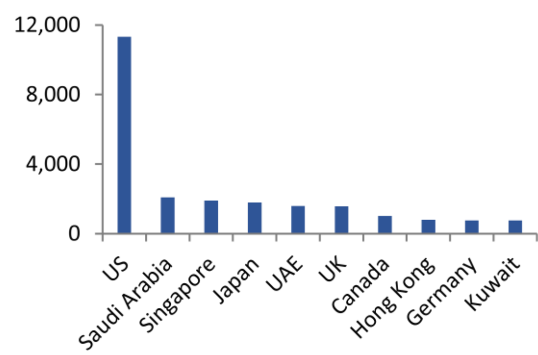
A recent survey by the Philippine Exporters Confederation Inc. revealed that 70 percent of the MSME exporters trade with severely-affected COVID-19 countries namely, China, US, Japan, and Singapore.[14] Moreover, these firms are appealing for government intervention, specifically financial assistance and tax breaks to offset the losses brought about by the recent pandemic (BusinessMirror, 2020). The developments have resulted in a slowdown in market demand, higher cost of raw materials and intermediate goods, and increase in logistics costs. The travel restrictions worldwide led to late shipments, canceled export and import orders, as well as loss of buyers and suppliers. On top of these issues are problems arising from the lack of funds, transportation issues, and delays in remittances.

COVID-19 is a threat to domestic employment. It is estimated that over one million workers employed nationwide have been displaced due to temporary business closures or flexible work arrangements (FWA), with Metro Manila recording the highest number (CNN, 2020). Most of the workers are from the manufacturing, hotel, restaurant, and tourism-related sectors, which are operating under FWA, including reduced workdays, rotation of workers, and forced leaves.[15] These sectors — manufacturing, transportation and storage, and accommodation and food services, comprise nearly half (21.1 million) of the total 42.4 million workers reported in 2019 (PSA, 2020).

[14] The 36 survey respondents came from shipping and logistics; chemicals; electronics; food; footwear; leather and travel goods; furniture; garments and textiles; holiday decors, gifts and premiums; housewares; IT products and services; metals; and resource-based sectors. Small enterprises dominated at 41.7 percent of total respondents.

[15] The implementation of an FWA for businesses is better than to totally close shop or retrench laborers according to Labor Secretary Silvestre Bello III (Yee, 2020).

Figure 1.11: 2019 OFW remittances of top 10 markets
In USD million



Source: BSP

Overseas employment is also affected especially in COVID-19 affected countries, which in turn, lowers remittances. Overseas Filipino Workers (OFWs) cash remittances reached USD30.1 billion in 2019, with 37.6 percent coming from the US. The top ten sources of remittances have already reported increasing cases of COVID-19 (**Figure 1.11**). Moreover, the Department of Labor and Employment stated that a thousand of OFWs were deported, while 1,500 and 521, were displaced and stranded, respectively (Yee, 2020). NEDA estimates that a 30.0 percent decline in OFW jobs in tourism related sectors will displace approximately 100,000 workers and translate to PHP5.7 billion losses in potential remittances (NEDA, 2020).

If there is some upside to COVID-19, it is that inflation is expected to stay low. [16] The lower oil prices should directly translate into reduced onshore gasoline prices, as well as lower production cost. This would be a tremendous boost in normal times but its positive effect will be partially muted by disruptions in the supply chain and the decrease in consumer demand once incomes are compromised. This highlights where the interventions may be targeted moving forward. In the meantime, for as long as inflation remains low, monetary authorities have added leeway to intervene in order to jumpstart the economy.

On the whole, the dislocations from COVID-19 are already evident but arguably its full effects still lie ahead. Authorities then face the difficult task of addressing the current difficulties while keeping an eye towards the future. Systemic risks must now be directly confronted. The effects of COVID-19 are already substantive and market updates are literally a day-to-day event. This chapter alone has been re-written and updated repeatedly so that it reflects a reasonable accounting of the latest developments. Numbers aside, however, no one can dispute that the global economy is in the midst of a systemic risk that has been realized. This is not because of the magnitude of the damage but rather by the fact that the world has been affected through channels of contagion, connectedness, and correlations. This reiterates that action needs to be organized and collective, not only to contain the spread of the virus but also to mitigate further systemic risks to the macroeconomy, their people, and to the financial market.

[16] YoY inflation continued to soften for March 2020 as it posted 2.5 percent from the previous month's 2.6 percent. It should be noted that this is within the BSP's target range of 2.0-2.8 percent for March 2020. Likewise, the year-to-date average inflation rate of 2.7 percent falls within the year 2020 Government target range of 3.0 percent ± 1.0 percentage point (BSP, 2020).

CHAPTER 2 FINANCIAL VULNERABILITIES

COVID-19 is a public health issue that caused a disruption to the real economy, with the IMF saying that the expected damage has not been seen since the Great Depression. As countries grappled to control the highly infectious virus, policy measures that inevitably lowered economic activity had to be in place to contain the spread, eroding incomes and financial conditions. The current dislocations are indeed systemic and have likewise triggered a change in behavior among investors. In particular, it resulted in a rebalancing of portfolios that consequently heightened risks and the pricing of risks.

2.1 Portfolio rebalancing and repricing

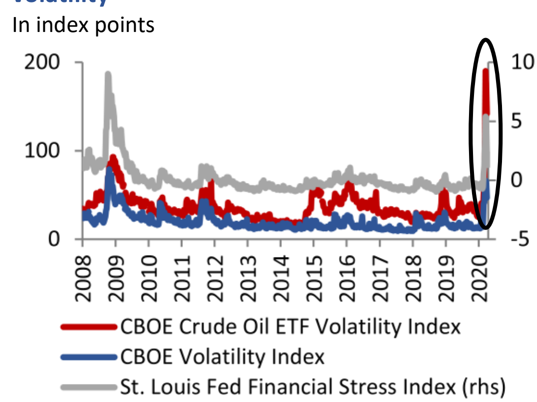
COVID-19 is causing a global recession and financial market investors have rebalanced their portfolios towards more liquid assets. The markets are seeing a spike in financial stress indices, reaching levels that have not been seen since the GFC (**Figure 2.1**). The IMF has suggested, however, that the world should be prepared for worse as their prognosis points to declines not seen since the Great Depression of 1929.

The rise in financial stress is easily evident in the US equity market. Supply chains have already been disrupted by COVID-19 and future corporate incomes will likely decline further as countries suspend domestic and cross-border economic activities to contain the spread of the virus. The equity market is already discounting this drop in income, with the stock prices of airline and oil companies as prominent examples.

With so much uncertainty about the current state and of the norms post-COVID-19, there has been a general movement out of longer-term assets and into more liquid investment outlets. Equity investors have seen losses as a result (**Figure 2.2**).

Figure 2.1: Market stress and asset price volatility

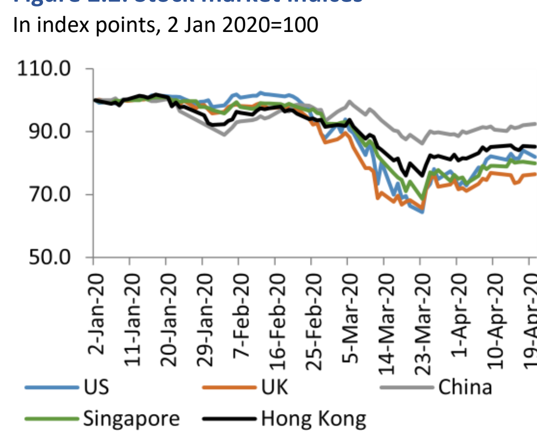
In index points



Source: FRED

Figure 2.2: Stock market indices

In index points, 2 Jan 2020=100



Source: Refinitiv, staff calculations

In EMEs, the same rebalancing is evidenced by the massive outflow of portfolio funds, levels that have surpassed the reversals recorded during the GFC (**Figure 2.3**). This is reinforced by the comparison done by the Institute of International Finance (IIF), which looked at the outflows from stocks and bonds in EMEs for a 51-day period, one after 08 September 2008 (GFC) and the other after 21 January 2020 (COVID-19 outbreak). They show that the rout during this pandemic, which stood at USD41.7 billion, is twice as much than during the GFC, with stocks being sold-off more than bonds (Wheatley, 2020). This highlights significant risk aversion, despite the initial shock not coming directly from the financial market.

The rush for liquidity and safe-haven assets raised the demand for the USD. The rebalancing saw the shift towards USD money market funds (**Figure 2.4**), US treasuries, and gold (**Figure 2.5**). With the rebalancing cutting across borders and currencies, the result is unsurprising — that is, the USD strengthened in trade-weighted terms (**Figure 2.6**). This conservative stance is expected to continue until the outbreak is under better control and the cross-currency price of risks becomes more tangible.

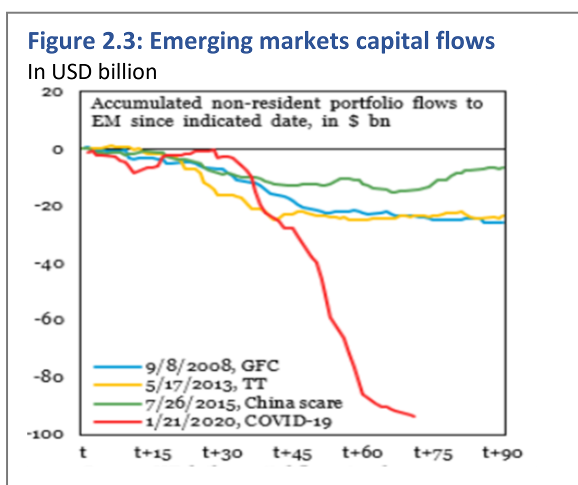


Figure 2.3: Emerging markets capital flows
In USD billion

Source: IIF

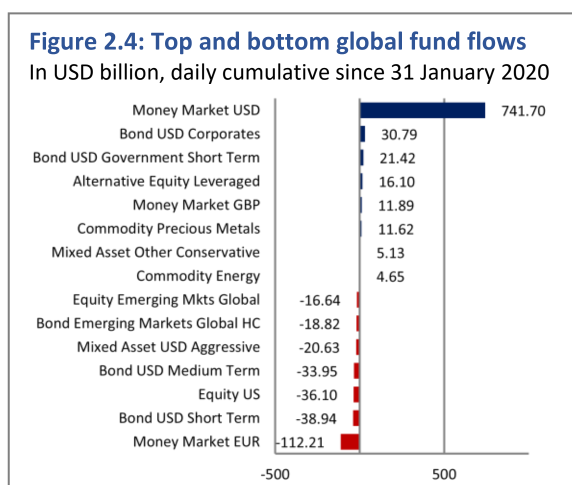


Figure 2.4: Top and bottom global fund flows
In USD billion, daily cumulative since 31 January 2020

Source: Refinitiv, staff calculations

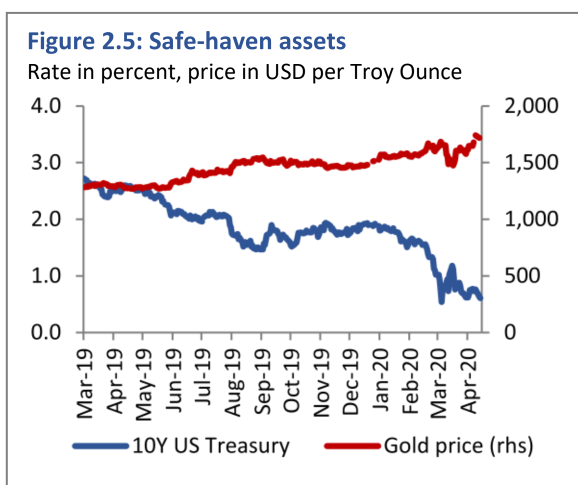


Figure 2.5: Safe-haven assets
Rate in percent, price in USD per Troy Ounce

Source: FRED

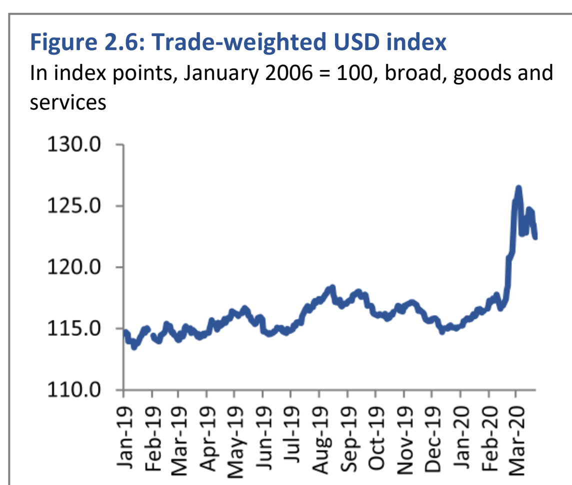


Figure 2.6: Trade-weighted USD index
In index points, January 2006 = 100, broad, goods and services

Source: FRED

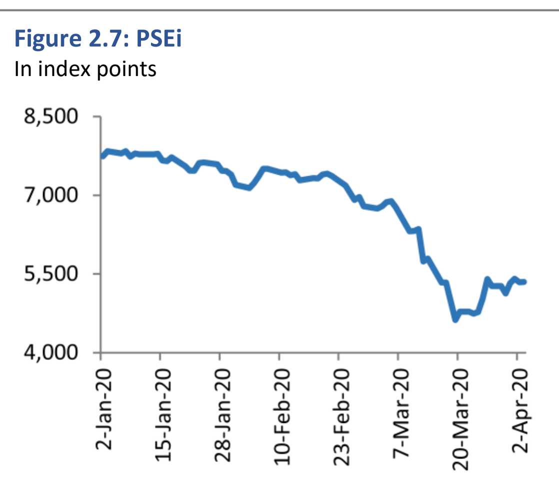
The tightening in the global capital and foreign exchange (FX) markets prompted various governments to take further action. On 16 March 2020, the European CB announced the coordinated action of several CBs to enhance the provision of liquidity in USD swap arrangements by lowering its price.[17] In addition, the US Fed eased the USD liquidity crunch by launching the Commercial Paper Funding Facility and Primary Dealer Credit Facility, both aimed at meeting dollar demand for the short-term (Westbrook, 2020).

This rebalancing was also evident in the domestic market. Philippine equities bore the brunt as it dove deeper into bearish territory (**Figure 2.7**). On 09 March 2020, the Philippine Stock Exchange index (PSEi) experienced its largest drop since the GFC, amounting to a PHP663 billion loss in wealth (Dumlao-Abadilla, 2020). This followed news of the confirmation of localized transmission and the announcement of "Code Red" sublevel 1 on the COVID-19 alert system for the country on 07 March 2020 (DOH, 2020). The equity sell-off escalated further, even with the circuit breakers of the PSE being triggered thrice in the same month.[18]

There are, however, notable differences in how rebalancing has been executed in the Philippines. When compared with other Asian economies, the rebalancing in the Philippines stands out (**Table 2.1**). In Thailand and Indonesia, there is a shift out of every asset class, which suggests a preference for cash. Malaysia shows the shift heading towards bonds, while India curiously shows a rebalancing towards longer-term assets.

The Philippines, in contrast, has shun mixed assets and shows a preference for specific asset holdings, particularly for local money market instruments. The country's credit default swap (CDS) spreads and term premiums have also eased in the recent period (**Figures 2.8** and **2.9**). Looking at the spreads between PH and US fixed income instruments, the risk premium gap has also tapered.

Figure 2.7: PSEi
In index points



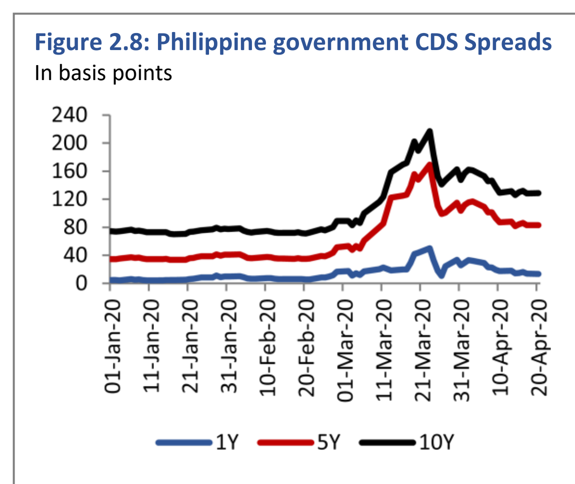
Source: Refinitiv

Table 2.1: Year-to-date portfolio rebalancing
in USD million

Fund Domicile	Bond	Equity	Mixed Assets	Money Market
India	344	5,324	-89	-7,669
Indonesia	-420	-136	-111	-144
Malaysia	664	-608	-32	-40
Philippines	38	91	-36	1,040
Thailand	-6,549	-1,089	-523	-5,943

Source: Refinitiv, staff calculations

Figure 2.8: Philippine government CDS Spreads
In basis points



Source: Refinitiv

[17] The Bank of Canada (BOC), Bank of England (BoE), Bank of Japan (BoJ), Federal Reserve (Fed), and the Swiss National Bank (SNB)

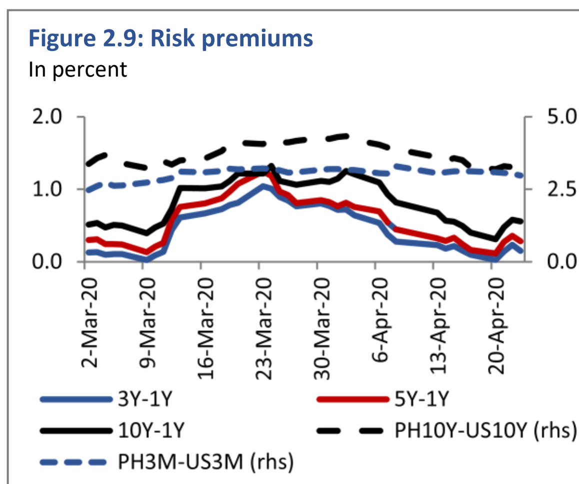
[18] The circuit breaker rule halts trading for 15 minutes if the main index drops by 10 percent. It was triggered on March 12, 13, and 19. The last time the circuit breaker was triggered was on 27 October 2008, just when the GFC was unfolding.

With no immediate shift towards foreign currencies, the PHP has been relatively stable compared to its peers. In February, portfolio investments actually posted a net inflow after several months of outflows (BSP, 2020). Recent imports data shows a drop in YoY growth to –11.6 percent in February 2020 from 2.0 percent in February 2019 (PSA, 2020), reducing demand for the USD. Likewise, the high level of gross international reserves (GIR)[19] seems to provide some assurance for the market. All these eased any downward pressure on the PHP while most EME currencies weakened sharply in the first quarter of 2020 (**Figure 2.10**). Spot prices show a stable PHP in April 2020 amidst low trading volume since the ECQ (**Figure 2.11**).

2.2 Heightened vulnerabilities

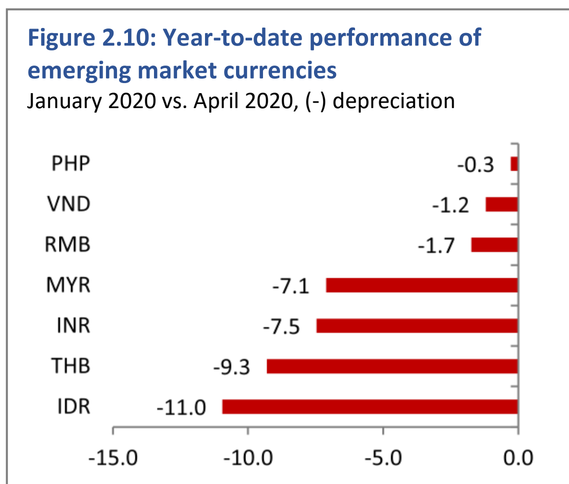
Risk aversion has undoubtedly increased. The uncertainties of the current situation and what the future arrangements may look like are clearly evident in the spike in risk aversion (**Figure 2.12**). The rise began in mid-January 2020 as the COVID-19 outbreak began to surface (BIS, 2020). Moreover, the repricing and rebalancing discussed in the previous section seem to have heightened risk perceptions further, particularly liquidity and credit risks (FSB, 2020).

Figure 2.9: Risk premiums
In percent



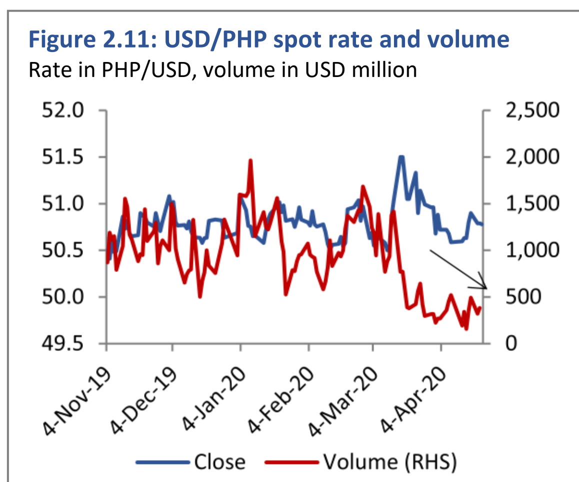
Source: FRED, PDS Group, staff calculations

Figure 2.10: Year-to-date performance of emerging market currencies
January 2020 vs. April 2020, (-) depreciation



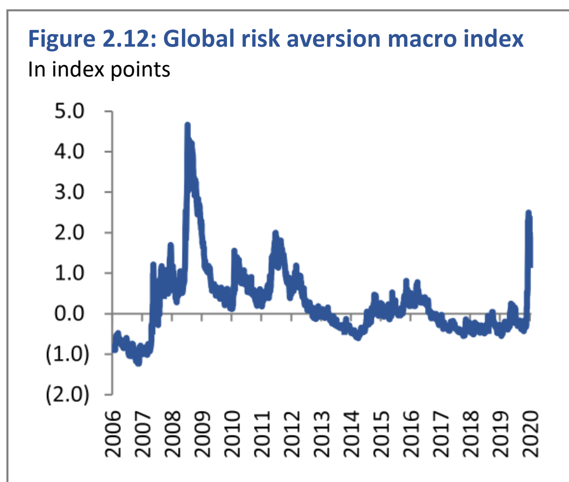
Source: Refinitiv, staff calculations

Figure 2.11: USD/PHP spot rate and volume
Rate in PHP/USD, volume in USD million



Source: Refinitiv, BAP

Figure 2.12: Global risk aversion macro index
In index points



Source: Refinitiv

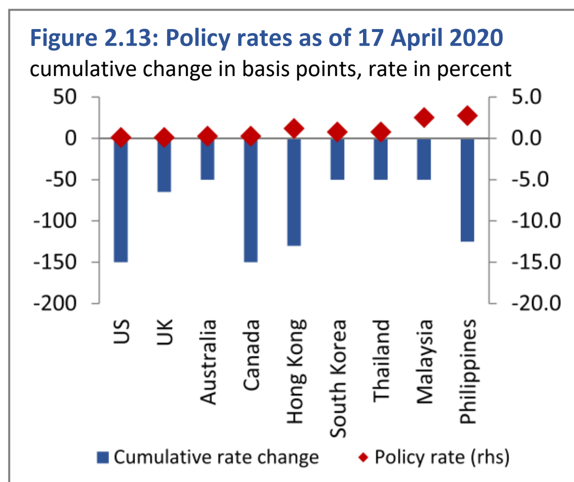
[19] As of end-March 2020, the country's GIR is at USD89 billion, which can cover as much as 7.9 months' worth of imports of goods and services and payments of primary income (BSP, 2020).

To support funding markets, CBs infused liquidity while reinforcing lower-for-longer yields. As the pandemic threatened macroeconomic and financial stability, CBs re-used their monetary tools deployed during the GFC, such as the reduction of the policy rate to near — if not, at — zero and the resumption of bond-buying programs (**Figure 2.13**). The challenge, however, is that if the adverse effects linger further and worsen beyond GFC levels, as suggested by the IMF, financial authorities will have to consider new and additional interventions.

A particular concern is debt-at-risk. For some time now, risk prognoses have pointed to the build-up of debt in the low-for-long era. While the level and growth of debt had been frequently cited as possible vulnerabilities, the strains imposed by the pandemic will cause debt servicing difficulties. This will primarily be driven first by reduced income due to suspended economic activity and, then second, through the interlinkage of the income fallout from one entity to another. This is the case between industries, among firms and even among household debt in the informal sector.

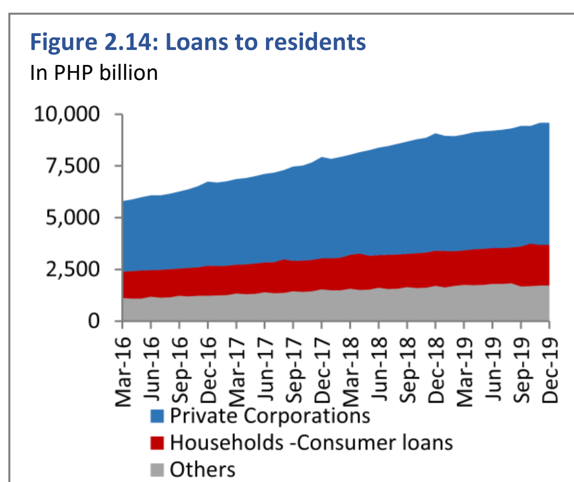
Available data limits us only to the formal markets. Loans to residents are still dominated by corporate borrowers, accounting for approximately 60 percent of the total (**Figure 2.14**). For cross-border claims, the non-bank private sector represents the majority of the debt (45.1 percent of total claims), but the sharp increase in the debt of the banking industry warrants further assessment (**Figure 2.15**). Moreover, the outstanding corporate debt among 200 listed companies stood at PHP9.3 trillion, 28.4 percent of which is denominated in foreign currency (FCY). This year, USD3.46 billion of FCY debt will mature, while PHP553 billion in local currency is likewise due (**Figure 2.16**). The latter will be tested by any impairment in revenues, and thus capacity to pay, while the former will add pressure on USD liquidity, on top of income capacity.

Figure 2.13: Policy rates as of 17 April 2020
cumulative change in basis points, rate in percent



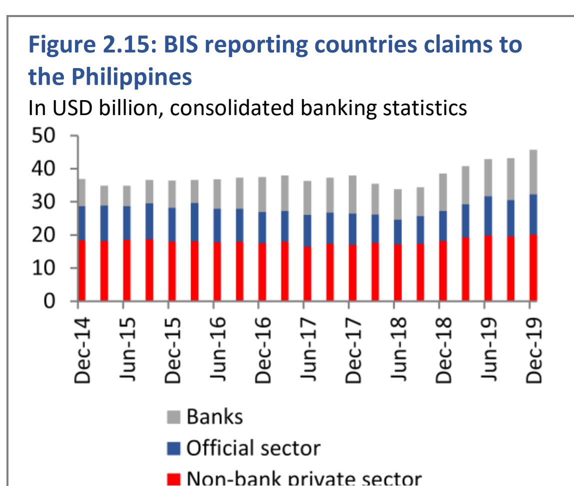
Source: Bank for International Settlements (BIS)

Figure 2.14: Loans to residents
In PHP billion



Source: BSP

Figure 2.15: BIS reporting countries claims to the Philippines
In USD billion, consolidated banking statistics



Source: BIS

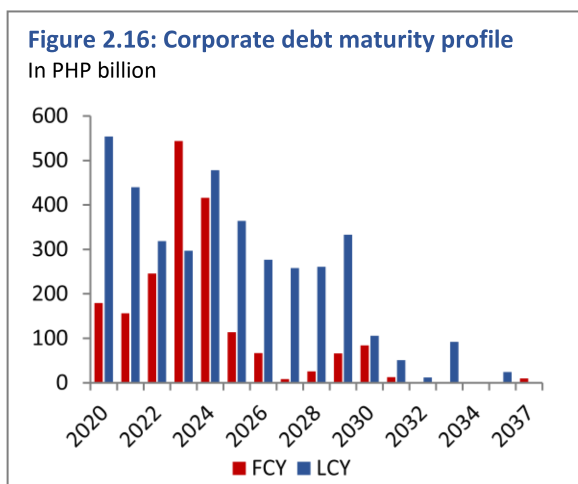


Figure 2.16: Corporate debt maturity profile
In PHP billion

Note: Sample based on 200 listed companies with debt capital structure data as of Q3 2019.
Source: S&P Capital IQ, staff calculations

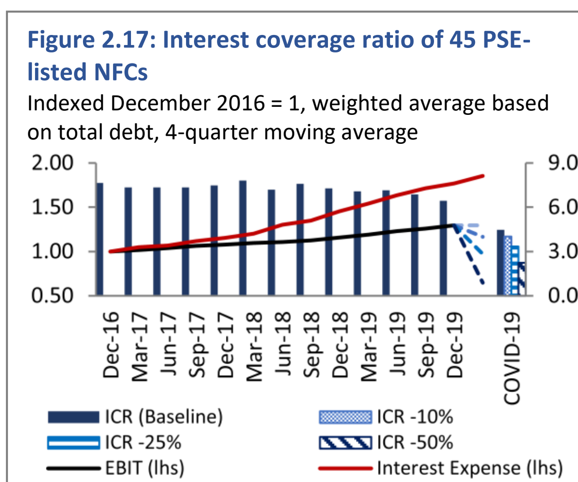


Figure 2.17: Interest coverage ratio of 45 PSE-listed NFCs
Indexed December 2016 = 1, weighted average based on total debt, 4-quarter moving average

Note: Based on 45 companies with Q4 2019 disclosure
Source: S&P Capital IQ, staff calculations

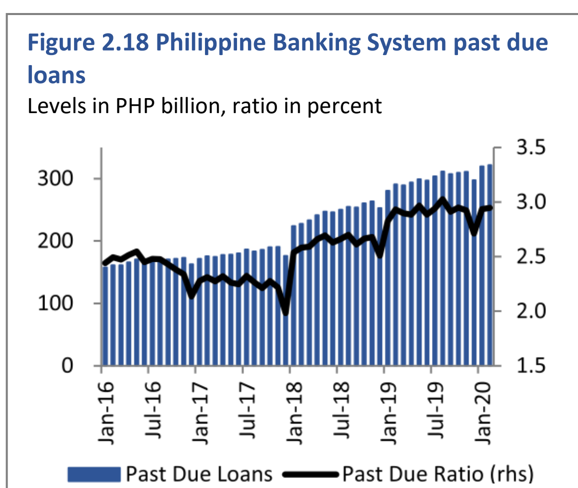


Figure 2.18 Philippine Banking System past due loans
Levels in PHP billion, ratio in percent

Source: BSP

It should be pointed out that the debt repayment capacity of some PSE-listed non-financial corporates (NFCs) was already declining before the emergence of COVID-19. The interest coverage ratio (ICR), which is a measure of the firm's ability to service the interest obligations of their debt, has been decreasing in recent periods as interest expense has grown by an annualized rate of 20.9 percent, while earnings before interest and taxes (EBIT) has only grown by 9.0 percent over the past three years (**Figure 2.17**). Stress test estimates suggest that the ICR declines from 6.44 in Q4 2019 to 4.01 (at 10 percent EBIT decline) or further to 2.23 (at 50 percent EBIT drop). Although the policy rate has been reduced starting April 2019, the impact of lower rates on existing bank debts would not be felt until the repricing of those loans usually a year later.

The strain on the banking books will come through a further impairment in past due loans (PD). The pressure on income increases the likelihood of missed debt payments. However, even before 2020, PD were already trending upward, both in absolute amounts and as a percentage of loans (**Figure 2.18**). Some caution is warranted in assessing the PD numbers since the new definition[20] calls for a loan to be classified as PD one day after it misses a due payment. A cure period is, nonetheless, provided for by current regulations and in this context, any volatility in reported PD needs to be understood alongside the trend of non-performing loans (NPL), in terms of both absolute amounts and as a percentage to total loans. Further to this, **Figures 2.19** and **2.20** show that PD but not yet NPLs exhibit a faster pace of growth compared to NPLs for both consumer and corporate loans. Despite the fact that the share of the impaired accounts to total loans remain minimal, there is a need to closely monitor the PD but not yet NPLs alongside the outright NPLs, and its respective proportion to outstanding loans, to determine the eventual impact of COVID-19 on the banking books especially in the event of a more protracted contraction in economic activities.

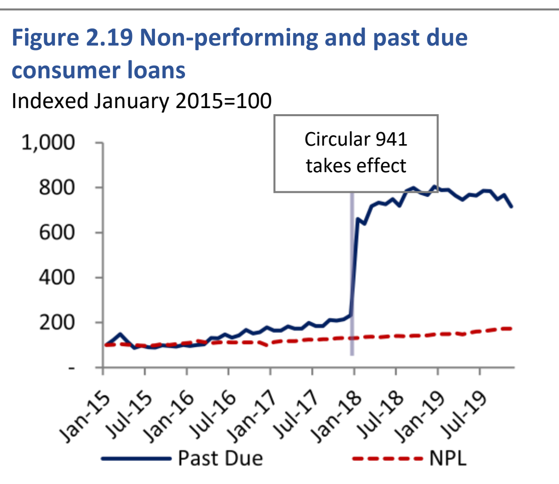
[20] Circular 941 brings back the pre-AFC standard of classifying an account as PD one day after the missed payment. Although a cure period is provided, the reckoning period was shortened to one day after due date from three missed monthly payments or one quarterly missed payment. Under the new guidelines, the new NPL definition is an account that has been PD for 90 days.

There may be vulnerabilities elsewhere in the system. For insurance companies (InsCos), massive and sudden shifts in market yields can cause a mismatch between the long-term returns promised in the policies sold to clients versus the yields realized by their investments. While actuarial estimates are still being recalibrated, there may also be a fair amount of unscheduled claims that may be redeemed by policyholders and it is not clear if liquidity is also at risk, given market conditions.

For households, we cannot directly estimate the impact on debt servicing from the erosion of incomes. On paper, salaries and wages account for about 36 percent of GDP (based on 2018 data). This, however, includes professionals who are under contract and will be paid on a monthly basis regardless if a pandemic materializes. The most vulnerable are the workers who are part of the informal sector or whose wages depend on the occurrence of events, that is, those who are on no-work-no-pay arrangement in the "gig economy". This aspect has not been assessed and would not benefit from the current relief program extended in the formal financial market.

Figure 2.19 Non-performing and past due consumer loans

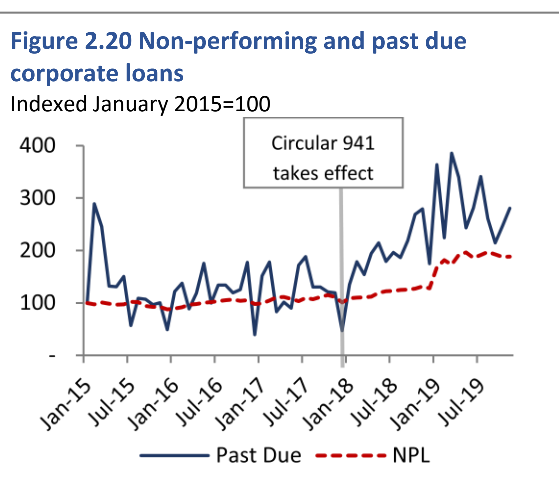
Indexed January 2015=100



Source: BSP, staff calculations

Figure 2.20 Non-performing and past due corporate loans

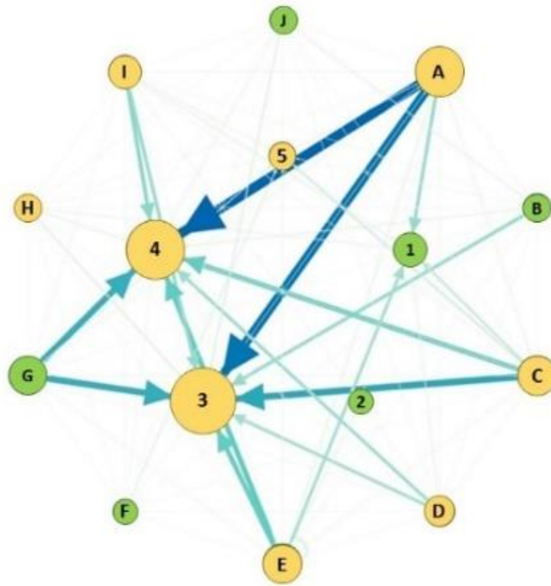
Indexed January 2015=100



Source: BSP, calculations

If the strain on incomes and economic activity linger, systemic risks will certainly amplify. The results of the network model show that the possible cascade of defaults is more than a function of size alone. There are certain firms that are "more contagious" and thus affect the system more due to the way they are linked with other entities, rather than their balance sheet size (**Figure 2.21**). For instance, node I whose total asset size is less than half of the largest nodes in the system caused two firms to fail while five out of the seven firms with larger asset size caused only one or no failures at all. Moreover, the average induced failures are greater for simultaneous shocks to the system than the summation of the failures emanating from shocks to individual firm. This observation is critical as it highlights one of the key lessons learned in previous crises — that is, small shocks can lead to large dislocations. It is, therefore, imperative to address the brewing risks identified in this chapter before it triggers a cascading failure in the financial system.

Figure 2.21: Visualization of Network Model



Note: Node size is based on the firm's total assets while the lines are the corresponding bilateral credit exposures of firms. Nodes that are labeled with letters are banks while those with number labels are conglomerates. Yellow nodes are the firms that were shocked in the simulation while green nodes are the firms who experienced failure after the shock.

Source: BSP, staff calculations

CHAPTER 3

OVERALL STATE OF STABILITY AND ACTION ITEMS

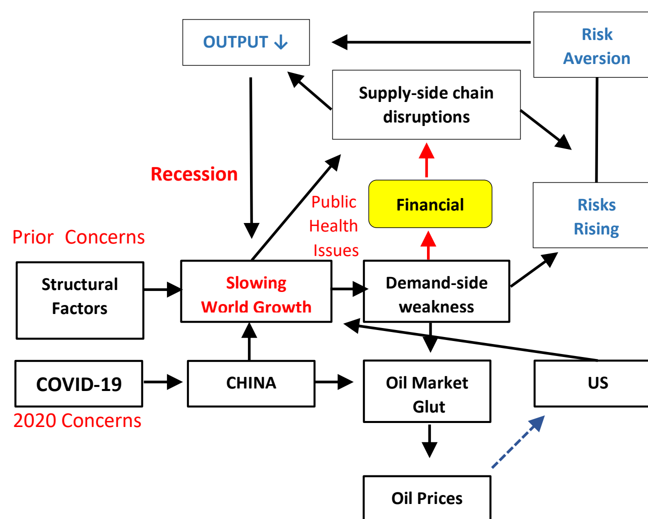
COVID-19 is unprecedented on many levels. The economic damage caused by the containment measures has pushed the world into a recession, with the shape of the recovery still unknown. Likewise, the events in the real economy have partially spilled over to the financial market, as shown by the changing risk premiums, falling asset prices, and pronounced shifting to safe-haven assets. The immediate response of authorities has curtailed some of the pressure points faced by both the domestic economy and financial market, yet there remain some vulnerabilities that warrant policy response. To this end, additional measures are proposed, some of which have more immediate impacts while others intend to instill resiliency against future shocks.

3.1 State of stability

The easy answer is that the economy is in a state of instability. This can be qualified further by noting that the macroeconomy is vulnerable and one can see portfolio shifts in the financial market in response to heightened risk premiums. The more difficult discussion is the prognosis of what lies ahead, with the IMF expecting that the damage will exceed those of the GFC and comes closer to those seen during the 1929 Great Depression. As of this writing, the Federal Reserve of St. Louis reports a quarter-on-quarter US GDP decline of 4.8 percent for Q1 2020 and a YoY nowcast of minus 16.6 percent for Q2 2020. From all accounts, one should reasonably expect more instability in the market before one can see any stabilization, let alone a recovery.

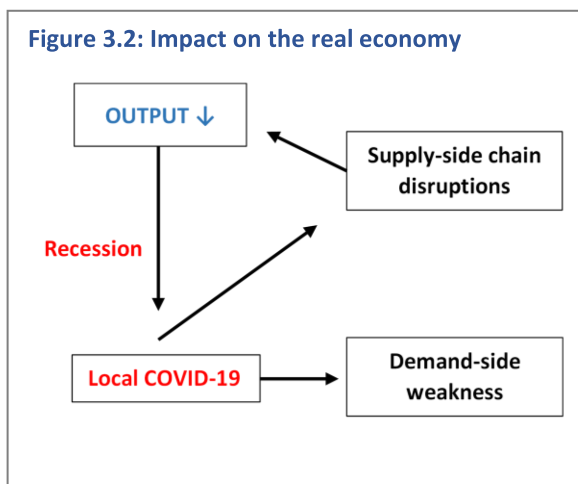
How economies move forward will depend on one's understanding of where the vulnerabilities truly lie (Figure 3.1). COVID-19 needs to be understood as a shock to the real economy, unlike the Great Depression, the AFC and the GFC, which all took root in the financial markets. The outbreak emanated from China — the factory of the world — and from the city of Wuhan (a transportation hub and aptly nicknamed "China's thoroughfare") that facilitated the breakdown in the supply chains and the spillover to other jurisdictions.

Figure 3.1: Underlying relationships



Source: FSCC

Figure 3.2: Impact on the real economy

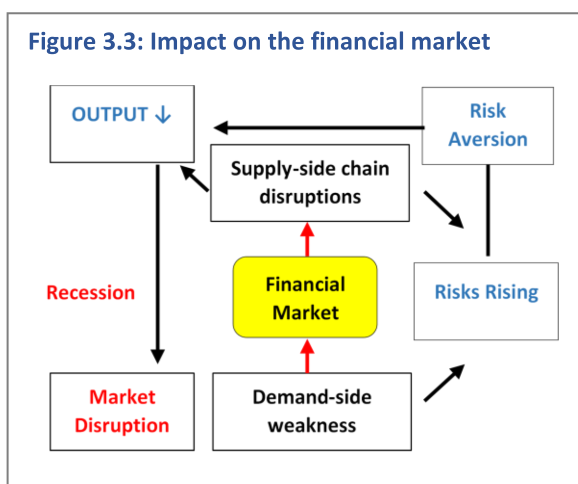


Source: FSCC

This does not change the fact that COVID-19 is principally a public health issue, and its containment requires the suspension of business activity, and instilling prohibitions on local and cross-border travels, both of which result in significant erosions in incomes and cashflows (**Figure 3.2**). To move forward then, one cannot escape dealing with rebooting large segments of the macroeconomy while risk aversion remains elevated and addressing the erosion of incomes at a time when the economy cannot be "business-as-usual."

Several analysts though are already looking ahead to the recovery. It certainly is difficult to forecast the path of the recovery given that so much of COVID-19 remains uncertain. Past crises though suggest that it could be a "V", "W", "U", or "L" (Kennedy and Jamrisko, 2020). These differ in terms of whether the shock is temporary ("V") or permanent ("L"), or whether a second wave is likely but readily addressable ("W") or the adverse impact lingers ("U").

Figure 3.3: Impact on the financial market



Source: FSCC

Carlsson-Szlezak et al. (2020) suggest that the outcome will depend on the extent of damage to capital formation or the supply side. However, delimiting one's view to the macroeconomy neglects the fact that risk premiums will also change, both because borrowers have difficulties servicing debt and because income pressures lead to impaired saving. As risk aversion increases, a threshold is reached where attractive market yields no longer influence risk-taking. This cuts off funding and liquidity, reduces output, and reinforces the damage to the rest of the economy (**Figure 3.3**).

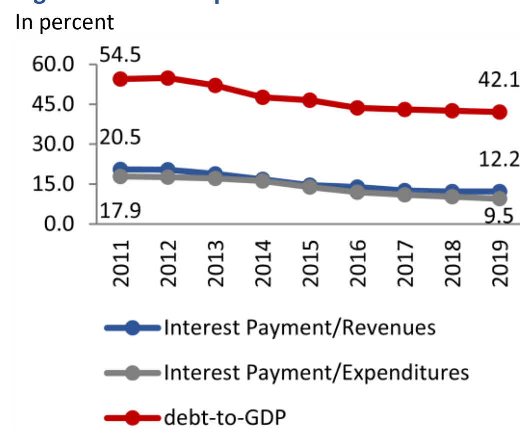
On the whole then, the country must address the public health issue, re-ignite economic activities, provide bridge funding to support eroded incomes, and manage the changing risk premiums in the financial market. All these come together and dictate the state of stability, both now and moving forward.

3.2 Policy initiatives

3.2.1 Early response

Given the disturbances caused by COVID-19, the National Government (NG) must take the point in terms of relief. Fortunately, the Philippines has fiscal space to carry a significant portion of the relief initiatives. The debt-to-GDP ratio of the country and interest payments as a percentage of revenues and expenditures have significantly dropped over time (**Figure 3.4**). This provides the government the leeway to raise their expenditures, subject to national budget appropriations under the law, to address the needs of the COVID-19 outbreak.

Figure 3.4: Fiscal space
In percent



Source: BTr, CEIC, staff calculations

a. *Bayanihan to Heal as One Act or Republic Act 11469 (Bayanihan Law).* The Bayanihan law was passed on 24 March 2020, granting special powers to the President to quickly respond to the COVID-19 health crisis. The law allows for the acceleration of the budget execution and reallocation of resources towards COVID-19-related programs. It also expedites the implementation of the necessary measures and provides emergency subsidies and payment holidays to help Filipinos cope during this difficult period.

b. *Three-phased program of interventions to counter COVID-19.* The NEDA has developed a three-phase program — response, mitigation, and transition — that will allow the economy to bounce back quicker from this crisis.[21] The response phase focuses on fast-tracking the public health response by ramping up the healthcare system's capacity and implementing the preventive measures to flatten the curve. The second phase deals with the rebuilding of consumer confidence and providing assistance to the affected sectors. Lastly, the third phase proposes a transition to a new normal state of economic activity as the economy recovers from the public health crisis.

c. *Four-pillar socioeconomic strategy against COVID-19.* As of 21 April 2020, the total budget of the four-pillar strategy is at PHP1.49 trillion. The first pillar is the emergency support for the vulnerable groups and individuals while the second pillar boosts the public health resources to fight the virus. The third and fourth pillars highlight the fiscal and monetary actions as well as the recovery plan that will support the overall macroeconomy (DOF, 2020).

[21] Prior to the enactment of the Bayanihan law, the NEDA released their proposed plan to counter the spread and economic damage of the virus (NEDA, 2020).

d. *Inter-Agency Task Force for the Management of Emerging Infectious Disease (IATF) and whole-of-government approach in overcoming the COVID-19 pandemic.* The IATF is the inter-agency body that is handling the NG's response to COVID-19 and has been providing recommendations to the President regarding the necessary measures to address the situation, such as the community quarantine guidelines. Moreover, with the Bayanihan Law, the Office of the President provides a weekly update on all the programs and activities of the Executive Branch (Official Gazette, 2020). In particular, it highlights the programs under the four major objectives:

   i. *Providing emergency assistance to all affected sectors.* This includes the social amelioration programs for the most vulnerable sectors, such as MSMEs, farmers, displaced workers, and the Pantawid Pamilyang Pilipino Program beneficiaries. It also details the transportation, logistical, and repatriation assistance provided to concerned individuals, as well as other measures to ensure that Filipinos have access to basic necessities, such as water, electricity, and internet connectivity, to name a few.

   ii. *Securing facilities and resources for the health sector and other frontliners.* This focuses on the programs that boost and augment the capacity of the health sector to address the public health crisis. Key programs are the COVID-19 testing and contact tracing measures, provisions of healthcare resources, and the improvement of the quarantine facilities.

   iii. *Establishing sound fiscal and monetary actions that are responsive to all stakeholders.* Given the restrictions on movement and activity brought about by the ECQ, relief measures, moratoriums, and deadline extensions were implemented to ease the burden on affected individuals and firms. For transparency, a summary of the allotments, cash allocations, and funding sources are also reported.

   iv. *Responsive and sustainable recovery plan.* In response to the "new normal" setup after the pandemic, this objective discusses the strategies and possible arrangements once the quarantine restrictions are lifted. Moreover, it provides updates on the post-rehabilitation plans and potential post-ECQ scenarios.

The BSP has also implemented several measures to support the NG in their response to the crisis as well as to keep the financial system functioning during this period. Policy measures — such as rate cuts and reserve requirement reduction — were made to infuse liquidity into the system while operational and regulatory relief measures were provided to ease financial conditions and lessen the burden on financial institutions during this challenging period (BSP, 2020). Specifically:

a. *Entering into a repurchase agreement with the NG.* On 23 March 2020, the BSP agreed to enter into a PHP300-billion repurchase deal with the BTr to support the programs of the NG to combat the impact of the COVID-19 outbreak. In addition, the CB stands ready to increase it further to PHP500 billion, if needed (Agcaoili, 2020).

b. *Reducing the policy rate and reserve requirement.* The BSP has reduced the policy rate thrice in 2020, resulting in a cumulative change of 125 basis points and bringing the overnight borrowing rate down to 2.75 percent. It also reduced the reserve requirement by 200 basis points, which took effect on 30 March 2020.

c. *Scaling down the Overnight Reverse Repurchase volume offering*. This lower volume offering, which began on 08 April 2020, is expected to promote lending in the interbank market.

d. *Purchasing government securities (GS) in the secondary market.* The objective is to encourage participation in the secondary market by reassuring participants of demand for GS. Starting 08 April 2020, the BSP also expanded the range of eligible GS by covering all peso-denominated issuances (Chipongian, 2020).

e. *Temporarily reducing the term spread on the peso rediscounting loans relative to the overnight lending rate to zero.* In April 2020, the Peso Rediscount Facility remained at 3.75 percent regardless of loan maturity to allow banks to tap the facility to meet their liquidity needs (BSP, 2020).

f. *Operational relief measures for FX transactions to facilitate the access to FX resources.* In particular, the BSP relaxed the documentary and reporting rules for FX transactions such as, allowing electronic submissions of documents, use of digital signatures, and relaxation of deadlines, to name a few.

g. *Regulatory relief measures for banks to encourage the supervised financial institutions to provide financial relief to their customers, clients, and employees.* These measures include the temporary grace period for loan payments, restructuring of loan accounts, and financial assistance.

h. *Prudential accounting relief measures to reduce the impact of mark-to-market losses on the financial condition of supervised financial institutions.* Specifically, the adjustments relax the rules on the expanded FCY deposit unit/FCY deposit unit and the reclassification of debt securities.

i. *Relaxed Know Your Customer requirements for both over the counter and electronic or online transactions.* This is to help facilitate the delivery of welfare funds to identified beneficiaries of the government.

Financial authorities — the Philippine Deposit Insurance Corporation (PDIC), Insurance Commission (IC), and Securities and Exchange Commission (SEC) — have introduced measures for their supervised entities. Various forms of regulatory relief had been granted by the financial authorities:

a. The PDIC announced the grant of payment relief for corporate and closed banks' clients whose *payments for loans, real property purchases, and lease fall due during the community quarantine period.* Under the relief measure, borrowers who have scheduled payments, including down payments, were not obligated to settle their accounts during this period. They can thus settle their payments due, without penalty charges, one month from the lifting of the quarantine period. All subsequent amortization schedules will also be adjusted by a month.

b. Meanwhile, the IC extended the coverage of insurance policies and Health Maintenance Organization agreements about to expire during the quarantine. The IC also extended the filing and submission periods of various reportorial and regulatory requirements due to the extension of the ECQ.[22] To ensure the continued availability of insurance products during the period, the IC allowed the remote selling of insurance products thru the use of information and communication technology. Lastly, temporary reprieve has been granted to the six insurers that failed to meet the PHP900 million capitalization requirement at the end of 2019.

[22] See Insurance Commission Circular letters 2020-43 and 2020-47

c. Likewise, the SEC extended the filing of annual reports and suspended the payment of cumulative penalties for covered companies. The SEC, in accordance with the Bayanihan Law, required all financing companies, lending companies, and microfinance non-governmental organizations to implement the mandatory 30-day grace period for all loans falling due during the ECQ. Further to this, foreign firms, which were initially required to file initial securities deposit within 60 days after the issuance of their SEC licenses, were allowed to file their initial securities deposit 30 days from the lifting of the ECQ. The SEC also approved the offsite trading protocols to be taken by the PSE in ensuring the continued operations of the capital market despite the quarantine. Lastly, the SEC has transferred PHP2 billion to the BTr to augment the government's funding pool for the pandemic response. These measures were meant to help their stakeholders cope with the current situation.

Apart from the government, the private sector has also been up to the task of bridging the gap and pitching in the needed assistance of the frontliners, their employees, and the most vulnerable sector. The Philippine Disaster Resilience Foundation's Project Ugnayan, a fundraising program composed of private business establishments, was able to raise over PHP2 billion and has so far reached 2 million families as of 23 April 2020 (de Guzman, 2020). Apart from Project Ugnayan, independent assistance from large-scale private corporations and individuals were reported to accumulate more than PHP13 billion worth of cash and in-kind donations, majority of which came from conglomerates.[23] In addition, the implementation of tax incentives for providing donations during the ECQ has also encouraged the private sector to help against COVID-19 (de Vera, 2020).

3.2.2 Moving forward

As extensive as the interventions have been thus far, there remain some vulnerabilities that warrant policy response.

The fiscal and income support are the appropriate interventions, particularly for the vulnerable sectors of society, but its impact will depend on how deep and how long will the economic turmoil last. In the financial sector, the measures introduced thus far loosen the monetary stance, together with an array of regulatory relief to the banks. Expanding funding, lowering the cost of liquidity, and temporarily relaxing regulatory standards are undoubtedly essential interventions. Yet, the price of risky assets has fallen, risk premiums have risen, and concentration has built-up towards certain assets at the expense of others, all of which are not easily reversed by more liquidity at lower cost and less binding regulations.

[23] Based on estimates as of 23 April 2020.

If risk premiums and risk aversion are left to passively react to the principal stress from eroded incomes and reduced business activity, then one's view of the future will remain clouded by the uncertainties of today. This would only hamper the stabilization and recovery efforts. The alternative is to use the ability of financial markets to price the future as a way to assess current developments. It is along this line that the recommendations below are provided, that is, to calm the surge in risk premiums and put the financial authorities in a better position to address current vulnerabilities.

The immediate tasks involve the capital market. A well-functioning capital market mitigates several facets of systemic risks. Forward prices can be generated with sufficient market depth and spot prices calibrate accordingly. Having these prices in place are critical for managing the high and concentrated risk premiums that we see today. Specifically:

- *More forward, less spot.* A concerted effort is needed to create forward markets as a portal for clues on impeding pressures. This is true for fixed income securities as well as FX. For equity prices, the ICR can be retooled to be more forward-looking, that is, the next two to three years of interest expense versus retained earnings. The authorities can actively develop the forward markets while new reportorial requirements can be designed for systemic risk surveillance.

- *Diversify, deepen, and discover the capital market*. With trading activity expected to be low, now is an excellent time to undertake recommendations for diversifying risks, deepening the capital market, and discovering risk premiums more efficiently:

    i. *Fewer but deeper benchmark tenors.* The current nine benchmark tenors can be reduced to four tenor buckets (i.e., one-year, five-year, ten-year and fifteen-year). Adequate depth for the tenor buckets can be ensured with the issuance of pandemic recovery bonds and infrastructure/ BBB bonds having medium- to long-term tenors. Aside from hedging instruments to ensure that liquidity flows through the system, these bonds can be the target of asset purchase programs and serve as the underlying for repurchase agreement (repos)/ reverse repos to help alleviate risk-off behavior. A specific recommendation is that a portion of the issuance would be allocated for insurance companies. In this, the Department of Finance-BTr and the IC could work hand in hand in crafting the appropriate bond for issuance. Although issuing more GS drains available liquidity while asset purchases does the opposite, distribution matters. Private sector liquidity is mobilized during uncertain times while the government creates and replenishes market liquidity which could reflow to other funding opportunities.

ii. *Transparent and accessible pricing.* It is essential that financial risks are priced fairly, in that the reference rates are reflecting the price of liquidity over pre-identified benchmark tenors. It is imperative to establish neutrality between the costs of security issuance and bank credit independent of structuring costs. Specific considerations have been proposed, such as:

- appointing market makers who have a specific mandate with respect to daily trade activity. They are to ensure that there is trade activity in exchange for exclusive access to a liquidity facility, which will be offered and maintained by the national authorities (i.e., special consideration for the implementation of Sec. 83 of BSP charter or more allocation from BSP/BTr reverse repos);

- adhering to the hierarchy required by the international standard on fair valuation and rejecting the use of any smoothening algorithms that cannot be independently recreated and verified by the financial authorities; and,

- appointing a Market Administrator for Financial Benchmarks with a mandate as prescribed under international best practice.

- *Manage the risk premiums directly on the yield curve*. Financial authorities can influence directly spot and forward rates in the GS market. The BSP may consider asset purchases of *de facto* benchmark bonds to rationalize risk premiums, supported by real market makers in the secondary market. Additionally, banks in the past preferred to keep the repo rate out of the price benchmarks which all the more heightens the need for purchase/trading interventions.

- *Mitigate solvency and liquidity risks at the industry level.* Having fair market prices is the necessary pre-condition for funding viable but troubled industries. Interventions such as Troubled Asset Relief Program (TARP) in the US and Special Purpose Vehicle (SPV)-type arrangements are often constrained by risk aversion, either because banks hesitate to take an equity risk with credit losses (in the case of TARP) or because the parties have a widely different view of the risk haircut (in the case of selling assets to the SPVs). These issues can be addressed, for example, by rediscounting or limited-life preferred shares arrangements.

- *Address investment and liquidity risks faced by InsCos.* Although the IC has allowed a temporary reprieve to six InsCos that failed to meet the capital requirement, the remaining 125 had already complied with the minimum PHP900 million capitalization. The additional capital exposes the insurance sector to further mismatches on their balance sheet. The existing investment and liquidity risks are likely to be exacerbated by investment losses caused by the pandemic. To assuage that these risks do not escalate into systemic consequences, a risk review of the industry and the financial situation of InsCos may be useful at this juncture.

3.3 Final thoughts

Macroeconomies worldwide are in disarray. A recession has been declared to be upon the global economy, with significant further dislocations expected.

The same macroeconomic difficulties are faced by the Philippines, with the public health infrastructure fully strained. Yet despite this and the commensurate increase in risk premiums and heightened risk aversion, there is no reason to believe that the local financial market is in a state of instability. Not yet.

The caveat is offered because one cannot tell yet how the public health issue will be resolved and how the corresponding stress points of eroded incomes and suspended business activities will be handled. The three cannot be dissociated, and in turn, these are symbiotic to the state of the financial market. Risk pressures will continue to build because debts will be increasingly difficult to service, banks will find it harder to source new deposits, and risk perceptions draw in further risk perceptions.

It is recommended then to address the risk premium directly. This is not to suggest that one should set aside the public health issues and its macroeconomic shocks. It is simply compartmentalizing, and part of this is an assumption of going concern. It is assumed that financial institutions remain liquid in PHP and USD terms, that depositors can routinely access automated teller machines or make electronic transactions, that clearing and settlement bottlenecks are effectively addressed, that fees for electronic payments are not a disincentive, and that the government is able to source funding for their interventions.

Over the medium-term, one should look to institutionalize macroprudential network stress tests and expedite the completion of the Systemic Risk Crisis Management Framework. The former provides a periodic check-up, covering both financial institutions and NFCs, in testing for vulnerabilities in the system. The latter is a pre-emptive initiative to organize the handling of future outbreaks of systemic risks so that the authorities respond rather than react to the emerging vulnerabilities.

Looking ahead, it would be a major oversight to expect that the economy could still go back to business-as-usual. COVID-19 is leaving scars that even a proven vaccine may not remove. The old economy has to "re-fit" into the new normal of social distancing. Business paradigms that relied on scale (incurring high fixed costs and catering to the retail market in mass) will have to rethink how they can operate in the post-COVID-19 world. Air transport (planes that cost from USD77 million to USD450 million depending on the model, ferrying hundreds of passengers per trip) and big shopping malls, for example, may not be as viable under reduced floor and foot traffic.

The key element now is that NGs are taking on the burden for funding the needed relief program. There is no other entity in place that can absorb the ultimate risks and the corresponding financing. This will certainly mean higher debts, much less fiscal space. Intertemporally, this debt can be bridge-financed with more debt just to sustain liquidity. Ultimately though, taxes will have to adjust intergenerationally to make up for the gap. This is a policy issue that, for the moment, is pushed down the road but is unlikely to be avoided.

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