

# Financial markets in the period of uncertainty – focus on the Slovak financial market

Igor TURUK<sup>a</sup>, Marcela PASSOVA<sup>b</sup>

<sup>a</sup>Faculty of Economics and Management, University of Agriculture, A. Hlinku 2, 949 76 Nitra, Slovakia

<sup>b</sup>Independent Consultant in Business & Finance, Translator, Dlhá 54, 949 01 Nitra, Slovakia

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## Abstract

Economic environment has changed significantly in recent days due to the COVID19 and measures the governments apply to combat it will inevitably cause the substantial shrinkage of economies due to reduced economic activities on the national as well as global levels. As a result, financial markets have been under great stress because there is no prediction on the size, scope, and duration of this situation. Simultaneously this causes a great uncertainty. It is obvious that financial markets play crucial role in the general good standing of economies because they are serving as a channel through which funds are transferred to and between entities on the market. Financial and monetary systems are a part of the economic system whereby for the latter it is important the former to be as stable as possible. In order this to be achieved or at least risks caused by uncertainty to be reduced both in short-term as well as long-term perspectives a wide scope of traditional as well as modern the financial market regulations have been applied and here we are going to present at least some of them.

*Keywords:* financial markets, risks, regulations, uncertainty, stability

*JEL Classification:* G00, G01, G10, G15, G18

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## 1. COVID-19 as a major uncertainty factor of present time

COVID-19 hit economies and financial markets globally and what is worse it arrived in the time when the global economy was already slowing down (or at least showed the signs of that). In addition to the effects on the supply and demand side, financial markets jolted too and since February 21, 2020, bond yields, oil, and equity prices have sharply fallen. For an illustration see the Figure 1 below depicting how in the USA stock prices dropped in more than 30 percent between February 19 and March 23. In comparison, the stock market fell 57 percent peak to trough (October 2007 to March 2009) during the Financial Crisis of 2007-09. (Martin, 2020)

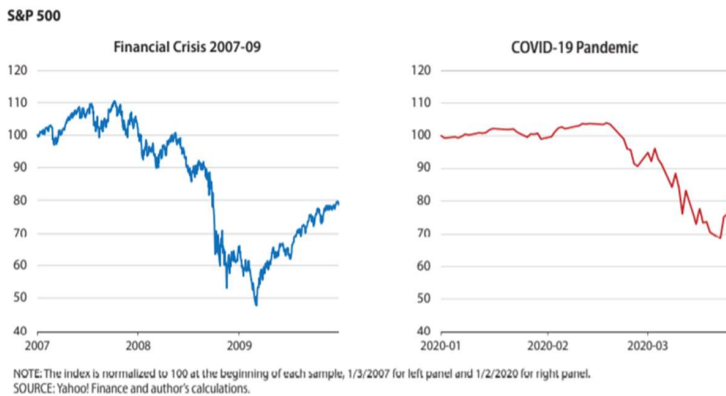


Figure 1. SP500 during the Financial Crisis (2007-2009) vs 2020 Covid-19 Pandemic

And since the Pandemic is still ongoing and lockdowns continuing shocks to the supply and demand side will persist and being a potential for further market disruption. Institutions and individuals may be experiencing liquidity stress, including limited access to credit. This requires interventions and application of measures to reduce the negative impact of this situation as much as possible. During crises in financial markets – no matter what the cause – the central banks worldwide try to alleviate the stress and ensure the adequate provision of liquidity. Nevertheless, the financial sector continues and most likely will continue to exhibit areas of fragility. Therefore, Central banks around the world, meanwhile, have already proactively intervened to calm markets and show commitment to go for and apply all possible measures and in order a proper functioning of the financial markets functioning to be secured the regulatory bodies worldwide (FED, ECB, central banks etc) were prompted to step in and apply measures with the crucial goal – to prevent a possible financial panic. Just for an illustration: the US Federal Reserve (the Fed) recently cut the federal funds rate by 50 basis points. The Fed has also actively intervened in the repo market to add further liquidity. The People's Bank of China (PBoC) has also pumped more than US\$240 billion of liquidity into the financial system as a countermeasure to the virus. The Bank of England and the European Central Bank (ECB) have announced various plans to counter COVID-19. (Baret et al., 2020)

Already in March 2020 the ECB committed to inject an additional 870 billion Euro – about 7% of the Euro area's GDP – into financial markets (Monnin, 2020) to address the significant challenge the economy has been facing due to the pandemic. It is obvious this crisis has and will have a significant impact and economic consequences most of all in the form of the liquidity shortages the businesses, in particular private individuals and SMEs (Small and Medium-sized Enterprises) have to deal with. Logically, this will cause difficulties in meeting their (not only) financial commitments including those they have towards the banks, credit institutions. Thus on the one side the individuals or SMEs may be marked as "non-performers" in terms of their loans or

other financial commitments repayments and on the other hand the delays in the repayment of the bank loans and other credit obligations may cause the increase of “non-performing loans” that would be reflected in the credit institutions balance-sheets. To avoid this, it is necessary to have deeper and more intense cooperation and coordination by and between central banks, regulators, and governments to have their economies and markets stabilized and prevent their collapse. In this respect, some EU Member States have introduced legislative moratoria on loan repayments granting the borrowers various forms of payment holidays on their existing loans. In order to eliminate negative impacts of the COVID-19 crisis and keep economies as vivid as possible many Member States have also introduced various forms of public guarantees to back-up the entrepreneurs and businesses when applying for new loans that shall be used to restart their activities once the pandemic is over. All these measures set at the national, Member States’ levels, of course require to be under the umbrella of a coordinated supervision that shall be performed by and through the European Banking Authority (EBA) that set the Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis<sup>1</sup> (EBA/GL/2020/02 as of April 02, 2020). Purpose of these Guidelines is not only to clarify the implication of such moratoria on the application of prudential rules, including the application of rules on forbearance and the definition of default and nonperforming exposures. These clarifications, in particular, mean that the payment holidays applied on the basis of these Guidelines on moratoria are not to be considered as forbearance measures, they do not change the pre-existing classification of exposures, and therefore such measures are not captured in the existing supervisory reporting framework. Being aware of the fact that adhering to these Guidelines will require a coordinated approach in terms of collection and access to respective data and information on the application of the payment moratoria to the existing loans and public guarantees schemes that shall be available for new lending, the EBA shall therefore introduce an additional guidelines on reporting and disclosure. Based on these Guidelines and their annexes on reporting and disclosure competent authorities will be expected to take all necessary supervisory measures to ensure that institutions report and disclose additional information accordingly and in compliance with the requirements and rules set in the Guidelines.

## **2. Basis of the Financial Market Regulations**

Financial markets are vital systems that are evolving continuously and are affected by ongoing economic and/or legislative changes. Dynamics of these changes in social, economic, legislation or fiscal environments and policies have had significant impact on the financial markets and vice versa. A key trend that is not related only with the financial markets issues is a globalization. A need to regulate financial markets on the multinational level has arisen together with the financial markets’ globalization and integration. Unification of the financial markets rules affects areas like providing of

financial services, AML (Anti-Money Laundering), compliance regulations and supervisory activities performed by the financial institutions. On the other hand, the neo-liberal approach tends to support a process of deregulation aim of which is to reduce and eliminate strict regulatory methods and tools and their replacement by liberal tools. That process of deregulation has been accompanied by a significant limitation of the interventions performed by the regulatory authorities. But in the COVID-19 times it is necessary to realize that authorities will have to intervene and regulate financial markets through a set of rules and policies regulating the operations of financial markets and financial institutions with the aim to ensure financial stability and protect all relevant stakeholders. And, of course their implementation and observance shall be duly supervised in order to secure these rules and measures to be applied in a due course.

Financial market regulation and supervision are executed on two levels, namely at the national one (secured by the national organizations, in most cases by the central banks) and at the international one. International regulation of the financial services is most of all related with the three areas:

- Banking (international institution – the Basel Committee on Banking Supervision),
- Insurance (International Advisory organization IAIS – International Association of Insurance Supervisors and IADI – International Association of Deposit Insurers),
- Securities (International Advisory organization IOSCO – International Organization of Securities Commissions).

Whereby, under the umbrella of the Basel Committee on Banking Supervision, IAIS and IOSCO there was established a Common Forum that deals with the common issues related with the banking, insurance industry and securities including regulation of the financial conglomerates.

### **3. EU Financial Markets – role of the ECB in this COVID-19 crisis**

As mentioned above the European Central Bank (ECB) committed to inject an additional 870 billion Euro A key role of the ECB is also in ensuring its financial help to reach those most in need, i.e. the most vulnerable households and businesses for which less economic activity means less income. The ECB also announced measures to support the banking system with the aim to ensure and guarantee the continuity of the European financial system as well as the banking and financial systems in the EU countries economies of which have been or will face to a very negative impact of the pandemics and it is inevitable to prevent them from being confronted with the failing banking system. On the other hand, apart from ECB or European Commission the Governments themselves shall also be proactive and support their businesses and households through fiscal and/or other measures such as ‘kurz Arbeit’, guarantee systems, ‘helicopter money’ etc., in order to sustain businesses as well as minimal living standards.

In short, the pandemic caused the ECB is facing a surge in demand for emergency debt by both the private and public sector. It must act decisively to ensure that the need for emergency credit is met, at conditions that do not jeopardize economic future of the EU. Here we shall realize that e.g. contrary to the US market EU businesses are extremely dependent on the banks. In the USA the situation is different – eight of ten Euros the businesses borrowed came from the capital market and maintaining stability of the financial system is arduous because the banking union represents a rescue net for innumerable subjects, entities – circa 500 million EU citizens and ECB regulatory measures affect decisions of banks as well as economic subjects. European leaders should not only give permissions but most of all support the European Central Bank (ECB) to provide whatever financial support that will be needed. Regardless the governments' efforts to support their economies, their measures were mostly aimed at support of businesses and entrepreneurial environment, but the crisis is broader and deeper, and it is affecting all sectors and areas of economies. Although government-subsidised reduced working hours (*kurz arbeit*) and sick pay are a solution for many businesses and workers, crucially they are not for those working on temporary contracts or for the self-employed. They need direct income support. Thus, Euro area countries' emergency fiscal plans sum up to trillions of Euros that must be generated somehow, i.e. countries will have to turn to sovereign debt markets to raise these funds whereby the critical issue will be terms and conditions the financial markets will set for this type of sovereign debts – terms and conditions that will affect not only governments' ability to respond to the crisis in present time but also the sustainability of their sovereign debt in the future.

The European Commission has already allowed member states to spend whatever is necessary to combat the crisis as the Stability and Growth Pact allows in emergency cases to apply such eventualities though being in contract with the generally applicable fiscal rules and policies (Bergsen, 2020). Several Eurozone countries do probably have the fiscal space to deal with this. Countries such as Germany and the Netherlands have run several years of balanced budgets, on the other hand, Italy, and even France are more likely to be viewed by financial markets as more questionable and risky in terms of sustainability of their debt levels because of their higher spending and 'gap' occurred due to the collapse in the tax revenues. To avoid this, the pandemic response must be financed collectively and backed up by the appropriate measures and actions undertaken by the ECB.

We shall not omit the role of the European Stability Mechanism (ESM) that shall provide states with the funds, while suitably ditching the political conditionality that came with previous bailout. But the ESM currently has €410bn in remaining lending capacity, which is unlikely to be enough and difficult to rapidly increase. So, this means the ECB is the only institution with effectively unlimited monetary firepower but still we shall not forget that a collective EU response is complicated by the common currency, and particularly by the role of the ECB that is not allowed to do whatever it

wishes or likes as its room for manoeuvring is even more limited than that of other major central banks. ECB's power to execute its programme to buy government bonds depends on countries agreeing to a rescue programme within the context of the ESM and with all therewith related political difficulties.

There are two main ways that the ECB could finance the response to the crisis. First, it could buy up more or all bonds issued by the member states. A first step in this direction would be to lift the limits because recently the ECB can only buy up to a third of every country's outstanding public debt. This is good regulatory measure and policy in normal times, but these are not normal times. If these limits are released (upon the European Council's acknowledgement and approval), the Euro-system central banks could then start buying bonds issued by governments to finance whatever expenditure they deem necessary to combat the crisis. Secondly, governments can be provided with an overdraft from the ECB or the national central banks regardless the fact that in normal times, the central bank lending directly to governments is outlawed, but as stated above we are facing critical times and need to save economies in as wide scope as possible.

#### Financial market regulations in Slovakia and its response to the COVID-19

Supervision on the national level - in Slovakia is conducted by the National Bank of Slovakia (NBS) and as per the Act No. 747/2004 of the Coll. About supervision on the financial market the NBS acts as an integrated regulatory body responsible for an integrated supervision on the financial market. This means that its functionality has been significantly extended and it executes not only the common banking supervision but also the supervision of the capital market and insurance industry, supervisions on the subjects acting as a capitalization pillar of the pension system and auxiliary pension insurance. NBS was also granted with the rights in terms of the financial market regulation. Main reason why the NBS supervises activities of all subjects is that activities of individual subjects of the financial markets are closely interwoven and the fact of having financial conglomerates established. There have been implemented a new framework of the prevention and resolving of potential critical situations on the financial market in compliance with the Act No. 371/2014 of the Coll. About Resolving of Critical situations on the financial markets. Priority of the subjected law is to implement an effective system of the crisis management created by the BRRD Directive (Directive on the restructuring, recovery and resolving of the critical situations of the banks) that is to be implemented in all EU Member States. Apart from that there was established a Council for resolving of critical situations and Fund for collecting monetary contributions from the selected institutions.

Since the COVID-19 Crisis is still ongoing and thus it is quite difficult to make any firm estimation or prognosis of the economic development, yet the National Bank of Slovakia (NBS) in its medium-term prognosis expects the recession will hit the Slovak economy contraction of which in 2020 can be in the interval between 5.8% and 13.5%

(officially presented expected contraction in 9.3%) not only because of the domestic measures adopted against the COVID-19 but also because of the decrease in the international demand that will significantly affect Slovak export-oriented economy. As stated above, many businesses, SMEs and self-employed individual have lost their income and consequently they became unable to meet their financial commitments in terms of the loans, credits repayments and this reflects in the major risk of “non-performing loans”. For example, the revenues in the most sensitive industries such as hotels, restaurants or tourism decreased by more than 57% in March 2020 (March 2019 = 100%) and by 63% in April 2020 (April 2019 = 100%). Negative development in the economy will have double negative impact on the public finance – the income will drop because of the negative economic development, decrease in tax revenues, on the other hand the expenses are expected to grow due to the investments into the anti-crisis measures in the form of subsidies and other support of the private businesses and entrepreneurs. This will be reflected in the increased deficit of public finance and in the increased government debt-to-GDP. The general government deficit for 2020 is expected to be between 6.9% and 10.3% of the GDP; and in spite of its declining tendency in last years – from 53.5% of the GDP in 2014 to 48% of the GDP in 2019 the government dept-to-GDP ratio will increase between 57% to 64%.

However, despite all these risks related with the “non-performing loans” the financial institutions will have to deal with, the health and endurance of the Slovak banking and insurance sectors is quite high. The banks have sufficient capital adequacy and their liquidity enable them to continue in their lending activities. And yet already in March 2020, at the beginning of the outbreak the annual profit of the banks decreased by 61% compared with the same period of 2019 and the tightened terms and conditions under the banks provide the loans to the households as well as to the corporate clients causes the demand for loans will continue to drop and not only because of the ongoing COVID 19 crisis. Even before the pandemic outbreak significant part of households and businesses had been in quite difficult financial situation with none or low level of savings. The uncertainty of the future economic development can cause the banks will be very cautious in providing loans and credits and that will have negative impact on the businesses that will need to get access to a bridge loans enabling them to eliminate temporary lack of income caused by the COVID 19 crisis. That means the bank will be willing to finance the business and provide corporate loan only provided that the business will have a good chance not only to survive the crisis but most of all to restart its activities based on the bridge loan the bank will provide to improve the liquidity and financial stability of that business. In this respect the access to the Government Guarantee schemes shall play a crucial role because, as we know most of the SMEs are unable to provide sufficient collaterals to backup the corporate loans from the bank though the banks are the main creditors the SMEs are getting capital from contrary to the large companies and corporations that are more flexible and have access to more diversified forms of

capital and funding – they can issue their own corporate bonds, get funding from their mother companies or affiliates or even issue new stocks and increase their equity this way. Yet, the expected worsening of global economic and financial environment and conditions will definitely affect the large companies too. But still these will still be in better position and have more options how to improve their liquidity or get access to the capital than small or medium-sized businesses because in the case of the large companies or corporations the equity to total assets ratio is always higher (in average 43.5% of total assets) compared to that of small or medium sized business or even microbusinesses (where it equals to max. 40% of total assets).

### 3.1. Three scenarios of the development as per the NBS estimation

In its Medium-Term Forecast the NBS published three possible scenarios (A, B and C) of the development. These scenarios are based on the different assumptions concerning the spread of the virus worldwide and suppression of the pandemic thanks to the respective measures applied globally. But all three expect the global economy will experience a V-shaped recovery following a dramatic fall in foreign demand in the second quarter of 2020 (see Table 1 below). In the most optimistic scenario (A), the global economy rebounds almost back to pre-crisis levels, while in the other two scenarios (B) and (C) the global economy and world trade experience heavier permanent losses.

Table 1. Key macroeconomic indicators

Table 1 Key macroeconomic indicators										
Indicator (annual percentage change)	Scenario A			Scenario B			Scenario C			MTF- 2020Q1 negative scenario
	2020	2021	2022	2020	2021	2022	2020	2021	2022	
Gross domestic product	-5.8	8.3	4.5	-9.3	8.0	4.3	-13.5	7.2	4.2	-9.2
Private consumption	-5.9	6.9	4.1	-10.6	8.3	3.2	-14.0	8.1	3.2	-3.6
Final consumption of general government	3.0	2.3	1.6	3.1	2.2	1.5	3.2	2.3	1.2	3.1
Gross fixed capital formation	-16.4	14.6	9.4	-19.4	11.7	9.5	-25.9	5.3	10.7	-17.2
Export of goods and services	-8.3	10.9	6.0	-11.8	9.4	6.4	-17.8	9.1	7.0	-19.3
Employment	-1.2	-0.1	0.8	-1.6	-0.8	0.8	-2.5	-1.9	1.0	-3.2
Unemployment rate (percentage)	7.0	7.4	7.0	7.4	8.3	7.7	8.2	10.1	9.5	8.6
Wage	-2.5	8.3	6.4	-3.4	8.3	6.1	-5.3	8.8	6.1	-1.5
HICP inflation	1.8	1.1	1.8	1.8	1.0	1.7	1.8	0.8	1.6	2.0
Foreign demand	-7.3	9.2	4.9	-10.4	7.5	4.9	-16.6	7.8	4.8	-17.6

Source: NBS.

### 3.2. Measures for preserving the financial stability and capital adequacy

In terms of the financial stability and to prevent uncertainty at the financial market it is inevitable to ensure as best functioning of the financial sector as possible – not



only during the outbreak but most of all when the crisis is over. We shall realize that the pandemic hit the real economy at first and not the financial sector (this was hit by the 2008 crisis as the first). However, the secondary impacts are expected to hit the financial sector too. Therefore, the NBS emphasizes the necessity to have in place respective measures that will, together with the good resistance of the financial sector, enable not only to prevent the Slovak economy from the fast and deep contraction of the Slovak economy but most of all to help its recovery as best as possible mainly through the accessibility of the funding and lending from the banks. For this purpose, there will be required a massive release of capital and bank financing support both from the ECB (at the EU level) and from the NBS (at the national level).

In April 2020, the NBS Bank Board adopted a resolution based on which the Countercyclical Capital Buffer Rate remains on the same level of 1.5% (for time being this level is not supposed to be decreased) and will not be increased to 2.0% as intended. This enabled the banks to release additional funds in amount of circa € 159 million whereby the total amount of funds accumulated from the Countercyclical Capital Buffer Rate is about € 476 million that represent a sufficient reserve for the future in terms of the capital adequacy that will be crucial for having the economy duly restored and revived once the COVID-19 crisis will be over. In addition, the amount of the liquid capital in the bank has increased by almost €2 billion since January 2020 whereby at the end of the 2019 the liquid capital of the banking sector was approx. €834 million. We can state that together with the retained 2019 bank profits, conservative dividend policy, adjustments (possible decrease) of the countercyclical capital buffer rate and other macroprudential measures the liquid capital of the banks is € 2.85 billion. Still, the amount of the liquid capital can be higher provided that the bank levy will be repealed as (even without the COVID 19) the bank levy would negatively affect the ability of the banks to provide loans to households and/or corporate loans. As an additional measure the NBS considers to be applied if necessary is that the banks will be have a certain level of flexibility by meeting the requirements of the Council for the resolving of the critical situations which includes e.g. issuing of unsecured bonds the banks are supposed to issue in 2020 – 2023.

Nevertheless, synergy with other fiscal and economic measures is required. And it is expected that within the Lex Corona issues, the Slovak Government shall continue in implementing of various measures and aids to preserve jobs (there are around 50,000 jobs under threat) and support entrepreneurial environment and for this purpose the Government can use not only the funds allocated from the State budget or public finances but also funds provided based on the respective EU and ECB measures. In order the economy to be restarted appropriately there will be also necessary to have effective and adequate Government Guarantee schemes for corporate loans in place and on the other hand, the households and corporate clients of the bank shall prepare for the resumption of their loan instalments and to start to create sufficient financial reserves as soon as possible.

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