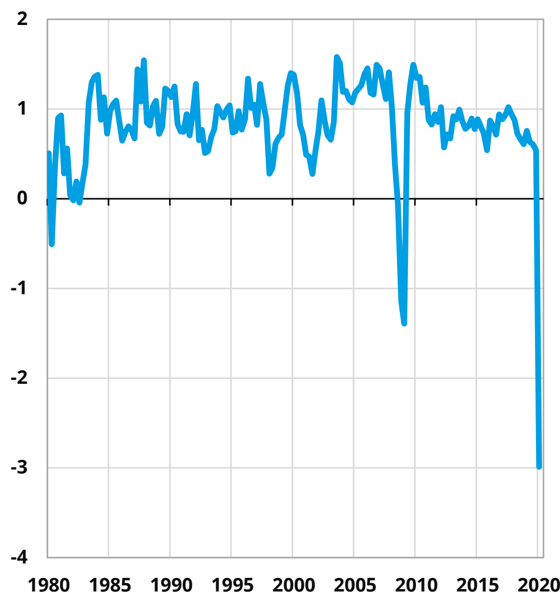
Creditreform Rating

Creditreform Economic Briefs: Brace for Impact

Several months into the Covid-19 pandemic and having overcome its most acute phase, more insights into the devastating effects on economies worldwide following lockdowns of various proportion are becoming available. Even though more or less severe restrictions to public life were imposed only from mid-March in many cases, global real GDP record-slumped in this year's first quarter, with the main negative effect yet to reveal itself in data relating to Q2, as the bulk of the lockdowns affected April and May, at least in Europe (see Figure 1).

Figure 1: Global economic activity in a long-term perspective

Quarterly real GDP growth up to Q1-20, in %, q-o-q

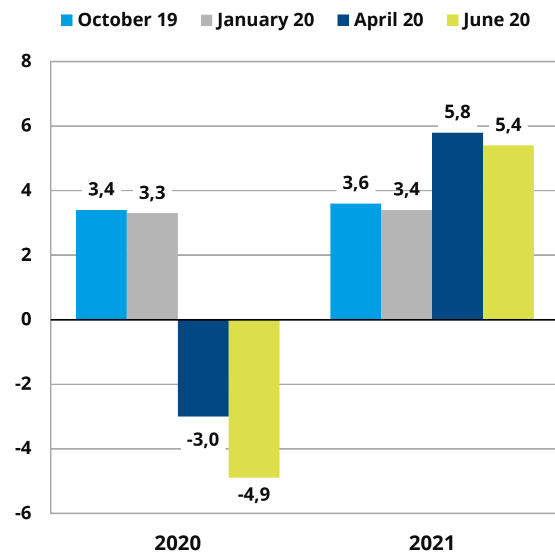


Sources: Creditreform Rating, OECD

Authorities stepped up and/or extended fiscal and monetary policy support measures to mitigate the fallout from the pandemic. Nevertheless, in June the IMF lowered its forecast for global economic growth from -3.0% to -4.9% in 2020, driven by a larger-than-expected adverse impact in the first half of the year, and due to the expectation of a slower recovery than previously envisaged (see Figure 2). Accordingly, forecasts regarding the expansion of world trade have been revised downwards to -11.8% for this year. Advanced economies are now assumed to see their economic output contract by 8.0% in 2020, while the effect on emerging market and developing countries is estimated to be milder, mirrored in an expected decline of 3.0%. For 2021, the IMF expects global GDP to grow by 5.4%. Advanced Economies should see their economic output rebound by 4.8%, thus staying well below pre-corona levels, whereas emerging and developing countries are projected to experience a stronger recovery, with real GDP forecast to rise by 5.9%.

Figure 2: IMF WEO global GDP forecasts over time

Global real GDP forecasts in %, at the time of publication of the World Economic Outlook/WEO Update



Sources: Creditreform Rating, IMF

Euro area: Steep GDP decline this year, with uneven recovery from the second half and in 2021

In light of steep declines in economic output already in Q1 and partly further deteriorating data in April and May, we have also revised down our euro area GDP forecast from -7.2% to -8.3% this year. In the first quarter, the euro area registered a real GDP contraction of 3.6% vis-à-vis the preceding quarter, with declines ranging from -5.3% in Italy and France to -0.3% in Lithuania. Ireland constituted a notable exception, recording a moderate GDP increase in Q1, not least boosted by a large positive contribution from the information and communication industry, which may be deemed as one of the beneficiaries of the lockdown phase.

In order to support household income, many European governments introduced some sort of job retention scheme, which should help private consumption to pick up in the second half of the year, although concern over inevitable job losses in the wake of a rising number of insolvencies may cause many households to increase precautionary saving. Notwithstanding the cushioning effect of the short-time work schemes, employment is set to fall, and unemployment will rise, with dampening effects on wage developments as maintaining jobs will be prioritized. Low inflation rates will to some extent support disposable income, but due to the dismal first half of the year, private consumption will likely see a large drop in 2020.

Moreover, most governments implemented credit lines and guarantee schemes to companies of all sizes, as well as deferrals of tax payments, to ensure sufficient liquidity and prevent widespread bankruptcies. In some cases, such as in Germany, this came along with immediate support to small and medium-size enterprises. However, investment activity will likely grind to a halt. Facing the unpredictable course of the Covid-19 pandemic and the prospect of subdued demand, many companies will be reluctant to invest, or cancel their investment plans altogether, leaving capital expenditure to register a steep decline this year. That said, some economies such as Spain had been experiencing diminishing growth in gross fixed capital formation prior to the outbreak of the coronavirus, amid a more mature economic cycle and lasting tensions over global trade.

Foreign trade will also be impaired, curbed by interrupted supply chains and falling domestic demand, affecting both exports and imports in most countries. In particular, economies highly dependent on income from tourism-related services (e.g. Spain, Cyprus, Greece, Malta, Croatia) should see services exports contract sharply and look set to suffer for longer, as many people seem reluctant to travel in view of extreme uncertainty over the evolution of the Covid-19 pandemic, and as long as tested vaccines are not widely available. Recent news over resurging infection numbers in several Spanish regions such as Catalonia or Galicia only make matters worse. Such incidents underscore that the recovery will likely be uneven across countries, and remains subject to high uncertainty.

We have to emphasize that the extent to which European economies are affected by Covid-19 varies with regard to the degree to which they generally seem equipped for a pandemic, as also illustrated by our Pandemic Vulnerability Index. To say that countries in a better position to deal with a pandemic saw a less steep decline in Q1, may not give the full picture, considering that the nature of the lockdowns varied. Arguably, however, a lockdown has to be more severe in a country that appears less well prepared to weather such a storm. We thus believe that a more or less structural vulnerability coupled with the stringency of the restrictions – also in terms of duration – largely explains why some economies experienced a less severe contraction (see Figure 3).

Figure 3: Stricter confinement measures entailing sharper fall in economic activity

Change in GDP between January and May 2020 in percentage points (forecast); Global Mobility Tracker ⇔ Index showing mobility relative to baseline, i.e. 3 January to 6 February, average for retail, recreation, grocery, pharmacy, workplaces and transit stations

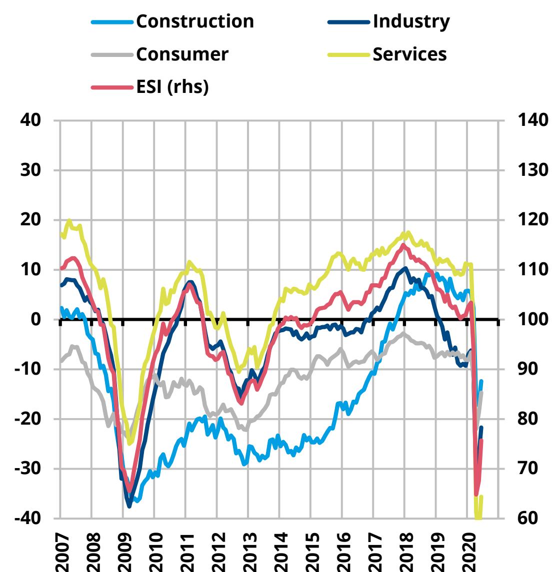
Sources: Creditreform Rating, Google Covid-19 Mobility Tracker, BIS calculations

With public life experiencing some normalization following gradual de-confinement from May, and based on the extensive fiscal and monetary policy support measures, we hold on to our view that the economy will gradually recover in the second half of the year, thereby laying the ground for a substantial rebound of GDP growth in 2021. Sentiment indicators such as the Composite Purchasing Manager Index (PMI) for the euro area are brightening up following spectacular declines in March/April, with the euro area PMI leaping to 54.8 in July, thus well above the 50-point-threshold hinting at expanding business activities and exceeding the pre-corona level of 51.6 in February. Strikingly, the services PMI so far points to a stronger recovery in the service sector than in the manufacturing sector (55.1 vs. 51.1).

While certainly a welcome development, at this stage we would remain cautious as to whether the rebound will prove sustainable, since to some extent the sharp July increase may reflect a more or less mechanical reaction following the lift-off of broad-based restrictions. What is more, we think that survey indicators tend to overshoot in time of extreme uncertainty.

Figure 4: Leading indicators for the euro area across sectors

Sectoral confidence indicators as balance i.e. the difference between positive and negative answers; Economic Sentiment Indicator (Index, 100=long-term mean)



Sources: Creditreform Rating, Eurostat

This being said, the picture among the sentiment indicators is somewhat mixed. According to the July flash estimate, the consumer confidence indicator compiled by the European Commission was broadly stable, after June saw the sharpest month-on-month-increase on record in the euro area, thus continuing a recovery that started in May, but still only making up for about 30% of the combined losses seen in March and April (see Figure 4). While, encouragingly, in June employment expectations improved sharply for a second consecutive month,

they remained far below levels seen prior to the current crisis. Overall, we think that real economic output in the euro area could expand by about 5.6% in 2021.

ECB ramps up monetary response

European governments' scaled-up response to Covid-19 has been flanked by the European Central Bank (ECB), which, at its monetary policy meeting in June, stepped up its initial Pandemic Emergency Purchase Program (PEPP) by EUR 600bn to EUR 1,350bn and extended it to at least end of June 2021. Moreover, the ECB will reinvest maturing principal payments from securities purchased under the PEPP until at least the end of 2022. In this context, it is worth mentioning that the ECB decided to include Greek government bonds in its PEPP, which further mitigates concerns over possibly resurfacing financial market stress in this regard.

The additional envelope of EUR 120bn to the Asset Purchase Program (APP) until the end of the year, as already announced in March, remains in place, as do a number of measures to ensure liquidity to the banking sector, a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area, and measures to temporarily contain adverse effects of rating downgrades on counterparties' collateral availability.

Germany: Comparatively moderate GDP contraction in Q1, but worse to come in Q2

As hinted above, Germany's economy experienced a more moderate GDP contraction in this year's first quarter compared to the euro area on the whole (-2.2% q-o-q vs. -3.6%). Nevertheless, private consumption and exports recorded sharp declines of 3.2% and 3.1% respectively. Gross fixed capital formation posted a 0.2% contraction, masking a slump of 6.9% in the machinery and equipment category, whereas construction investment increased by 4.1% and thus remained a stabilizing element. Government consumption contributed positively to GDP growth in Q1-20, expanding by 0.2%.

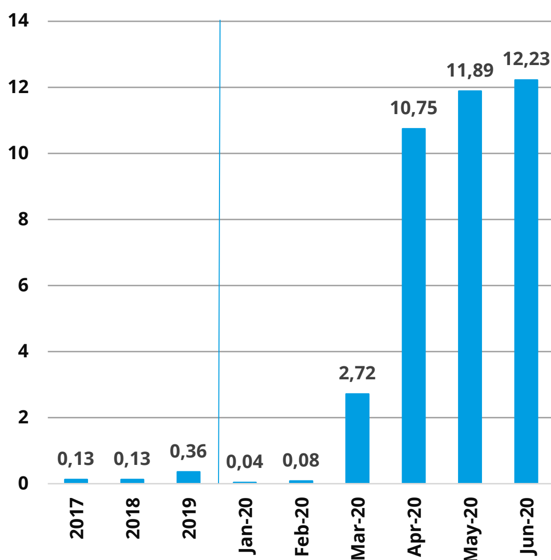
While Q2 should represent the trough given that large parts of the lockdown occurred in that quarter, data on resuming activity along with supplemented/extended fiscal measures since our last Economic Brief to assist a recovery support the expectation of returning economic growth in the second half of the year. May's industrial production (excluding construction) increased by 10.3% versus April, but the massive month-on-month drops in March and April, -11.0% and -21.0%, were not yet made up for. A similar picture emerges regarding new manufacturing orders, which in May went up by 10.4% versus April, following monthly declines of 15.0 and 26.2% in the two prior months. Real retail sales, on the other hand, presented a more positive picture, with the monthly increase in May offsetting prior declines in March and April.

As to developments on the labor market, available data until April pertaining to short-time work show that a staggering 6.8 million employees were affected by this instrument, with about 80% thereof working in the service sector. Having said that, the preliminary number of short-time work notifications as of 25 June has come down to 342,000 persons, from 1.14 million in May and 10.66 million in March and April combined (see Figure 5). Latest estimates by the government and the German Employment Agency suggest that the cost for the short-term work schemes could amount to approx. EUR 27bn. Against this backdrop, the instrument might be modified from 2021, with a view to combine it with stronger incentives for training or re-education. Reportedly, proposals in this regard are to be presented in September. Meanwhile, actual unemployment data are only

starting to deteriorate, and it will have to be seen to what extent inevitable insolvencies will ultimately drive up the numbers. In June, the seasonally adjusted unemployment rate rose by 0.1 percentage points to 6.2%, 1.3 percentage points above the level seen a year earlier (national data).

Figure 5: Short-time work in Germany

In millions, annual sum for 2017-19, 2020: cumulative number of short-time work notifications



Sources: Creditreform Rating, Bundesagentur für Arbeit

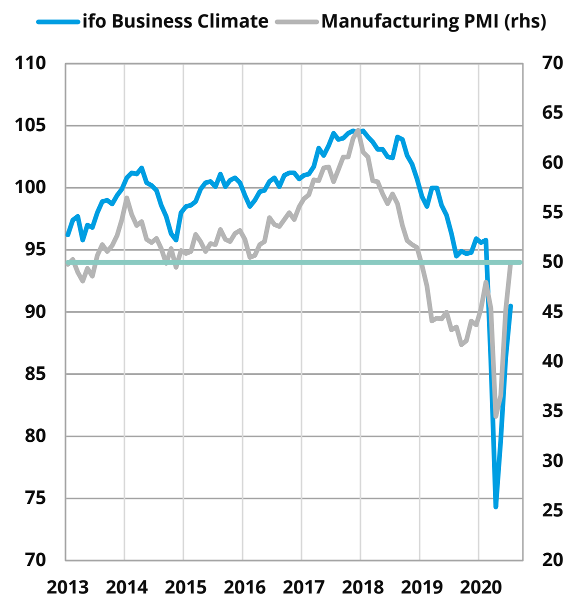
Sentiment indicators on German economy picking up markedly

Sentiment indicators for July strengthen our expectation of a rebound in the second half of the year (see Figure 6). The preliminary German composite PMI in July snapped back above the 50-point-threshold (55.5), with the service index suggesting stronger activity (56.7 points) than the respective indicator for the manufacturing sector (50.0 points). A word of caution seems applicable here as well, as for instance data pertaining to backlogs of work fell further, suggesting ongoing availability of spare capacity.

The ifo index climbed for a third consecutive month in July, rising from 86.3 to 90.5 points. While the component pertaining to companies' assessment of their current situation has not yet caught up with pre-corona levels, the index compiling companies' expectations has surged to the highest level since November 2018. Survey results pertaining to ifo export expectations, available until June, have largely recouped lost ground since February. Consumer confidence, while brightening since April, remains depressed compared to the phase prior to the corona crisis, thus raising some question marks over the strength of private consumption in the near future. Overall, we would largely stick with our GDP forecast for this year and next, with real GDP shrinking by about 6.1% and rebound by about 4.8% in 2021.

Figure 6: Leading indicators for Germany

Ifo (Index, 2015=100), Purchasing Managers' Index (50=growth threshold)



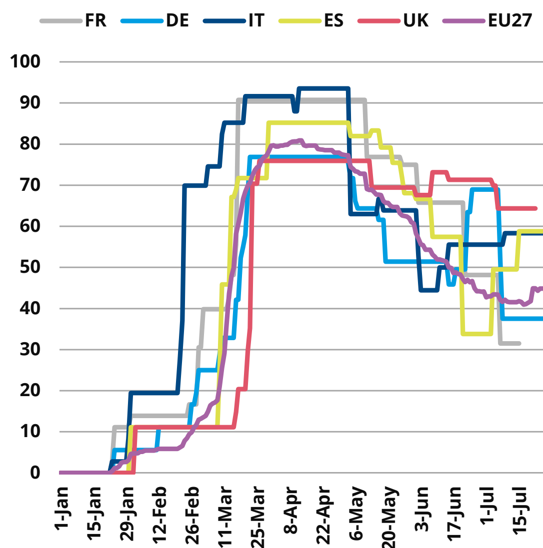
Sources: Creditreform Rating, Refinitiv, ifo Institut

Late change of strategy costs UK dearly – with a possible hard Brexit to add to that

Since our last Economic Brief, economic news in the UK has worsened dramatically, as has the number of Covid-19 infections and, sadly, related fatalities. The impression is that the UK government decided for a change of strategy towards the lockdown path followed by most European countries at a relatively late stage (see Figure 7). Moreover, crisis management and related communication has partly been perceived as rather poor. While due to the late change of strategy real GDP saw a comparatively mild contraction to the tune of 2.2% in the first quarter, Q2 results should mirror a drastic deterioration. Indeed, monthly GDP estimates for April pointed to a roughly 20% contraction in that month.

Figure 7: The strictness of the state Covid-19 measures

Government Response Stringency Index (100 = strictest response), based on 9 response indicators, including e.g. school closures, workplace closures and travel bans, up to 27 July 2020, unweighted average of the individual member states for EU27



Sources: Creditreform Rating, Blavatnik School of Government

While according to the Bank of England, payments data seem to confirm recovering consumer spending in May and June, a relatively strong take-up of the Coronavirus Job Retention Scheme suggests a higher number of furloughed employees in Q2-20. Hence, we view short-term prospects for household spending as clouded as more people appear set to display precautionary behavior which might spill over onto businesses. In this scenario, the dwindling likelihood of striking a trade deal with the EU before the transition period following Brexit ends at the end of December weighs even heavier on the economic outlook for the UK. We now expect real GDP to contract by about 9.4% this year, with an assumed recovery of 6.0% in 2021 even more uncertain in light of the more or less stalling negotiations with the EU.

At its June policy meeting, the Bank of England's Monetary Policy Committee (MPC) voted unanimously to maintain the policy rate at 0.1%. The Committee also decided unanimously to continue the existing asset purchase program that foresees purchases of UK government bonds and sterling non-financial investment-grade corporate bonds of GBP 200bn. However, in order to meet the inflation target of 2% in the medium term, the MPC voted by a majority of 8-1 to increase the target stock of purchased UK gilts by an additional GBP 100bn, which would then lift the total stock of asset purchases to GBP 745bn.

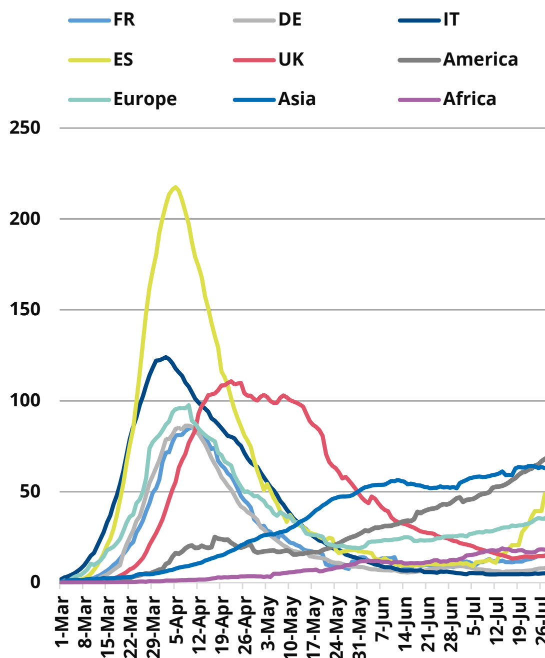
Resurfacing risks of second infection waves

Looking ahead, risks of a renewed broader infection wave surround the economic outlook, in particular as we progress into fall/winter, and respective broader lockdowns may be reinstated, underscoring immense ongoing uncertainty (see Figure 8). This at least holds for as long as there are no effective vaccines or medication available on a sufficient scale. Tourism-

related services, food and accommodation, entertainment, the aviation industry, and more generally, consumer-related services who intrinsically center around personal exchange, remain set to suffer under these circumstances.

Figure 8: Covid-19 infections around the world

Cumulative number for 14 days of Covid-19 cases per 100,000 inhabitants, unweighted mean for continents



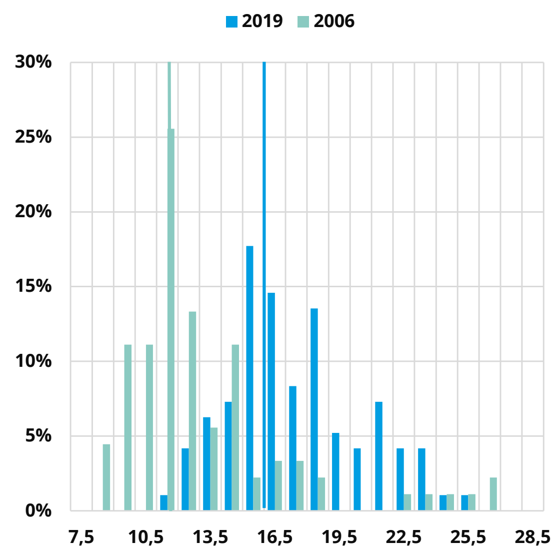
Sources: Creditreform Rating, European Centre for Disease Prevention and Control

Looming financial stability risks emanating from rising insolvencies and defaulting households

We note that negative reverberations from impaired economic activity could result in widespread insolvencies. As a corollary, these may extend to emerging distress in the banking sector, despite a significantly better situation in terms of capitalization and asset quality than prior to the global financial crisis (see Figure 9). So far, significant disruptions have been avoided and funding needs of the non-financial private sector have been met, thanks to loosened capital requirements and macroprudential measures, as well as government support given to households and corporates, involving state loans, public guarantees, and moratoria on payments.

Figure 9: Capital buffers among large international banks

Total capital ratio in %, sample of 135 major international banks



Sources: Creditreform Rating, Aldasoro et al. (2020)

Despite significant deleveraging efforts over recent years, household and corporate balance sheets appear stretched in some economies, mirroring very high debt levels. Pressure on banks may build up eventually, as declining corporate revenues and worsening labor market conditions may create an unfavorable backdrop for credit quality, which has already begun to deteriorate and prompted banks to provision for rising expected losses on their loan portfolio. In an adverse scenario that would probably come with a larger number of insolvencies and stronger rising unemployment, credit defaults would increase considerably, severely testing banking sector resilience.

Against this background, we are somewhat concerned with a view to the end of the year, as government support measures may be gradually wound down. We deem developments on the labor markets and in the corporate sector as somewhat distorted, since debt moratoria are in place, short-term work schemes have been implemented, and in countries such as Germany, the obligation to file for insolvency has been suspended.

At the same time, bank losses may be aggravated by weakening residential property markets, and pressure on the funding side may mount, coming on the back of rising spreads on bank bonds. In any event, we expect asset quality to deteriorate, reflected by increasing NPLs, and further pressure stemming from banks' low profitability, which is likely here to stay and is compounded by the ongoing low interest rate environment (see below).

Political fragmentation potentially weighing on medium-term growth prospects in Europe

More generally speaking and taking a more medium-term perspective, the corona crisis has struck at a time that is characterized by an increasing degree of political fragmentation in Europe. A number of countries is governed by multi-party coalitions or minority governments, both of which raise question marks over political stability. Belgium for instance is currently governed by a caretaker minority government equipped with 'power of attorney' to manage the corona crisis. Spain's left-leaning government has no majority in parliament, and in France president Macron's La Republic en Marche lost its absolute majority in parliament in May.

While we acknowledge the extraordinary circumstances as regards the emergency measures taken to prevent a longer-lasting economic slump, we remain wary as far as the need to address existing medium-term challenges to economic growth and, in some cases, competitiveness is concerned. We think that in some cases the consensus necessary for decisive reform action could be jeopardized against the challenging political backdrop, which could be compounded by the need to reduce extensive public debt following the most acute phase of the Covid-19 pandemic (see below).

In addition, we see a tail risk of increasing regional/communal disparities, and arguably more importantly, a potential deterioration in terms of social cohesion and rising inequality due to the Covid-19 pandemic. Hence, already existing difficulties in finding broad-based political consensus over structural reforms aiming at social inclusion and revamping pension systems may become more entrenched.

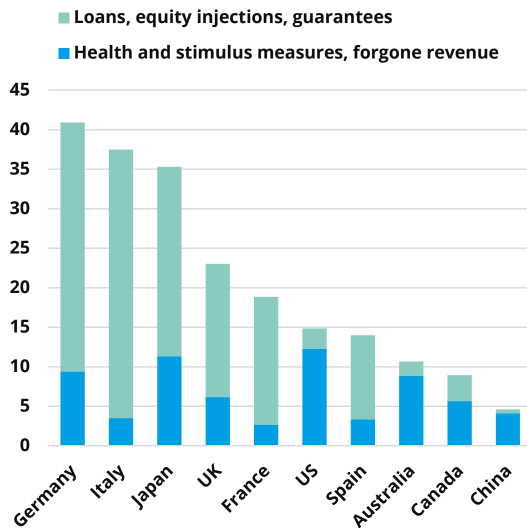
Government deficits and debt-to-GDP ratios to soar, with affordability a soothing factor

Amid plunging economic output entailing revenue losses and the operation of automatic stabilizers such as unemployment insurance and welfare systems, and in the face of extensive fiscal support packages (see Figure 10), government finances are set to deteriorate significantly.

Soaring deficits will push debt-to-GDP ratios up, in some cases to levels far beyond any assumed prudential threshold (e.g. in Italy, Spain, and France), and may erase any fiscal means otherwise earmarked to fund necessary structural reforms. However, we would reiterate that in light of the key priority to save lives and safeguard the viability of the health system, the question over available scope to counteract Covid-19 from fiscal sustainability perspective is of secondary importance at the current juncture.

Figure 10: Sizeable fiscal packages in response to the Covid-19 pandemic

Fiscal response in % of GDP, as of 12 June 2020



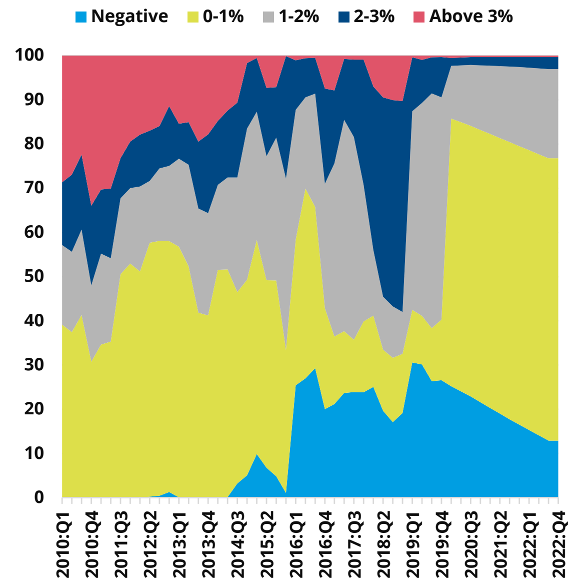
Sources: Creditreform Rating, IMF

Having said that, we believe that continued market access and mostly sound debt management along with increasingly favorable debt profiles will continue to bolster debt affordability, mitigating fiscal sustainability risk, and cater for fiscal leeway to address structural impediments to healthcare and social security systems going forward.

In our view, the interest rate environment will remain supportive in the short to medium term, as government bond yields should stay lower for longer. Due to central banks' decisive monetary policy easing (e.g. ECB PEPP, see above), government bond yields in advanced economies have declined further or remained at historically low levels at least. While a quarter of all outstanding government bonds (25.2%) displayed negative yields at the end of Q1, the share of bonds with yields of less than 1% shot up to 60.6% as compared to 13.7% at the end of last year (see Figure 11).

Figure 11: Government bond yields in advanced economies

In % of total government bonds outstanding, by yields in %, estimates (market expectation) start after Q1-20



Sources: Creditreform Rating, IMF

Coronavirus as a catalyst for a deeper European integration?

Diminishing fiscal space could strengthen dividing forces among EU countries, widen both the economic and social gap within and between member states and ultimately put the Union as such at risk.

It is mainly against the threat of such a scenario that, in a landmark decision and after a heated debate, the EU heads on 21 July not only adopted the – slightly delayed – Multiannual Financial Framework (MFF) for the period 2021-2027. More importantly, decision-makers clinched a deal on the large-sized recovery effort under Next Generation EU (NGEU) in order to mitigate the likely socio-economic damage resulting from the corona crisis. The consent by European Parliament is still pending, but we do not expect this to be a major stumbling block.

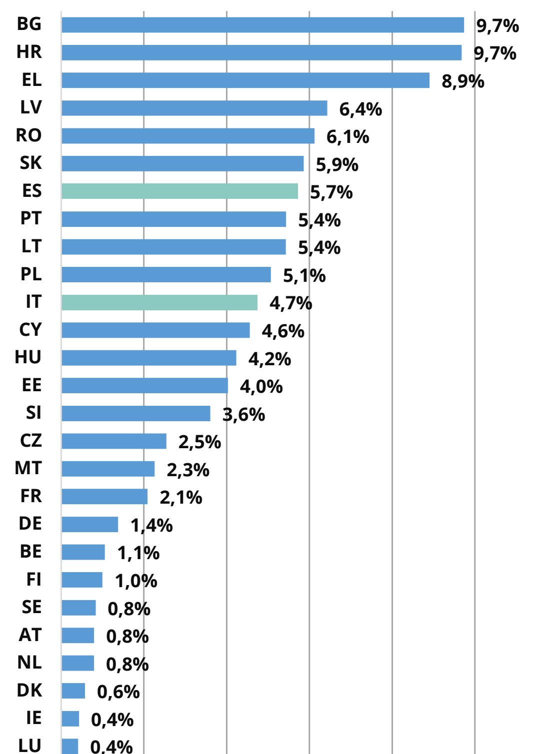
In a historic decision that – in our view – represents nothing less than first steps towards a European fiscal union, the Commission will be authorized to borrow up to EUR 750bn (in 2018 prices) on behalf of the European Union on capital markets. In order to underscore the exceptional nature of this step, the powers granted to the Commission are limited in size, duration, and scope. The proceeds will be transferred to EU programs in accordance with NGEU. New net borrowing activity is to stop at the end of 2026 at the latest, and the countries have agreed to use the funds borrowed on the capital markets for the sole purpose of addressing the consequences of the COVID-19 crisis, with up to EUR 360bn in the shape of loans and up to EUR 390bn as grants. The repayment is scheduled until 31 December 2058.

However, payments are not likely to commence before the second half of 2021. While the agreement undoubtedly represents a compromise for all members involved, we remain cautious of the fact that a still sizeable part of the support will come via grants, thus foregoing a chance to significantly strengthen the structural reform momentum. Smaller economies mainly from Central and Eastern Europe are among the main beneficiaries pertaining to grants. Italy and Spain, which have been particularly hard hit by the health crisis, are also about to receive substantial funding, with allocations of roughly EUR 85bn and EUR 71bn respectively (see Figure 12).

We note that according to the EU Commission's decision, 70% of the funds allocated under the Recovery and Resilience Facility (RRF), which accounts for the bulk of NGEU financing (EUR 672.5bn) depend on the 2019 population, the inverse of 2019 GDP per capita, and the 2015-2019 average unemployment rate – all relative to the EU-27 value. As regards the allocation key for the remaining 30%, the unemployment criterion will be replaced by the loss in real GDP over 2020 and the cumulative loss in real GDP over 2020-21 – to be calculated by June 2022.

Figure 12: Cross-country grant allocations under NGEU

Total in % of 2019 GDP, all individuals programs



Sources: Creditreform Rating, Bruegel

Digital transformation progressing in view of Covid-19

On the positive side, the crisis has drastically exposed existing deficiencies in terms of digital transformation and is thus proving to be a catalyst to press ahead with establishing necessary infrastructure including upgrading respective equipment and providing required training. As with every structural shift of this sort, the flipside of the coin will include some industries' losing out and a larger number of people having to

be retrained as different skills are required. However, more investment into these areas should ultimately pave the way for increasing Europe's growth potential in the medium-to-longer term and possibly enable it to finally set something against the extreme digital dominance of the US and China.

CONTACT

Dr. Benjamin Mohr, Head of Economic Research and Sovereign Ratings

Fabienne Riefer, Senior Economist

Disclaimer

This analysis is protected by copyright. Any commercial use is prohibited without prior written permission from Creditreform Rating AG. Excerpts may only be used with the express consent of Creditreform Rating AG. Publication of the report without the consent of Creditreform Rating AG is prohibited. Creditreform Rating assumes no liability, express or implied, as to the accuracy, completeness, or timeliness of any assessment, opinion, or information in any form or manner whatsoever. The analyses underlying this publication and their results do not constitute a recommendation for investment.