

## Economic Insights

### Covid-19 pandemic and market risks: a systemic crisis in the making?

#### Key takeaways

- The novel coronavirus will trigger a global recession, and potentially a systemic crisis.
- While extreme monetary and fiscal measures curtail some of the economic and financial tail risk, uncertainties remain significant.
- The risk of a systemic crisis is higher than a decade ago. The euro area is more exposed to systemic risk than the US and China.
- Gauging transmission channels is crucial to interpret systemic risk.
- Key amplifiers such as high and risky debt levels and elevated liquidity risk contribute to prolonged and more severe recessions.
- Corporate debt levels have reached all-time highs, and we see 25% chance of a global credit crisis.

#### About Economic Insights

Analysis of key economic developments and their implications for the global re/insurance industry.

#### Managing Editor

Jérôme Haegeli  
Swiss Re Group Chief Economist

#### Authors

Daniel Kubli  
Economist

Marius Haibel  
Investment analyst

We welcome your feedback. For any comments or questions, please contact: [institute@swissre.com](mailto:institute@swissre.com)

#### In a nutshell

We are sliding into a global recession caused by the Covid-19 outbreak, which could potentially morph into a full-scale systemic crisis. It's key to understand how various factors can amplify the impact of this shock on the economy. We believe the euro area remains more exposed to systemic risk than the US and China.

The Covid-19 pandemic will trigger a global recession. Given the unprecedented nature of this global event, we cannot rule out the possibility of an outright systemic crisis. Even though massive interventions by monetary and fiscal authorities have limited economic and financial tail risk, uncertainties remain significant. It's therefore key to understand the transmission mechanisms and amplifying factors to gauge the potential length and depth of the unfolding crisis and the imminent systemic risk.

In the context of increasingly interconnected economies amid a global shock, understanding transmission mechanisms is crucial. Although almost all parts of the world are shocked by the same event, the subsequent economic consequences are influenced by many global, regional and structural factors.

To assess systemic risk, we look at various political, economic and financial factors, that can amplify, or in contrast weaken the speed and impact of a recession. Among amplifying factors are highly indebted households or corporates. These are less able to service their debt as a downturn becomes more severe and incomes fall, making recessions deeper and recoveries more protracted.<sup>1</sup> Institutional buffers such as monetary policy actions can help to offset the shock, with central banks cutting interest rates and introduce asset purchase facilities to avoid extreme tail risks such as a global credit crisis.

We previously highlighted countries' reduced resilience from increasingly exhausted monetary policy and often constrained fiscal policy. Absent comprehensive global policy coordination, policymakers will have to come up with novel and unorthodox means to shield the economy from deeper recession. This could include tools like helicopter money (see *sigma* 5/2019).

Importantly, systemic risk and the underlying composition of economic amplifiers and buffers have changed since the global financial crisis (GFC) of 2008-09. This means that shocks will spread differently through economic systems. Overall the risk from amplifying factors has increased over the last decade. At the major region/country level, we think the euro area is more fragile than the US and China, with relatively less room for manoeuvre on the monetary and fiscal policy fronts. In addition, a weaker banking sector (despite improved capital ratios) and more rigid labour markets make the euro area more fragile compared to the US. Figure 1 presents a stylized overview of amplifiers that we deem important for the different regions.

<sup>1</sup> O. Jordà et al "When Credit Bites Back", *Journal of Money, Credit and Banking*, 2013.

**Figure 1**

Stylised view of crisis amplifiers and buffers, current view by region (red: likely to amplify shocks, green: likely to act as buffer)

Amplifiers/buffers		US	Eurozone	China
Policy space / buffer	Fiscal space	Green	Orange	Green
	Monetary space	Red	Red	Orange
Structural adjustment mechanisms/buffers	Economic diversification	Green	Green	Orange
	Labour market efficiency	Green	Orange	Orange
	Bank resilience	Green	Orange	Red
	Portfolio concentration	Red	Red	Red
	Private debt levels	Orange	Orange	Red
	International cooperation	Orange	Orange	Orange
	Funding market liquidity	Red	Red	Green

Source: Swiss Re Institute

Contrary to the GFC, we do not expect systemic risk from banks, especially in the US. However, debt outside financial institutions has become more worrisome. Corporate debt levels have reached all-time highs, and we see a 25% chance of a global credit crisis unfolding. The USD 10 trillion investment grade credit market has become riskier, with the share of BBB-rated debt growing from just 17% in 2001 to 50% today. Many of these bonds are just two downgrades away from slipping into junk status and exacerbating credit volatility. This risk is more elevated in the US than in Europe. Household debt, meanwhile, has resurfaced as an issue in the US, where increasing levels of student loans, credit card debt and auto loans are experiencing growing or high rates of delinquencies despite ongoing wage growth. Suddenly falling incomes could amplify widespread defaults of household debt. Central banks have restarted corporate bond buying schemes and encouraging loans to households. All to keep systemic risk at bay.

Severe liquidity issues – in some cases even more severe than during the GFC – have emerged both in corporate and government bond markets. Liquidity problems in funding markets can further amplify the depth of a recession and ultimately lead to a systemic crisis. Crowded investor positioning and simultaneous de-risking have also amplified risk asset volatility. International investors' portfolios have become increasingly homogenous as a result of more risk-taking and passive investing amid the low-yield environment.

Where does this all leave us? Amplifiers and buffers help us gauge whether a virus-born crisis ultimately morphs into a systemic crisis. Country-wide containment measures are targeted to avoid the worst health outcomes, while massive central bank and fiscal actions have somewhat reduced the financial and economic tail risk. But we are not out of the woods yet. Monitoring the state of amplifiers over the coming months will be crucial, as the uncertainty around the magnitude of this recession and its impacts on the global economy remain significant.

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