Creditreform Economic Briefs: COVID-19

The outbreak of the Covid-19 pandemic and the related emergency measures to contain it have caused widespread economic paralysis worldwide and have triggered a massive wave of fiscal and monetary policy support measures to help alleviate the economic and financial market fallout from what can be understood as a combination of extreme supply and demand shocks. This arguably represents the most devastating crisis hitting the global economy since World War II.

In its April World Economic Outlook, the IMF reckons that global economic growth contracts by 3% in 2020, much more pronounced than during the Great Recession back in 2008/09, when global economic output more or less stagnated (2009: -0.1%). According to the Fund, advanced economies could see a much more severe economic slump (-6.1%) than emerging and developing markets (-1.1%). In its baseline scenario, the IMF expects global real GDP to rebound, envisaging a growth rate of 5.8% for 2021, with advanced economies projected to experience an output increase of roughly 4.5% and emerging/developing countries of about 6.6%.

Coronavirus pushing the euro area economy into a deep recession

We expect that the economic impact from the crisis will be material, as the fallout due to Covid-19 will very likely see the euro area economy fall into a deep recession in 2020. Our current baseline scenario assumes that the worst effects will become visible in the second quarter of 2020.

While no reliable hard economic data is yet available, our baseline scenario foresees real GDP to contract sharply by 7.2%. Predicated on the key assumption that detrimental effects associated with the pandemic will gradually wane in the second half of the year, amid a prospective incremental relaxation of the lockdown in the respective euro area member states, we currently anticipate a more or less V-shaped pattern and real GDP to pick up strongly by 5.2% in 2021.

Whilst modest inflation and policy measures will mitigate some of the negative effects on real incomes, income declines, contagion fears, extremely high uncertainty, and redundancies will induce households to spend less. At the same time, business investment is set to contract sharply and export growth will take a severe hit.

It has to be highlighted that the assessment and interpretation of economic developments in the near future is much more challenging than under normal circumstances, as is the case for other indicators, given the current considerable uncertainty in the economy and financial markets, and the very dynamic development of Covid-19 (see below *Forecasts subject to substantial uncertainty*).

Economies such as Denmark and Austria or, to a lesser extent, Germany have started to loosen some of the containment measures in April, for instance permitting small non-essential retail shops to re-open, but the easing remains conditional on progress made in terms of containing the spread of the virus. As opposed to that, countries like Italy and Spain, whose health sectors have been particularly heavily hit by the coronavirus, are not yet in a position to start unwinding restrictions on a broader basis.

The pronounced economic slump, entailing retreating tax revenues and social contributions as well as higher spending enhanced by government's support measures, will inevitably have public finances deteriorate substantially in the near term. Also, political risks associated with rising populism and a no-deal Brexit remain a

viable threat, and risks pertaining to international trade are here to stay.

Monetary policy response by the ECB

To provide monetary policy support, the ECB announced a Pandemic Emergency Purchase Program (PEPP) with an envelope of EUR 750bn, on top of increased net asset purchases to the tune of EUR 120bn under the existing asset purchase program (APP) until the end of the year, along with a number of measures to ensure ample liquidity. Furthermore, the ECB adopted a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area including the temporary increase in the Eurosystem's risk tolerance in order to support credit to the economy, easing the conditions for the use of credit claims as collateral and a general reduction of collateral valuation haircuts. The central bank also decided to temporarily mitigate the effect on counterparties' collateral availability from rating downgrades.

Germany in its tenth consecutive year of output expansion, but slowing momentum

The pandemic has hit at a time in which the country's economic growth has lost further momentum. Real GDP growth came in at only 0.6% in 2019 (2018: 1.5%), posting below overall euro area GDP growth (1.2%) for a second year in a row, mainly on the back of slowing gross fixed capital investment and a large negative contribution from inventories.

The significant inventory reduction was based on low industrial production owing to the persistent weakness in manufacturing sector and growing exports. By the same token, investment growth declined from 3.5% to 2.6% in 2019, as investment in machinery and equipment, which accounts for close to a third of total fixed investment, almost came to a standstill (0.6%, 2018: 4.4%), also in light of uncertainty over the global trade environment and potential fallout from a no-deal Brexit. Construction investment, on the other hand, gained traction in 2019 and grew by 3.9% (2018: 2.5%) amid an ongoing domestic housing boom and more vividly rising civil engineering. In fact, construction investment recorded its highest increase since 2011.

Private consumption meanwhile proved a reliable pillar, expanding by 1.6% (2018: 1.3%) and contributing 0.8 p.p. to overall GDP growth last year, buoyed by the well-performing labor market and robust increases of incomes along with moderate inflation. Real incomes increased by 1.2 after 1.3% in the preceding year. Government consumption also contributed positively to overall output growth (0.5 p.p.), rising by 2.6% compared to the previous year. Against the backdrop of persistent trade tensions and corresponding muted global demand, Germany's exports only rose by 0.9% (2018: 2.1%). At the same time, import growth slowed to 1.9% (2018: 3.6%), resulting in a negative GDP growth contribution of 0.4 p.p., as seen in the prior year.

Turning to the labor market, 2019 represented the 14th consecutive year of increasing employment in Germany, although the growth rate diminished noticeably to 0.9% from 1.4% in 2018. The unemployment rate fell for the 10th year in a row and to a new post-reunification low of 3.2% (2018: 3.4%). With that, Germany's unemployment rate remained well below the euro area's 7.6%.

Covid-19 will likely cause steep, though temporary decline in German economic activity

Prospects for economic development are bleak. The ifo business climate nosedived to 74.3 index points in April from 85.9 in the previous month, corresponding to the lowest level on

record – the previous all-time low dating from the Great Recession in 2008/09 was 79.9 points.

Accordingly, we expect German real GDP to fall sharply by 6.1% in 2020 due to the corona pandemic and the containment measures taken to mitigate it, and to rebound by approx. 4.8% in 2021. The lockdown has largely been extended to 3 May, albeit with some conditional loosening of measures, e.g. permitting retail shops of a certain size to re-open. We currently expect the adverse economic impact to be transitory, with the lion's share of the negative impact being visible in Q2, while acknowledging that it is hardly possible to fully grasp the scope of the impact at this stage. This will not only depend on the range and duration of the measures taken to combat the virus, but also on the development of effective medicines. Judging by political discussions, another round of economic support to assist a possible recovery later this year or in 2021 seems conceivable, but at this stage is speculative and only highlights the degree of uncertainty around our forecasts.

In response to the pandemic, German authorities are implementing comprehensive emergency measures, which according to the Ministry of Finance exceed 1.1 trillion euro, of which approx. EUR 353bn would affect the budget immediately and about EUR 820bn would be provided in the shape of guarantees. The measures also include direct support such as grants to self-employed and small companies for instance. Short-time working schemes to enable employers to retain qualified staff, which proved helpful in the global financial crisis, have also been activated, along with the possibility to defer tax payments. For companies experiencing financial difficulties as a result of the pandemic and the related counter-measures, filing for insolvency can be suspended until end of September.

The course of the economy in H2-20 rests on whether the restrictions continue or are eased or lifted towards the summer. While our baseline scenario assumes a more or less V-shaped pattern of economic development, such assumptions remain subject to high uncertainty and may experience stark revisions as more information on the fallout and a potential exit strategy become available.

Household spending is likely to be curtailed by declining employment growth and receding disposable income. According to the federal employment agency, roughly 725,000 short-time work arrangements have been reported as of 13 April. This compares with an average of about 1,300 of such arrangements per month in the year 2019, and offers a first glimpse of the extent of the initial economic fallout of the corona crisis on the labor market. Moreover, a recent round of wage negotiations in the metal and electrical industry resulted in foregone wage increases and ultimately a postponement of further negotiations until at least the end of the year in light of many companies having to embark on short-time schemes, presumably setting a blueprint for other industries.

Prior to the corona outbreak, Germany's manufacturing sector had shown signs of a nascent recovery following a recession that had its origins in the second half of 2018 and developed further over 2019. New orders increased by 3.3% in a two-month average comparison (Jan/Feb vs. Nov/Dec). Business surveys had started to improve at the beginning of the year, with the manufacturing PMI reaching a 13-month-high in February, although the indicator was still within a territory typically associated with contraction of economic activity.

In March, the PMI saw its sharpest drop since April 2009, suggesting that gross fixed government investment will see a further significant deterioration in 2020, driven by negative growth in investment in machinery and equipment, before rebounding to some extent in

2021. Moderately increasing construction investment could prevent an overall decline of gross fixed capital investment, although the lockdown should at least slow growth in this segment as well. Government expenditure should add positively to GDP growth this year, in light of envisaged discretionary measures amounting to about 0.5% of GDP for 2020 pre-corona and with numerous emergency measures now kicking in.

Net exports seemed set to pose a drag on GDP growth in 2020, with imports expected to rise stronger than exports, on the back of robust domestic demand and still ongoing uncertainty over trade relations on the global level. In light of the spreading virus and impaired trade flows, both exports and imports should now see negative growth rates, with export growth probably seeing a considerably steeper decline than imports. Hence, net external trade should weigh more heavily on GDP growth.

This is also underscored by plummeting sentiment among German exporters. The ifo export expectations of the industrial sector fell from -19.0 to -50.0 points in April. While the April reading represents a historical low, the extent of the decline is also unprecedented.

Fiscal risks mitigated by very high debt affordability and favorable initial fiscal position

Amid suspension of the debt brake as laid down in the German Basic Law, parliament thus adopted a supplementary federal budget to the tune of EUR 156bn (approx. 4.5% of GDP) to finance the emergency measures, of which 33.5bn represents assumed lower revenue, and 122.5bn are dedicated to spending increases. We would tentatively pencil in a deficit of about 6.5% of GDP, acknowledging that this remains subject to possibly stark revisions. Bearing in mind the substantial risks surrounding the current situation, the deficit could thus be markedly higher. It is not known for how much longer containment measures affecting production and services will have to remain in place, either fully or partially, or whether there may be a second wave of rising infections requiring a return to stricter restrictions, let alone how many insolvencies and unemployed the country will end up with, to illustrate a few major uncertainties.

General government gross debt has been on a firm downward trend since 2012, falling from 81.1 to 59.8% of GDP in 2019 (2018: 61.9%) and thus below the 60% reference value as per the Maastricht Treaty for the first time since 2002. We expect debt-to-GDP to experience a strong increase to a level of approx. 72%, before gradually falling back from 2021 onward. However, we deem fiscal risks as limited against the backdrop of strong debt affordability and prudent debt management, which have resulted in considerable fiscal space to act in order to shield households and companies from the fallout of the crisis.

UK already displaying weak macroeconomic backdrop before the outbreak of Covid-19

The UK's real GDP growth has slowed down from a cycle high of 2.6% in 2014 to 1.4% in 2019 (2018: 1.3%). Brexit-related uncertainty has been weighing in particular on domestic demand over the last two years.

Above all, political uncertainty has had a bearing on gross fixed capital formation since the UK's decision to leave the EU. In 2019, investment seemed to stabilize (0.4%) after falling slightly in 2018 (-0.2%). Significantly dragged down by domestic political turmoil and unclear prospects as to whether the UK would leave the EU in an orderly way, businesses' willingness to invest was subdued over much of 2019, despite ongoing favorable financing conditions.

Additionally, the expansion of private consumption, which had reached a peak of 3.6% in 2016, decelerated further to 1.3% last year (2018: 1.6%) despite increasing real wage growth and expansionary fiscal policy, but against the backdrop of the uncertain political course of the country in relation to the EU. Households' saving rate point to more cautious behavior in the context of several assumed dates on which the country was to exit the EU before ultimately leaving in January 2020.

With an increase in exports by 3.7% and import growth of 3.6%, net trade seems to have had a broadly neutral effect on GDP growth in 2019. However, in the course of 2019, trade data was volatile. Sterling has been on a relatively steep rollercoaster over 2019. As per December 2019, the currency (effective exchange rate) appreciated by about 5% versus other currencies compared to December 2018, still weaker than in the pre-referendum phase.

UK economy assumed to plunge, followed by strong recovery

In light of the corona crisis, we currently envisage a decline in real GDP to the tune of about 4.8%, thus considerably lower than a decline of 1.0% as communicated in our March rating report, which is based on information available through 20 March 2020. This is mainly due to the introduction of severe restrictions to public life since finalizing our report. For 2021 we would project real GDP to recover by 4.5% at this stage.

Notwithstanding some hoarding purchases, private consumption now looks likely to experience a dent due to the restrictions in place, and as job losses in light of corporate bankruptcies are likely. Prior to corona, the UK labor market had still been very tight in a context of low unemployment and continued employment increases. Business surveys had brightened up at the beginning of the year. However, a rebound of business investment is now unlikely given prospectively large economic fallout caused by the novel corona virus. Government expenditure, on the other hand, should add favorably to economic output in 2020, on the back of combined emergency measures to support the economy against Covid-19 and planned fiscal loosening. Net external trade appears set to exert a negative effect on GDP growth in 2020, with exports presumably seeing a more pronounced decrease.

In view of the corona pandemic, the UK government announced support measures unprecedented in scope to cushion the impact from the supply and demand shock caused to the economy by the spread of the virus. As of now, a fiscal stimulus to the extent of 18.1% of GDP, including backing for up to GBP 330bn of state loans and guarantees for struggling businesses, has been offered. Measures feature an emergency response fund for the National Health Service (NHS) and other public services, along with support to businesses and self-employed, as well as initiatives geared towards strengthening the social safety net to support vulnerable people.

Brexit uncertainty remains in place, although we are currently assuming that the transitionary period following the exit from the EU will ultimately be extended beyond the end of this year, despite official communication to the contrary on the part of the UK. Developments will have to be closely monitored. If negotiations were to be terminated prematurely – a risk that we cannot rule out entirely but consider rather unlikely under the current extraordinary circumstances – trade frictions could occur beyond assumed temporary ones caused by corona, potentially disrupting supply chains. Adding to this uncertainty is the fact that the UK will have to agree separate trade deals with major

third parties, too, with no guaranteed success in the short term.

BoE further loosening monetary policy stance

The Bank of England (BoE) lowered the monetary policy rate by a total of 65 basis points to 0.10% and decided to increase its holdings of UK government bonds and sterling non-financial investment-grade corporate bonds by GBP 200bn, mainly through timely purchases of government bonds, to GBP 645bn. Furthermore, BoE introduced a Term Funding Scheme for SMEs to ensure transmission of the rate reduction to the real economy. The Bank also decided to enhance liquidity provision by activating a facility enabling participants to borrow central bank reserves in exchange for less liquid assets to help alleviate observed frictions in the money market. In addition, HM Treasury and BoE have agreed to extend temporarily the use of the government's overdraft account at the BoE to provide a short-term source of additional liquidity to the government if needed.

Forecasts subject to substantial uncertainty

At the current juncture, we generally expect that the impact across industrialized economies (incl. euro area) will be hefty but short-lived, with the pandemic fading in the second half of this year and economic disruptions concentrated predominantly in Q2-20, and GDP growth presumably rebounding in a more or less V-shaped pattern next year.

That being said, all assumptions related to this pandemic and its economic consequences are subject to extreme uncertainty, since little is known about this new virus and its characteristics, and developments are very dynamic. Progress towards normalization will also depend on the time it takes to find effective medication and/or vaccines. In the meantime, extensions of protection measures and/or intensification thereof may become necessary. We treat these as risk scenarios for now, and would describe our baseline forecast as cautiously optimistic, as second and third round effects related to the corona pandemic cannot be ruled out.

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