Worst slump since the 1930s

Global output to shrink by 3 per cent this year, IMF predicts

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Wednesday April 15 2020, 12.01am, The Times

Gita Gopinath, IMF chief economist, said that the loss of output caused by the Covid-19 pandemic would likely dwarf the losses that triggered the global financial crisis

A prolonged lockdown could trigger another financial crisis and credit crunch despite emergency action taken by central banks, the International Monetary Fund has warned.

The longer the shutdown persists, the greater the damage and the more losses the financial system will have to bear. That could stretch banks and asset managers to breaking point in some countries, Tobias Adrian, the IMF's financial counsellor, said.

The global economy went into the pandemic with banks in much stronger shape than before the 2008 crisis, but with markets carrying far higher levels of risky corporate debt.

High-yield, leveraged loan and private debt markets have "expanded rapidly since the financial crisis, reaching $9 trillion globally, while credit quality, underwriting standards, and investor protections have weakened", Mr Adrian said.

"A further tightening in financial conditions may expose more cracks in the global financial system [as] larger than anticipated losses" emerge.

If the recession was worse than expected and losses mounted, "the resilience of banks may be tested in some countries. A prolonged period of dislocation in financial markets may result . . . to an extent that could lead to a credit crunch", he added.

The warning came as:

•The IMF forecast the deepest global recession since the 1930s as world GDP shrinks by 3 per cent this year, including a 6.5 per cent annual fall in Britain;

•It said the global recession could be as deep as 11 per cent if national lockdowns continue into next year;

•The Office for Budget Responsibility said that GDP would fall 35 per cent in the three months to June, two million people would lose their jobs and public sector borrowing would reach £273 billion this financial year, the biggest deficit since the Second World War;

•It also said that the national debt would hit 100 per cent of GDP for the first time since 1963 and that every additional month of lockdown would cost up to £45 billion in borrowing.

Gita Gopinath, the IMF's chief economist, said: "This crisis is like no other. The output loss . . . likely dwarfs the losses that triggered the global financial crisis. This makes the great lockdown the worst recession since the Great Depression, and far worse than the financial crisis. The magnitude and speed of collapse in activity that has followed is unlike anything experienced in our lifetimes."

Speaking as the IMF published its twice-yearly global financial stability report, Mr Adrian said: "A further intensification of the crisis could threaten global financial stability."

Officials across the world have taken unprecedented action to prevent a financial crisis because experience has shown that these leave deeper and more lasting scars than recessions.

"Widespread distress of banks and other financial institutions could lead to a permanent scarring of balance sheets, which may further delay the recovery," the IMF said.

To prevent another financial crisis, central banks have cut interest rates to their lowest, launched more quantitative easing, provided $6 trillion of extra liquidity, extended dollar financing and started buying risky corporate debt.

Mr Adrian said that central banks were "effectively stepping in as buyers of last resort in these markets" to keep the cost of credit low for households. The action has worked. Market volatility reached financial crisis levels and risk assets such as equities had taken more than half the losses in 2008 and 2009 before the central bank bazooka steadied the situation.

Among the outstanding risks are the losses that banks may have to take as business insolvencies increase.

"The longer the sudden stop in economic activity continues, the more likely it is that banks will see credit losses," the IMF said. Strains on liquidity as companies draw down credit lines may also prove a problem. Total undrawn lines of credit amounted to $10 trillion at the end of 2019.

In its separate *World Economic Outlook* report, the IMF hinted at the possibility of another round of bank bailouts. It said: "Bank asset quality should be closely monitored to determine whether fiscal support equity injections, for instance, is required, particularly if the downturn persists."

Mr Adrian said: "The global spread of Covid-19 may require the imposition of tougher and longer-lasting containment measures, actions that may lead to a further tightening of global financial conditions should they result in a more severe and prolonged downturn.

"Such a tightening may, in turn, expose financial vulnerabilities that have built in recent years in the environment of extremely low interest rates. This would further exacerbate the Covid-19 shock. For example, asset managers facing large outflows may be forced to sell into falling markets, thus intensifying downward price moves."