COVID-19 exposes the limits of debt-driven capitalism, writes Emilios Avgouleas

Economies based on high levels of leverage are inherently fragile and with no inbuilt resilience to withstand even mild shocks (let alone the ripple effects that the pandemic has caused. Even before the outbreak of COVID-19, the forecasts about global economic growth and the stability of financial markets were gradually getting darker. Both the International Monetary Fund (IMF) and the World Bank had warned that systemic risk – the risk of serious disturbance to the financial system – might be about to make a potent comeback due to trade wars and the very high levels of private sector debt.

Financial instability has the potential to cause serious economic and social harm as it did in all earlier episodes of serious disturbance to the financial system like the 2008 banking crisis and the 2010-2015 sovereign debt crisis.1 Moreover, this century's earlier episodes of serious disturbance to the financial system and the ensuing austerity policies sparked social discontent – which morphed into today's populist movements and trade wars.

Since 2008 a host of new financial regulations have tried to augment the resilience of the financial systems of G20 countries and prevent a new systemic episode of existential proportions. These regulations have mostly focused on banks which were at the heart of the previous two crises making them both more resilient and more risk averse. But the biggest source of worry these days, in spite of the severity of the GDP falls across the western economies, is not the regulated sector or the threat of an imminent sovereign collapse. It is rather the build-up of hidden levels of private indebtedness in the system of parallel lending we call shadow banking which proved troublesome in 2008 as well. Specifically, fears concentrate on a new segment of shadow banking markets, what I call the shadows of the shadow credit system, namely, short-term corporate-to-corporate lending. This relatively new development has all the ingredients to turn into a mighty catastrophe when combined with a major macroeconomic event such as the loss of economic activity due COVID-19 and a deep global recession.

In the short-term an avalanche of central bank liquidity will make sure that we will not see a string of corporate bankruptcies as short-term debts will be rolled over. But should economic operators and markets always operate on the knife-edge? Is it too audacious to explain the current economic collapse as not being just the result of the pause of economic activity during the lockdowns but also due to a combination of debt accumulation and overreliance on the gig economy during the past decade? Was that a combination that could create a viable framework for resilient economic growth when so much relied on share buybacks, interest rate arbitrage, and short-term and insecure employment adding scores of new working poor?

There is of course much to lament about the current lack of coordination among G20 countries in tackling the consequences of Covid-19. Still, it may not be impossible, however, for the IMF and the Financial Stability Board (IMF and the FSB), to ask them to act in a coordinated way to make sure that their economies become less short-termist and leveraged. To begin with widespread accumulation of bad debts (so-called debt overhang) would mean a slower rate of economic recovery when the worst phase of the pandemic is over.

There are two steps that the IMF and the FSB could recommend to G20 governments:

(a) extend the regulatory net to all forms of credit intermediation and maturity transformation, obliging such entities to some form of licensing and a duty to act prudently when facilitating new lending; and

(b) use macroprudential powers beyond the regulated sector to avoid the emergence of a new generation of too-big-to-fail entities.

In addition, unregulated big corporations (over a certain turnover threshold) engaging in short-term lending to recycle their cash surpluses in global markets should be required by G20 regulators to observe large exposure restrictions in their short-term borrowing and lending outside the banking sector. They could also be made subject to a minimum of liquidity reserves to meet a portion of their short-term liabilities over a month. Given the lack of transparency in this sort of activity and the promise of yields in an environment of very low interest rates it may be absurd for authorities to merely rely on market discipline to restrain it.

Measures to restrict corporate short-term lending in shadow banking markets will prevent free-riding on the public safety net. They would also make the present economic crisis less devastating for individuals and households whose livelihoods depend on the solvency of these corporates. In the longer term, such restrictions would make corporate boards more determined to focus on productivity gains and innovation, moving away from the toxic mix of short-termism and debt-based capitalism of the last decade.

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Emilios Avgouleas holds the chair of banking law and finance at the University of Edinburgh and he is a visiting professor *in the LUISS school of European political economy.*

(1) The authors of a recent collection published by CIGI: Arner, Avgouleas and Schwarcz (eds), Systemic Risk in the Financial Sector: 10 Years After the Crash *(2019), offer a thorough exposition of the different facets of systemic risk and of ways to counter it.*