

BAROMETER COUNTRY AND SECTOR RISKS BAROMETER

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By the Coface
Economic
Research team

COVID-19: heading towards a sudden global surge in corporate insolvencies

In the previous Coface quarterly barometer published on 4 February 2020, we anticipated that the main risks for the world economy in 2020 would be, paradoxically, of non-economic nature. We included political and environmental risks in this category. Three months later, it is another type of non-economic risk that is tilting the global economy into recession. The COVID-19 epidemic in China, initially affecting a limited number of value chains, has turned into a global pandemic that requires the containment of over half of the world's population, in more than 50 countries. For businesses, the sudden measures taken by governments to stem the expansion of the virus represent a double shock - supply and demand - that is affecting a large number of industries. The uniqueness of this crisis makes comparisons with the previous ones useless, as the latter have a financial origin (world credit crisis of 2008-2009, great depression of 1929).

In this context, the question is no longer about the countries and sectors of activity that will be affected by this shock, but rather the (rare) ones that will be spared. For instance, the pharmaceutical sector and, to a lesser extent, the food industry are among these relatively spared sectors. In 2020,

the world economy should experience its first recession since 2009 (-1.3% after +2.5% in 2019) and 68 countries are expected to be in recession this year against only 11 last year. The volume of international trade will drop for the 2nd consecutive year (world trade down by 4.3% this year in volume, after -0.4% in 2019), the credit risk of companies will be rise sharply and Coface forecasts that corporate insolvencies will increase by 25% worldwide (compared to only +2% expected last January). It would be, by far, the strongest increase since 2009 (+29%), even if economic activity gradually restarts in the 3rd quarter, and without the occurrence of a second wave of epidemic in the second half of the year. This trend would affect the United States (+39%) and all the main Western European economies (+18%): Germany (+11%), France (+15%), United Kingdom (+33%), Italy (+18%) and Spain (+22%). The shock could be even more violent in emerging economies: in addition to the pandemic, which might be more difficult for them to manage, they are also facing the fall in oil prices, as well as capital outflows that have quadrupled compared to their 2008 level. Finally, the pandemic should also have many political consequences, the most obvious being that it exacerbates existing geopolitical tensions in the short term.

From a health crisis...

The data on the spread of the pandemic by country constitute essential and necessary information to establish one or more economic scenarios, even if their degree of reliability depends on the frequency of tests carried out on the population, on the quality of the data reporting system in each country and on the transparency of local authorities. The Johns Hopkins University in the United States is a benchmark in the compilation of this data.

The analysis of their evolution highlights several stages in the spread of the pandemic. First, the spread rate of the virus (called RO , i.e. the number of people infected by each person carrying the virus) increases exponentially, establishing itself at a high level: between 2 and 3 in the case of COVID-19. When the population was alerted about the risk involved, the growth of the number of new confirmed cases becomes linear albeit strong (the number of cases increases by around one third daily, so that the number of people affected doubles every three days). Then, the government takes measures to slow the spread, the success of this strategy depending in most cases on the degree of severity to limit contacts between people.

In fact, according to the epidemic propagation models, the degree of propagation (RO) is the product of three factors:

- The number of daily contacts of an infected person with other people;
- The probability that an unaffected person be contaminated at the contact of a person afflicted by the virus;
- The duration of the illness in number of days.

With an RO equal to three and without any action from the authorities to slow the expansion of the virus, almost the entire population is affected within two months (see **Chart 1(a)** for France's case). Halving this degree of propagation ($RO = 1.5$) - for instance, if each person halves the daily number of interpersonal contacts - is valuable but insufficient: almost half of the population is infected in six months. To stem the epidemic, RO must be inferior to 1. Once below this threshold, the number of additional contaminated people drops as fast as it had increased during the spreading phase.

By the end of March, a small number of countries had reached the reflux of the epidemic and almost all of them are in Asia (see **Box 1**). Elsewhere, only a few northern European countries appeared to be in a similar situation: Norway, thanks to early containment measures and Sweden, despite much less stringent containment measures.

In October 2019, the Johns Hopkins Bloomberg School of Public Health's Center for Health Security, Nuclear Threat Initiative and the Economist Intelligence Unit released their Global Health Security (GHS) Index for 195 countries. The GHS Index data are drawn from publicly available data sources from individual countries and international organizations, as well as an array of additional sources including published governmental information. Among many indicators, the countries' Emergency preparedness and response planning (containing a national emergency response plan for diseases with pandemic potential), as well as the Emergency response operation (link between public health and security authorities, drills for Emergency Operation Centre, etc.) seem particularly relevant in the present pandemic

Chart 1(a):
COVID-19 propagation model for France

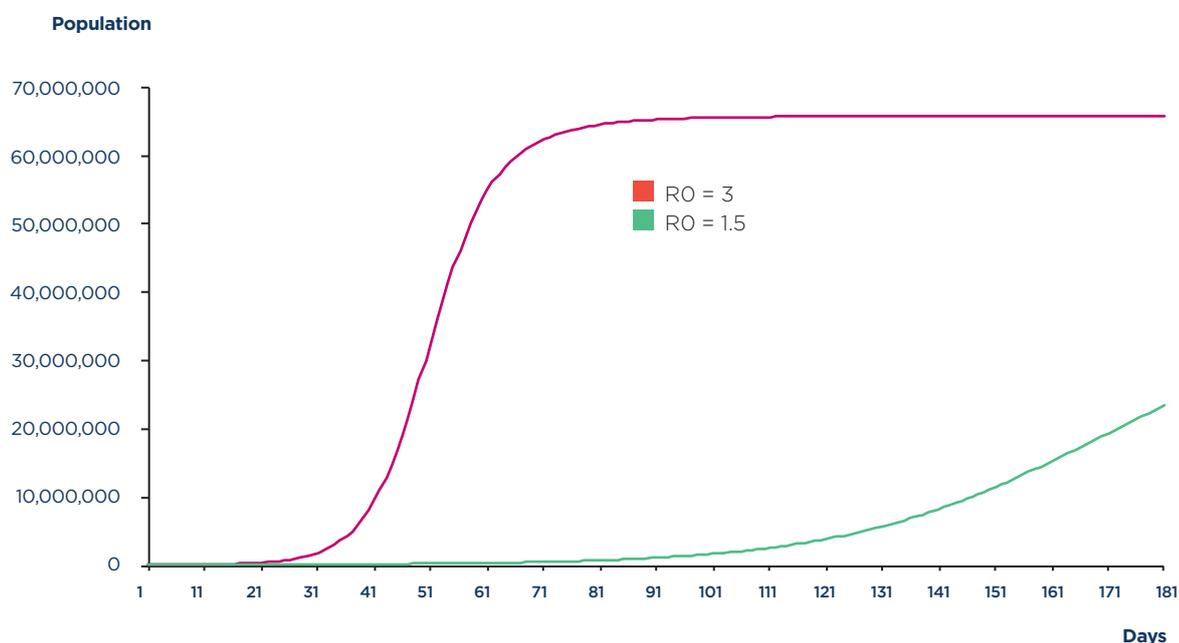
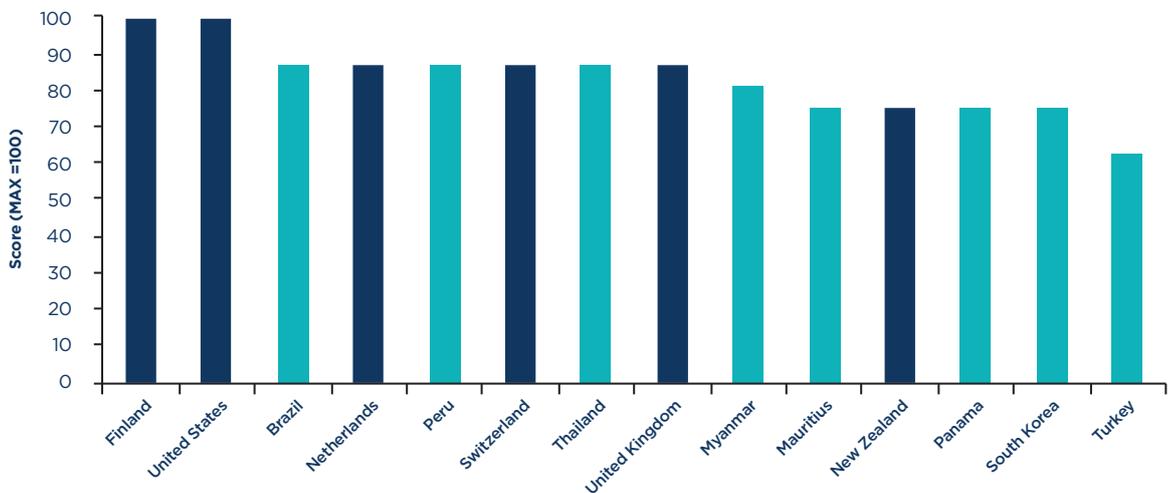
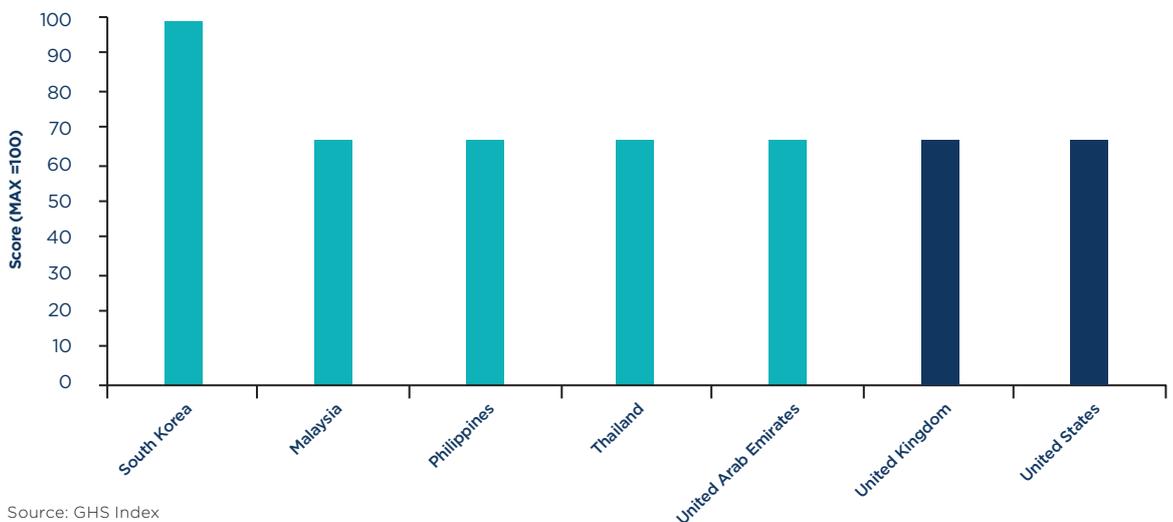


Chart 1(b):
Emergency Preparedness and Response Planning
(countries scoring above average)



Source: GHS Index

Chart 1(c):
Emergency Response Operation
(countries scoring above average)



Source: GHS Index

situation to qualify the capabilities of countries to respond to public health emergencies. They show that emerging countries, especially Eastern Asian ones are well represented, while only a couple of advanced economies manage to get above an average score (see **Charts 1(b) and 1(c)**).

In this context, it is reasonable to expect that the containment measures adopted in Europe, at varying degrees, will be gradually lifted during the 2nd quarter. There would be fewer restrictions on movement and gathering, albeit without returning to the original situation. The implementation

of a lot more testing policies in countries that did so shortly before containment, alongside the continuation of certain measures of social distancing and the possible arrival of effective antiviral drugs (pending a vaccine in 2021), would allow a very gradual recovery of the economy.

However, the degree of uncertainty is extremely high, and a second scenario, in which a second wave of contagion would happen in the second half of this year, is possible. Keeping in mind all the limits of the exercise, the forecasts presented below are based on the first scenario.

Box 1:

How long will the lockdown last? Lessons from Asia:

According to data compiled by Johns Hopkins University (JHU) as of March 31, there were 82,198 confirmed cases in China, of which 75,916 have already recovered (even if there are doubts about the reliability of these data in China). This means that China has 6,282 active cases – how did it get there? China was the first country to impose mandatory social distancing measures, starting with Hubei’s provincial capital and epicentre of the outbreak, Wuhan, on January 23. These were soon expanded to cover 60 million people in Hubei province on February 13. Other parts of the country followed suit, implementing similar measures of varying degrees of severity in the following days. Despite the initial criticism towards China’s draconian measures, many other countries around the world have had to resort to similar means to control the spread of the virus in their domestic economies. Most importantly, the perception is that the lockdowns have prevented a more severe epidemic in the world’s most populous country, which would have been disastrous for the global economy. As of March 27, Wuhan lifted its lockdown and resumed transportation, allowing residents to leave the city using a green code (in order to monitor the level of contagion, the authorities assign a colored QR code to each individual, on their mobile phones. The green color allows movement, while the orange and red colors mean that the person has a high risk of contagion) similar to that carried by other residents in the province.

The challenge for China will be to avoid a second wave of infections as the country gradually resumes operations. According to official figures, the country is operating at 75% capacity compared to normal levels before the COVID-19 outbreak started. There are some differences depending on company size, with large companies registering higher rates (80.1%) compared to small and medium enterprises (71%), which in China account for the lion share of employment. Moreover, while many companies have reopened, they may be facing labour shortages. According to data compiled by Baidu, which uses triangulation data from mobile phone users to identify a migration intensity index, the flow of people back into the cities following the Chinese New Year break has only been a trickle relative to the same period last year. Compounded with mandatory self-quarantine periods for travel between provinces, this means that it may still take a few more weeks before businesses can resume their normal operations.

South Korea has deployed a different approach to contain the virus. In addition to reducing inbound flights and mandatory quarantines for travellers, Seoul rolled out a mass public testing programme in response to a severe outbreak in the country’s fourth largest city, Daegu. Officials sought to test anyone who might have been exposed to the virus, asymptomatic or not. More than 210,000 tests were conducted with 10,000-new tests carried out daily during the height of the epidemic in February. This approach seems efficient: JHU figures show that there were 9,661 confirmed cases in South Korea as of March 31, of which 5,228 have already recovered (4,433 active cases). All new cases are related to a cluster linked to a sect, as churches restarted worship services despite social distancing rules. Most importantly, the mortality rate has remained below 1%, something that is consistent with observations in other countries with pre-emptive testing (for instance, Germany and Switzerland)¹. One theory could be that the tests allow carriers to be detected early, prompting them to self-isolate, thereby preventing them from infecting other people. Since many are asymptomatic, it does not encourage caution. Indeed, while the disease is almost asymptomatic in many cases, it can sometimes cause a severe inflammatory reaction through a storm of cytokines in the lungs around the ninth day. Early detection and prevention can avoid overwhelming health services and reduce the risk for medical personnel.

Last but not least, there is a case to be made about behavioural differences between advanced Confucian societies in East Asia (Japan, Hong Kong, Singapore, South Korea and Taiwan) and other parts of the world. Populations in these countries were very responsive to initial warning signals issued by the government. A recent paper by Imperial College² shows a positive correlation between social distancing measures and a lower rate of COVID-19 reproduction. Interestingly, East Asian economies that implemented mild forms of social distancing, together with other hygiene and prevention measures, were able to sustain intermediate levels of economic activity without provoking a large-scale outbreak. A great example of this sort of prevention measure includes the quasi-mandatory use of surgical facemasks to go outside. Unlike Europe and North America, East Asian economies experienced SARS in 2003, and populations may have been more compliant (as well as diligent) in deploying these measures.

1 Financial Times (March 11, 2020). Coronavirus testing: how are the hardest-hit countries responding? <https://www.ft.com/content/dd416102-5d20-11ea-b0ab-339c2307bcd4>

2 Ainslie, Walters, Fu et al (2020). Evidence of initial success for China exiting COVID-19 social distancing policy after achieving containment. Imperial College London. <https://www.imperial.ac.uk/media/imperial-college/medicine/sph/ide/gida-fellowships/Imperial-College-COVID19-Exiting-Social-Distancing-24-03-2020.pdf>

... To an economic crisis through a double shock of supply and demand

The containments are reflected by a type of supply shock never observed during previous great crises (Great Depression of 1929 and global credit crisis of 2008-2009). The nature of these previous shocks was very different: they were financial crises in the first place, which then had consequences on real activity. This time around, the initial shock comes from the real economy: many activities are penalized because 1) they have to close due to quarantine measures that prevent people from going to their workplace and/or to consume. 2) They are indirectly affected by this supply shock, through disruptions in the supply chains of intermediate goods because of the activity interruption of suppliers and transport issues (see section on world trade hereinafter). The companies the most hit by this double shock on supply and demand will be services linked to tourism (sector for which the UN anticipates a drop in activity of 20% worldwide this year, against “only” -4% in 2009), such as hotels, restaurants (on 25 March, data from the Booking.com website indicated that reservations for restaurants fell by almost 100% worldwide), leisure (museums, amusement parks, sporting events). Secondly, transport has to be mentioned, in particular air transport: the International Air Transport Association (IATA) signalled that the pandemic could cost the air market between 11% (63 billion US dollars, USD) and 19% (USD 113 billion) of passenger revenue this year³. Almost all segments of specialized retail (such as clothing and electronics) are also affected, despite the support of e-commerce. Other service sectors are expected to be much less impacted (telecommunications, water, sanitation).

Most manufacturing sectors are also directly affected by containment measures, with the agri-food industry being the exception. In France, excluding agri-food, only half of manufacturing activity would be maintained during the containment period according to INSEE. For construction, almost 90% of building sites were stopped after the restrictive measures came into force (see **Table 1**). Unsurprisingly, small businesses will be the most vulnerable in all of these industries.

An equally brutal demand shock adds itself to the supply shock, as many consumers are cancelling or postponing their expenditure on goods and services because of quarantines and the compulsory closure of non-essential businesses. In addition to this immediate effect, the impact of containment on household confidence is an aggravating factor. For instance in Germany, the GfK benchmark indicator of consumer confidence fell sharply in March, under the combined decline of its various components: income expectations and the desire to make purchases. The drop in inflation expectations (arguably linked to the fall in oil prices) did not compensate all the negative factors affecting the morale of German households.

In this environment of extreme uncertainty, businesses and households will also be inclined to postpone their investment decisions. Firms might stop hiring or even lay off workers. The historically high level of unemployment benefit claims recorded in the United States on 2 April 2020 indicates that this process started very quickly: 10 million Americans applied for unemployment benefits in two weeks. The latest figure has set a new record since the first publication of this data in 1967 and at a level over ten times higher than the previous record-high (695,000 reached in 1982). Admittedly, this exceptional increase is also partly due to the introduction of unemployment insurance at the federal level, which should have prompted independent workers to apply for an allowance.

Table 1:

Estimated output and household consumption loss due to containment measures (difference between the economic activity estimated during the last week of March and the activity of a “normal” week)

	Output loss compared to normal activity	Household consumption compared to normal activity
Agriculture/agrifood	-4%	+6%
Industry (excl. agrifood)	-52%	-60%
Construction	-89%	-90%
Market services	-36%	-33%
<i>Excl. housing services</i>		-56%
<i>Housing services (rent)</i>		0%
Non-market services	-14%	-34%

Source: INSEE, Coface

3 Data dated 5 March 2020. IATA specifies that this figure may change depending on the duration of the crisis.

Moreover, in detail, it is likely that the precarious employees of the restaurant or even the hotel industry in large metropolitan areas were the first to bear the cost of these redundancies. Similar trends are already observed in Canada and Norway, where the unemployment rate rose from 2.3% to 10.4% of the working population in one month.

In France, the previously mentioned INSEE study assesses total household consumption during containment at 65% of the normal level. In other words, the estimated loss of consumption linked to containment measures amounts to 35%. Durable consumer goods such as vehicles should be badly hit by this shock. Auto sales in China fell by 80% year-on-year in February, as the epidemic neared its peak in the country. Other expenses, such as textile-clothing and electronics, are also likely to be reduced to almost zero. At the other end of the spectrum, the consumption of electricity or water should not suffer from this new environment and agri-food and pharmaceutical products should even benefit from this exceptional situation. Indeed, governments protect the two aforementioned sectors and distributors are authorized to remain open despite quarantine measures because of their essential nature. Therefore, the continuity and sustainability of functioning value chains in these sectors is the subject of all the attention, from both governments and supranational organizations.

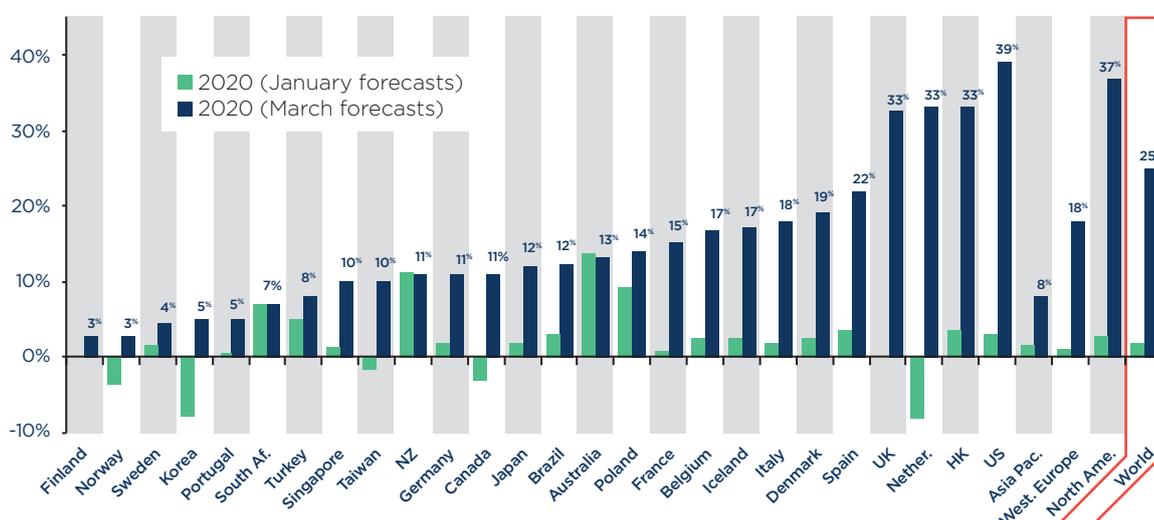
Finally, the degree of vulnerability of a business to this demand shock also depends on the consumer's propensity to postpone the purchase of the good or service it produces. Thus, for most service activities, the aforementioned consumption losses will probably not be made up for once containment is over. Assuming a person has the habit of going to the restaurant once a week in normal times and

is temporarily deprived of this possibility, he/she will not increase the number of visits to restaurants per week to compensate for the loss when the ban is lifted. Hence, many service companies will suffer outright losses. This is also the case for companies producing fuels (petroleum for transport, coal, etc.) that are less used because of reductions in transport traffic. On the other hand, the purchase of an automobile or real estate is easier to postpone. The same goes for companies producing raw materials or parts used in the production of these durable consumer goods (metals for construction and automotive for example). Some business sectors are in an intermediate position (luxury, electronics, etc.).

What are the growth forecasts for business insolvencies and GDP for 2020?

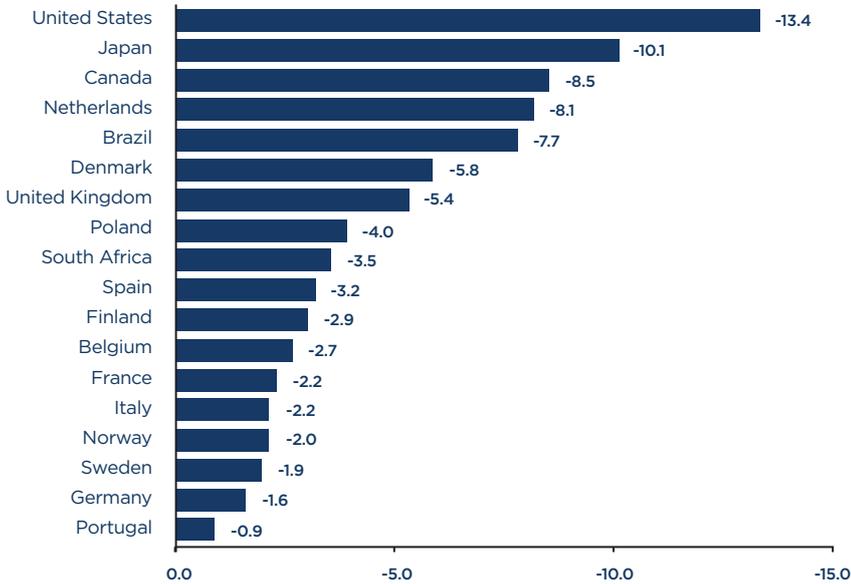
In any case, the production and consumption shutdowns (or quasi-shutdowns) are expected to worsen cash flows and margins of companies. Thus, the number of business insolvencies is expected to increase sharply. Coface anticipates an increase of 25% this year worldwide (compared to only 2% in 2019 and the initial forecast for 2020 made last January, see **Charts 2(a) and 2(b)**). If proven true, this increase will be the strongest in ten years (+29% in 2009), despite governments announcing the modification of insolvency procedures of companies in several countries, in order to limit their magnitude (for example in France and the UK). In the United States, the number is expected to increase by 39%, a rate superior to that of Western Europe (+18%). Even in Japan, where the number of corporate bankruptcies was on a declining trend for ten years and despite an average growth rate close

Chart 2(a):
Annual evolution of corporate insolvencies per country
(in %)



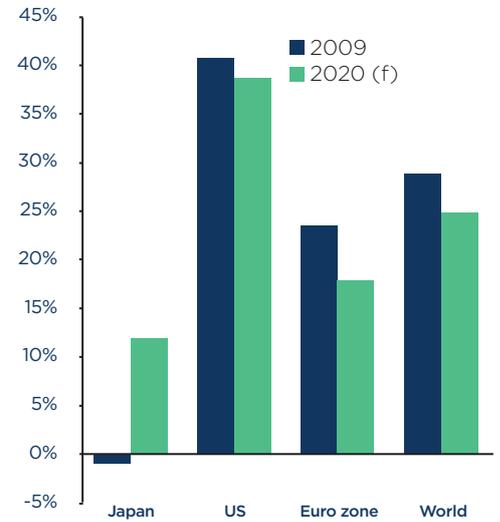
Sources: National data, Coface

Chart 2(b):
Ratio of insolvencies growth forecasts (%)
to GDP growth forecasts (%)



Sources: National data, Coface

Chart 3:
Insolvencies growth
(in %)



Source: IMF, National authorities, Datastream, Coface

to 0 (0.7% on average between 2009 and 2019), a double-digit growth rate of corporate loss ratio is now expected (+12%). In 2009, the number of business insolvencies had increased more sharply in the United States (+41%, see **Chart 3**) and in the Eurozone (+24%), but less in Asia (+2% only 11 years ago).

These forecasts for the evolution of the number of insolvencies by country are made through a statistical model that uses Coface's GDP growth forecasts as an explanatory variable for bankruptcies. Despite the very high degree of uncertainty outlined above, these growth forecasts are based on the assumptions of estimated loss

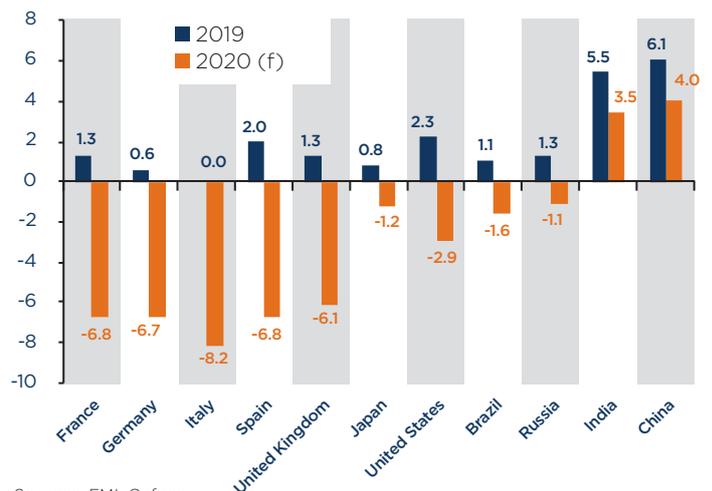
of production by sector of activity and from the central scenario of evolution of the pandemic that was adopted. However, even in this more favorable scenario, global GDP growth would be negative this year (-1.3%) for the first time since 2009 (see **Chart 4**). Among the main world economies, the United States (-2.9%), Japan (-1.2%) and the Eurozone (-6.2%) will be in recession (see **Chart 5**). This will also be the case in Russia, Brazil, Mexico and South Africa. While remaining positive, growth should slow down significantly in China and India. At the end of the day, Coface anticipates negative growth in 68 economies this year, compared to only 11 in 2019.

Chart 4:
Coface's World GDP Growth Forecast
(annual average, %)



Sources: IMF, National authorities, Datastream, Coface

Chart 5:
Annual Growth rate
(% of GDP)



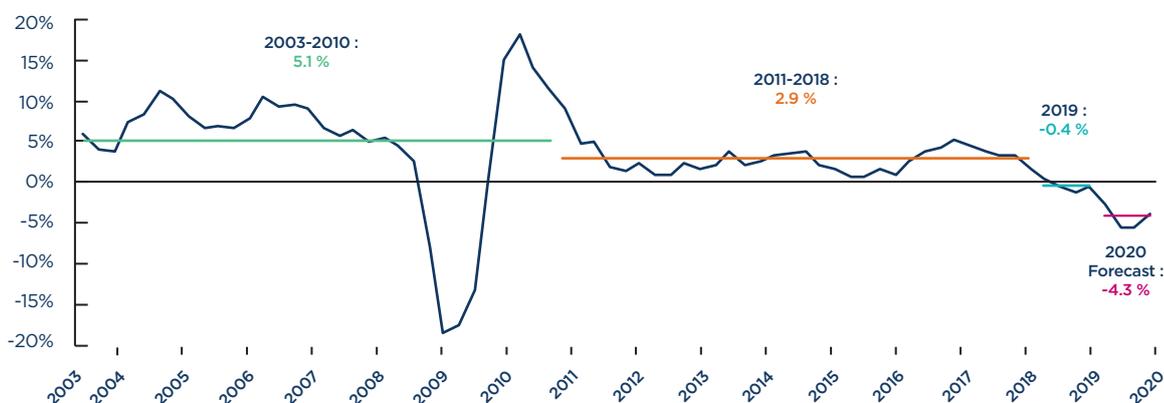
Sources: FMI, Coface

Global recession, halted transport, tighter border control and rethinking of supply chains: the headwinds to international trade are even stronger than in 2019

Coface’s forecasting model, which uses oil prices (Brent barrel), shipping costs (Baltic index), confidence of manufacturing companies in the United States (ISM index) and Korean exports as explanatory variables, indicates a 4.3% decline of world trade in volume in 2020 (see **Chart 6**), the worst performance since 2009 and the second consecutive year of decline (-0.4% in 2019). Risks to this forecast are tilted to the downside, since the numerous border closure announcements that are not taken into account in this model could exacerbate this decline. For instance, the European Union decided on March 17 to further control its external borders for at least 30 days, to contain the COVID-19 pandemic. Admittedly, these border closures only apply to people, while the flow of goods is not officially restricted: “the flow of goods to the European Union must continue to secure the supply of goods, including essential items such as medicine, but

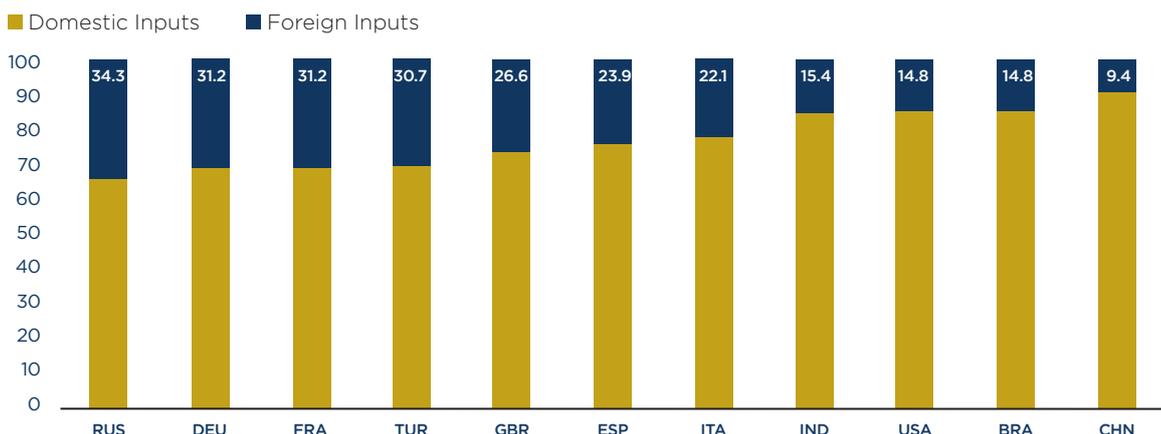
also food and components that our factories need,” said Ursula Von der Leyen, President of the European Commission. However, the great difficulties that the transport sector will meet, especially air transport, should be a barrier to trade (even if the maritime transport sector seemed to be in a slightly better shape at the start of the year, especially on regional routes). Additionally, the pandemic control measures should slow the circulation of goods at each stage: transport, customs clearance, storage and sales. The closure of some borders within the EU (in particular Spain, Poland, Denmark, Czech Republic), the decision by Germany, Austria and Slovenia to introduce stricter controls at some of their borders, and the tightening of some associated regulations will not help matters. The trend of closing borders is not specific to Europe: Canadian Prime Minister Justin Trudeau announced on March 18 the closure of the longest land border in the world, the one between his country and the United States, while specifying as well that it would only concern people and not goods. In Africa, Ivory Coast, Burkina Faso and Cameroon have closed their borders, and many other countries have implemented various

Chart 6:
World: Growth in export volumes (% YoY)



Sources: CPB, Datastream, Coface

Chart 7:
Share of Inputs Sourced Domestically and in Foreign Countries



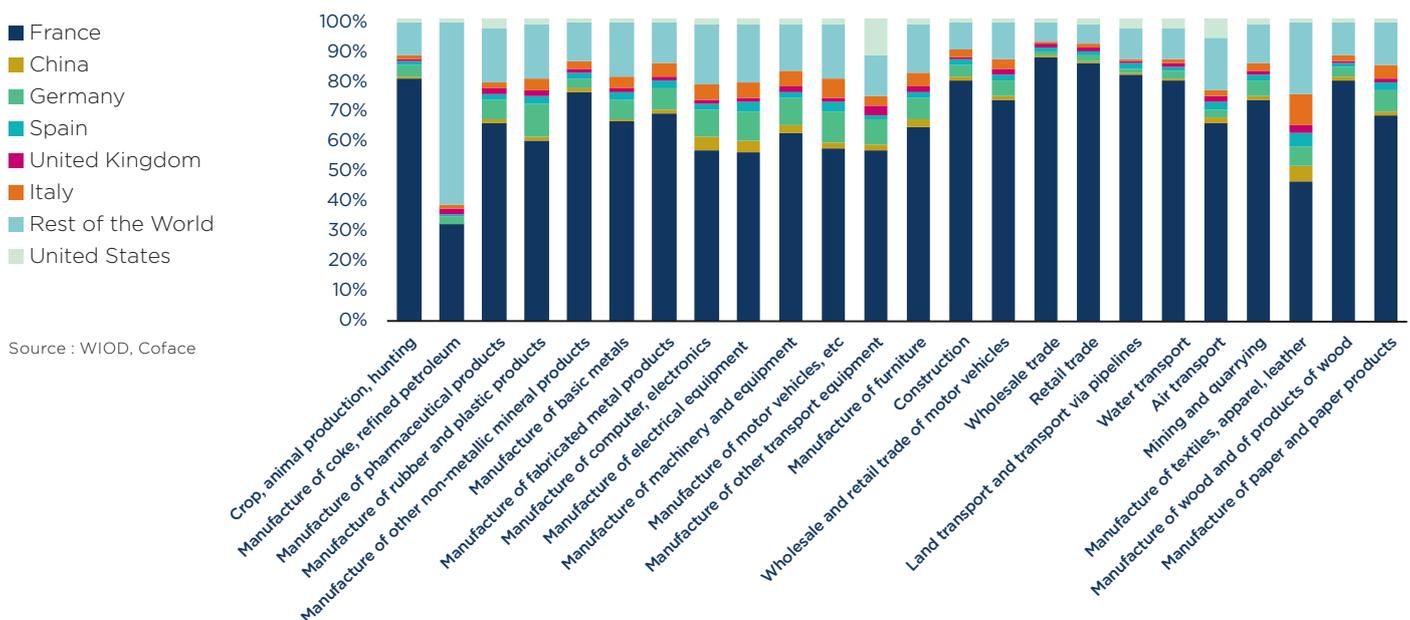
Sources : Coface, WIOD

restrictions on movement (closure of certain borders, suspension of air connections, etc.): Nigeria, Senegal, Morocco, Algeria, Kenya, Ghana and South Africa. On other continents, Russia, Pakistan, Egypt, Australia, New Zealand, Lebanon, Brazil, Argentina, Chile, Colombia, Peru, Venezuela and Bolivia are on the same line.

In the longer term, the COVID-19 crisis could also have consequences on the structure of global supply chains. Even though the majority of companies in the advanced economies remain primarily dependent on their local suppliers (see **Chart 7**), the dependence on international production chains varies greatly from one sector of activity to another, as shown by the example of France (see **Chart 8**)⁴. Not surprisingly, almost half of consumed intermediate products come from

abroad in the automotive, electrical equipment and even textile sectors. In the current context, even if the crisis could encourage companies to reduce this share and relocate certain productions, the main source of vulnerability for companies is their heavy dependence on a reduced number of suppliers located in a few or even a single country. Therefore, increasing their number to anticipate possible supply chain disruptions will now be a priority for companies. However, this diversification of suppliers and countries could penalize trade with some countries (for example, China in the electronics, automotive and textile sectors) and benefit others (South East Asian countries for electronics, Turkey, Morocco or Mexico for automotive). In other words, this pursuit of diversity could modify the structure of international trade in goods without slowing it down further.

Chart 8:
Repatriation of Intermediate Inputs by Country Source for French Sectors



The markets have finally understood that central banks fully support the economies in the United States and the Eurozone

To make national lockdowns bearable for businesses and households, a number of governments have announced large-scale fiscal stimulus that include sets of similar measures. To prevent the lack of liquidity from turning into corporate insolvency, the payment of taxes and social security contributions will be deferred, and massive funds have been set aside to be used as loans and guarantees. Salaries will be partially covered, particularly by

partial unemployment of which the rules have been relaxed. Vulnerable households will benefit from moratoria on mortgage repayments and the payment of rents and utilities.

So far, the size of the responses appears consistent with the pre-existent fiscal space in the Eurozone. Germany stands out with a fiscal impulse of approximately EUR 150 billion (4.5% of GDP), banking on years of fiscal restraint. On its own, Berlin's EUR 50 billion programme of direct grants to SMEs is larger than the entire French package and twice the size of Italy's. In France, the widespread extension of partial wage subsidies and corporate tax deferrals are

4 However, it should be noted that these data do not take into account indirect effects, for example if a supplier is local but its own supplier is itself foreign.

among the main elements of the EUR 45 billion package (1.9% of GDP). Ravaged by the epidemic but limited by strained public finances, Italy and Spain will both raise expenditure by 1.4% of GDP (EUR 25 and 17 billion respectively).

Beyond immediate spending, governments have also made loans and guarantees available to support illiquid businesses for an indefinite period. These conditional commitments will only be disbursed if and/or when the companies default, part of the burden being borne by the financial sector. In Italy, the pledged amount covers 43% of short-term corporate liabilities (trade credits and bank loans under 1-year maturity). The figure is 21% in Spain (42% if the EUR 83 billion of announced private sector involvement is included).

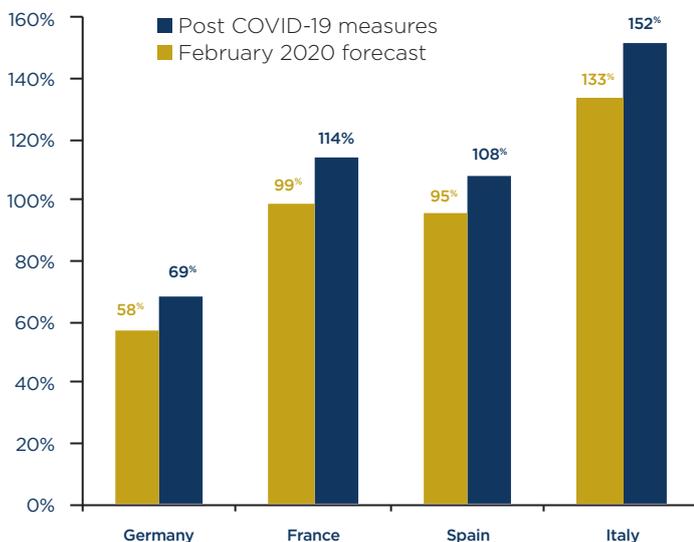
A simultaneous increase in spending and contraction of GDP will severely impact public finances. Assuming 10% of the public guarantee funds are solicited and tax revenue falls by 1% of GDP⁵, Spanish and French public debt would easily break 100% of GDP, and Italian debt would go over the 150% threshold (see **Charts 9 & 10**). Given the exceptional health crisis, as well as the synchronized and exogenous nature of the resulting economic shock, the European Commission has shown exceptional flexibility. Fiscal rules have been suspended, and the European Stability Mechanism (with EUR 410 billion in unused lending capacity) will open a special lending facility. Some would like to go further, with nine Eurozone members (Belgium, France, Italy, Luxembourg, Spain, Portugal, Greece, Slovenia and Ireland) calling for a common bond issuance (dubbed “Eurobonds” or “Coronabonds”), with the support of ECB

president Christine Lagarde. Such initiatives will face resistance from countries opposed to fiscal risk sharing like Germany, Austria and the Netherlands. If the inconclusive meetings of late March are any indication, despite the consensus behind full fiscal support to defeat the pandemic’s negative impacts, the coronavirus could reignite political tensions and test the Eurozone’s institutional resilience (see **Box 2**).

Given the expected rise in deficits and public debts in the Eurozone, sovereign bond yields have increased (up to 150 basis points for the 10-year Italian bond), before the extent of the central banks’ announcements is fully taken into account by investors. Indeed, the major central banks have adopted unprecedented quantitative easing measures to fulfill their role in ensuring financial stability. In the Eurozone, the ECB’s announcement of the Pandemic Emergency Purchase Programme (PEPP), an additional asset purchase program worth 750 billion euro (in addition to the 120 billion previously announced), coincided with a drop in government bond yields, which had almost returned to their initial pre-crisis level at end March (see **Box 2**).

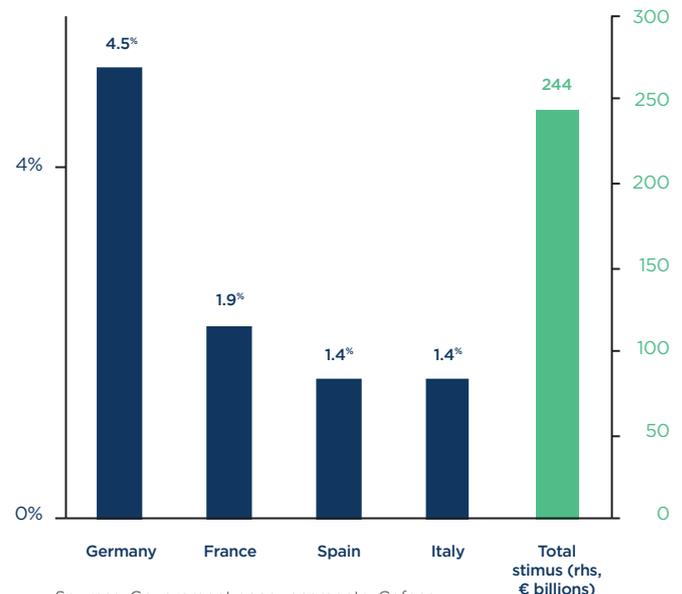
The same goes for the United States where, during the last two weeks of March, the Federal Reserve increased the size of its balance sheet by about 1100 billion dollars (about 5% of GDP), that is to say over half the rise recorded between end-2012 and end-2014. This dramatic increase reflects very large purchases of US government bonds (375 billion dollars the week of March 23, after 275 the week before). Thus, in the United States and in the Eurozone, the additional public debt created by this crisis will be partly financed by the central banks.

Chart 9: Public debt, (% of GDP)



Sources: Government announcements, Coface

Chart 10: Fiscal stimulus, (% of GDP)



Sources: Government announcements, Coface

5 The German ministry of finance expects a EUR 33 billion fall in tax revenue

Box 2:

The European Central Bank (ECB) is back at crisis management

After the support measures of 2008/09 and the quantitative easing (QE) programmes following the European debt crisis between 2014 and 2018, there was only a short time period of “new normality” before the return of new extraordinary measures to help absorb the COVID-19 shock. The latter include:

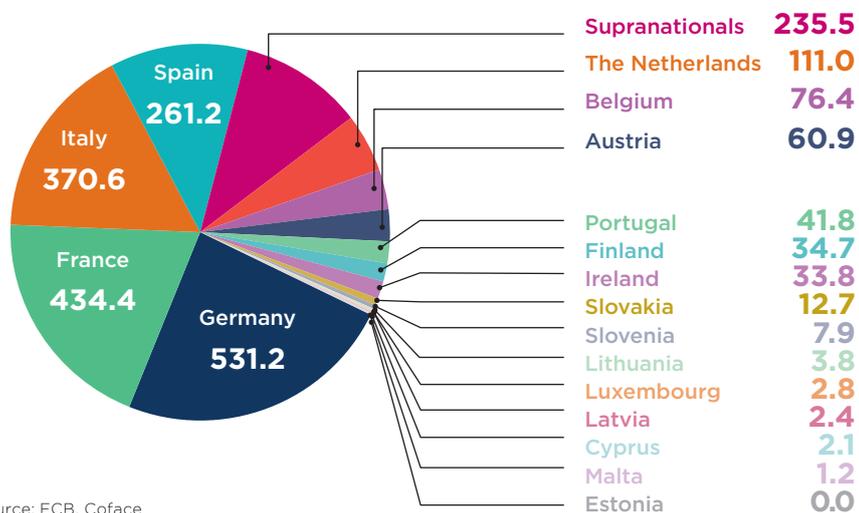
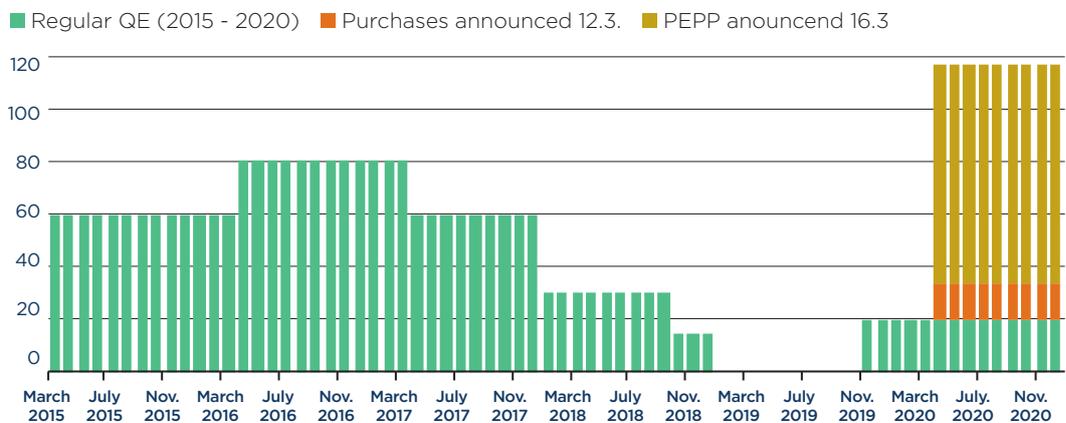
- Additional longer-term refinancing operations (LTRO), at a low rate of -0.5% (equal to the deposit rate), in order to protect the liquidity of the banking system and prevent a dynamic of credit crunch towards the real economy, in which banks decrease lending while the demand for credit increases. The ECB has announced new terms for the new TLTRO III program, in which the volume of funds that banks can borrow has been increased by over EUR 1 trillion, reaching a total volume of almost EUR 3 trillion. Rates have never been

better, with the minimum borrowing rate set at 25 basis points below the average interest rate on the deposit facility (-0.5%).

- A widening of the existing asset purchase programme (APP), in which the ECB buys assets of EUR 20 billion per month on average, to a temporary envelope of additional net asset purchases of EUR 120 billion until the end of the year, with a strong contribution from the private sector. The aim is to prevent the financing conditions of the economy from tightening in a pro-cyclical way.
- In addition to this first extension of the APP, the ECB launched a new temporary asset purchase programme of private and public sector securities. The Pandemic Emergency Purchase Programme (PEPP) has an overall envelope of EUR 750 billion. This means that

Charts 11 and 12:

Net Asset Purchases in different QE-Programmes per month (in billion Euro)



Source: ECB, Coface

the monthly purchases will be averaging EUR 116.6 billion, the highest level in the history of the ECB (see **Chart 11**). The purchases will be conducted until the ECB judges that the crisis is over, but the PEPP will last in any case until end-2020 and will include all asset categories that are purchased under the existing programs. While the benchmark for purchases of public sector securities will continue to be the capital key of the national central banks, the criteria for public asset purchases were eased for this programme, so that the ECB is allowed to buy Greek government bonds. To be more flexible in the new PEPP, the ECB is expanding the eligible assets under the corporate sector purchase program (CSPP) to non-financial commercial paper.

The ECB wants to show that it is willing to do “whatever it takes” to support European banks, governments and financial markets, as well as fending off the economic headwinds of the COVID-19 crisis’ demand shock. While pushing liquidity in the market is not something new and the added volume of the new packages are around the size of the last QEs, the ECB is going further and straining the rules of the European Monetary Union. The ECB communicated that it still has room for manoeuvre and would revise its own rules if they prevented policy tools from functioning as intended. For instance, one of these rules is that asset purchases conform to the capital allocation key (the capital with which each country funds the ECB that is dependent on the share of the country’s population and the size of its GDP within the Eurozone). In this case, the ECB already said that it would buy assets in a flexible manner, allowing monthly

deviations from the capital key (the yearly average should still stick to the capital key, the current purchases can be observed in **Chart 12**). Another rule is that the ECB only buys up to 1/3rd of any one country’s debt to prevent the central bank from hidden state financing. The latter is a major issue when the ECB extends its purchase programmes while still reinvesting maturing assets from old programs, as the governments are not necessarily issuing more bonds at the same time. In the last years, the ECB purchasing share got close to this threshold in Germany and some smaller countries like Portugal. With the large fiscal packages introduced by several countries, this lack of eligible bonds - especially in Germany - should vanish. However, according to media reports, the ECB would also be willing to leave the buying limits behind and even to focus its stimulus where it is most needed, without resorting to its emergency bond purchases (OMT). A legal challenge would be created if the ECB followed this path, as the European Court of Justice specifically pointed to these thresholds (in a 2018 ruling) in case the ECB breaches a prohibition on monetary financing. This would become a big political issue, particularly in Germany, where the Constitutional Court is still deliberating on the matter (the extreme-right party AfD was founded as a reaction to the European debt crisis). Therefore, the ECB will potentially have to decide between a short- and medium term prevention of an economic crisis and the longer-term survival of the Eurozone in its current dimensions, as it is unlikely that Germany and other Northern European countries witness a rule violation without reacting.

Box 3:

After the COVID-19 crisis, the EU will be challenged

The COVID-19 crisis exposed shortcomings in the European Union (and the Eurozone). Some were already known before, others erupted on this occasion. Moreover, the crisis has led the European Union to give up on many of its economic and financial principles. This will leave its mark and is likely to lead to questioning after the crisis.

Among the already known shortcomings, the absence of a significant common budgetary policy is a considerable issue. The current European Union budget represents just over 1% of European internal income and is mainly based on a fraction of VAT and customs duties. It is principally dedicated to the agricultural policy and structural aid intended for member states. Faced with the crisis, each country reacted independently according to its needs and budgetary capacities. Similar to the 2008-2009 and 2011-euro crises, collective action rests on the European Central Bank, which also sets the pace for the Union’s independent central banks. Among the shortages that have emerged, the lack of a collective health policy is the most important issue. Policies to deal with the epidemic have been mostly national. States have closed their borders with other member states or implemented controls (at least for people) without consultation and disregarding the rules laid down in the Schengen Agreement. Others have banned the export

of sanitary supplies to other member states. However, Germany, Luxembourg (and Switzerland), relatively less affected, accepted the transfer of patients in intensive care from countries with saturated capacities.

The crisis is also accompanied by the abandon of economic and financial principles, at least temporarily. Thus, the public deficit and debt targets set by the Fiscal Stability Pact are abolished and will be easily exceeded by several countries. Some of them were not respecting these targets even before the COVID-19 crisis. The limitation of public aid to businesses, meant to prevent distortions of competition, is de facto removed as budgetary and financial aid is introduced. Capital injections and nationalizations are planned to prevent bankruptcies. The existing instruments to prevent hostile purchases of European companies (which have become easy prey following the collapse of the markets and are considered as strategic) are being reinforced with the support of the Commission. Insolvency rules have been suspended or relaxed in several countries. States can once again reinsure credit insurers to encourage the continuation of their guarantees for the benefit of businesses.

This will leave a mark. A debate is already looming around the introduction of the «Coronabonds», which

would be issued by the Union to finance the fight against the economic consequences of the crisis. Unsurprisingly, the southern countries are opposed to the northern ones, who are reluctant to implement fiscal solidarity. However, the northern countries are not wrong in recommending that public finances should be in order: it has been observed that the countries that are better managing the epidemic are also those with the most prosperous public accounts. Regarding health, the inability of most of the member states to meet the material requirements for the crisis should lead to an increase in national capacities for the production of masks, detection tests, and drugs intended for reanimation. This might mean breaking free from the trade rules that have led to outsourcing most of the supply to outside countries,

but could also increase the role of the state in strategic areas such as health. It will also be necessary to determine whether this management should be done at national or community level, therefore, whether the Union's powers in health matters should be increased. One could imagine that in the event of an emergency going beyond the geographical framework of a member state, competence shifts to the Union, in this matter as in others. Alongside climatic and health emergencies, there could also be technological emergencies. These questions will be added to the ones on the expansion of the Union, the management of structural aid, the competitive rules, defense questions, and the reform of the institutions to make them more efficient and democratic in order to find the trust of citizens.

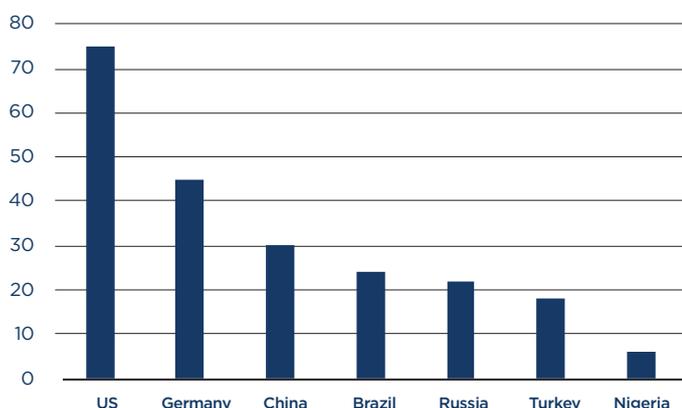
In addition to the pandemic, emerging countries are facing falling oil prices and four times more capital outflows than in 2008

The emerging countries will also have to face all the shocks previously mentioned for the more mature economies. However, several factors are likely to worsen the economic consequences of the pandemic. Many emerging countries have already decided on more or less strict containment measures, similar to those implemented in Europe. At the end of March, the list includes in particular: South Africa, Russia, Saudi Arabia, Colombia, India, Jordan, Argentina, Malaysia, Nigeria, Kenya, Morocco, Tunisia, Kuwait, El Salvador, Poland and the Czech Republic. Nevertheless, for many of them, the containment and reflux of the pandemic could be more difficult to reach because of economic and social specificities, such as the tendency to have closer family ties between generations in certain regions like Africa, or a higher population density. For instance, the average living space in the US and Germany is 75 and 45 square meters respectively, compared to

only 24 in Brazil, 22 in Russia and 6 in Nigeria (see **Chart 13**)⁶. Other handicaps like limited health infrastructures are added to the existing ones. The fall in oil prices, which affects many *black gold* producing countries, is one of them (see **Box 4**).

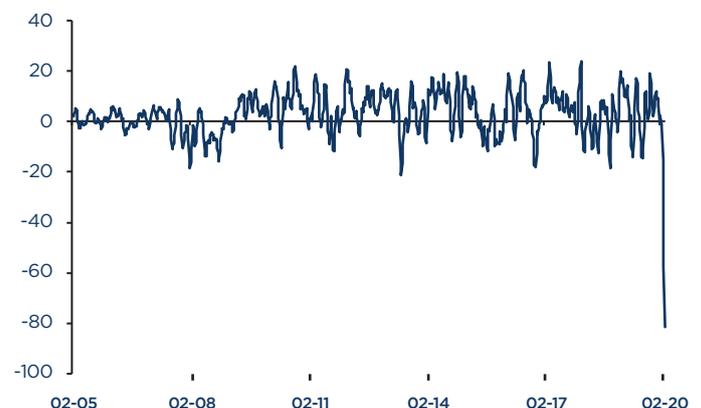
The second difference is that compared to mature economies, emerging economies suffered from larger scale capital outflows in March 2020 compared to 2008. These exceeded USD 80 billion for stocks and bonds alone, about four times higher than the peaks observed during recent crises (including 2008, see **Chart 14**). The emerging economies with a current account deficit, developed capital markets, little foreign direct investment – hence a dependence on portfolio foreign investments –, with public accounts in deficit, weak growth and high political risks are obviously on the front line as the global risk aversion rises. South Africa fits this definition, so does Turkey albeit to a lesser extent (the 2018 exchange rate crisis had the merit of rapidly reducing the current account deficit). Mexico and Colombia can also fall into this category. That said, the scale of these capital outflows is such that they have also affected economies that do

Chart 13:
Average living area per person in 2014
(square meters)



Sources : Statista, Coface

Chart 14:
Total monthly portfolio flows (Debt and Equity)
for 24 emerging countries (USD billion)



Sources: IIF, Coface

⁶ However, it is to be noted that Singapore or Hong Kong have so far managed to contain the expansion of the pandemic on their territory despite a very high population density.

not meet any of these criteria, highlighting their irrationality. Thus, the Korean won has depreciated sharply, although South Korea has low public debt, comfortable foreign exchange reserves, a current account surplus, a stable internal political situation and is seen as one of the countries that has been the most successful at stemming the epidemic so far. This sharp rise in global risk aversion is prompting investors to favor so-called risk-free assets in dollars, which create increased risks for economic agents indebted in this currency. This dependence on dollar financing can be in the form of bank loans or bonds, the latter accounting for most of the rise in dollar denominated debt in emerging economies over the past decade. They concern various types of economic stakeholders: governments (Argentina and Saudi Arabia), non-financial companies (Mexico,

Turkey), banks and other financial institutions (Malaysia, South Korea).

Similar to the case of mature economies, these challenges will lead to an increase in public debt, which is already at a historically high level in emerging and developing economies as a whole. However, unlike the Eurozone and the United States, the ability of local central banks to embark on quantitative easing programs without jeopardizing their credibility, inflation expectations or confidence in the local currency is much weaker. In this context, an increase of sovereign risk for emerging countries is to be expected in the coming months and the role of the International Monetary Fund will be crucial to help resolve some of these financing problems and get through this ordeal.

Box 4:

The oil (price) war is declared

On January 6, 2020, the price of a barrel of Brent crude oil broke the USD 70 threshold, following a rise in geopolitical tensions in the Middle East, after a US air strike in Iraq killed the influential Iranian General Qassem Soleimani. Nearly three months later, after reaching a level rarely seen since the oil counter-shock of 2014-2016⁷, Brent crude is trading at less than USD 25 per barrel, the lowest level in more than 18 years. During this period, COVID-19 went from a Chinese epidemic to a global pandemic, upsetting the balance of the oil market.

While world crude consumption was already affected in 2019 by trade tensions, the Chinese economic slowdown and the end of the European industrial cycle, the appetite for black gold was slashed when economic activity came to a halt in early 2020. In the wake of China, responsible for 80% of the marginal increase in demand last year and the cradle of the pandemic, global oil consumption is expected to contract for the first time since 2009. In its March report, the International Energy Agency predicted a drop in consumption of 90,000 barrels per day (b/d) on average in 2020.

Faced with this shock to world demand, the OPEC+⁸ group, which was implementing a voluntary production cut agreement since January 2017 to support crude oil prices, imploded. More specifically, faced with the resistance of Russia, the world's second largest crude oil producer, to reductions greater than the 2.1 million b/d jointly withdrawn by the group from the market in Q1 2020, Saudi Arabia, the world's third largest producer and de facto OPEC leader, announced its intention to increase production volumes.

The end of this alliance restarts a race for market share, in which the United States has become the world's leading crude oil producer since the end of 2018. Although some producers are facing major disruptions in their activity (Iran, Venezuela, Libya) and despite the slowdown in shale production growth in the United States, this race for market share is flooding the world with oil at a time when demand is at a standstill. This double shock of supply and demand threatens to push oil storage capacities to their limits.

As a result, Coface is reducing its oil price forecast from 60 to 45 USD on average over the year 2020 for a barrel of Brent. Oil prices should bottom out in Q2 2020, before gradually rising in the second half of the year as activity and, with it, the thirst for black gold, picks up again. The price recovery could be exacerbated if U.S. production collapses in response to lower prices. Indeed, experience suggests that a drop in oil prices will affect new drilling in the United States with an average delay of about 4 months (see **Chart 15**) and then production.

This fall in prices will be particularly detrimental to oil-exporting countries that are still struggling to recover from the oil counter-shock of 2014-2016. Fiscal and external breakeven oil prices are above our forecast in the vast majority of oil-exporting countries (see **Chart 16**). Angola, Algeria and Nigeria in Africa; Iraq, Kuwait, Oman or Bahrain in the Middle East; Azerbaijan and Kazakhstan in Central Asia are particularly exposed to the price collapse. In importing countries, the shock to consumer confidence caused by the global COVID-19 pandemic is expected to wipe out any gains in household purchasing power resulting from lower oil prices. Both upstream and downstream, the oil and gas sector will be the

7 Between July 2014 and February 2016, the price of a barrel of Brent fell from a level above USD 110 to around USD 30 due to a prolonged supply glut.

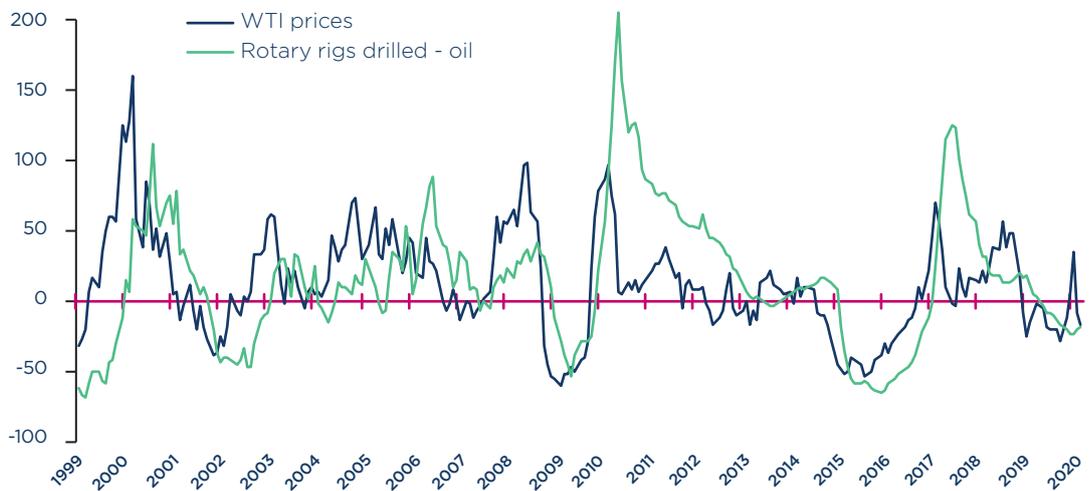
8 Group bringing together members of the Organization of the Petroleum Exporting Countries or OPEC (Algeria, Angola, Equatorial Guinea, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, the Republic of Congo, Saudi Arabia, the United Arab Emirates and Venezuela) and allied oil-exporting countries (Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Mexico, Oman, Russia, Sudan and South Sudan).

first victim of the price collapse, while chemicals and transport, sectors that can traditionally benefit from lower oil prices, will suffer from weak demand.

The failure of the OPEC+ negotiations is partly linked to the mixed results of three years of cooperation. Prices have certainly been lifted, but at levels far below those preceding the oil counter-shock of 2014-2016. Above all, the OPEC+ strategy

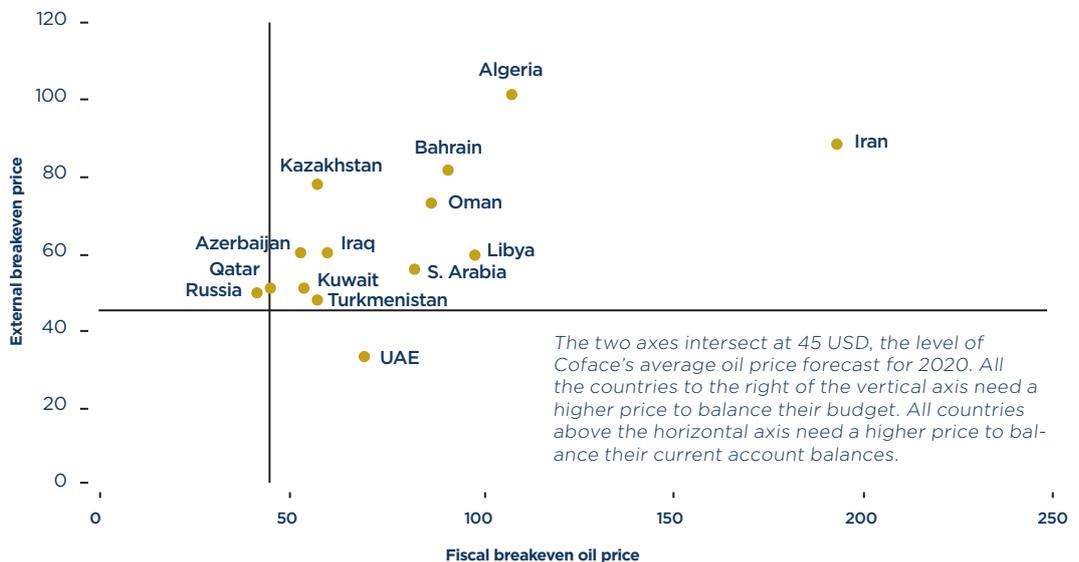
has kept oil prices at a level that has allowed US producers to thrive and erode the group's market share. In spite of this mixed record, at the time of writing, US President Donald Trump had just announced that he expected Russia and Saudi Arabia to announce huge cuts in oil output, raising hopes of a truce in the price war. Russia nonetheless denied the suggestion.

Chart 15:
Oil prices & new rigs drilled
(% YoY)



Sources: Refinitiv, Datastream, Baker Hughes International, Coface

Chart 16:
Oil-exporting countries: fiscal & external breakeven oil prices
(In USD)



The two axes intersect at 45 USD, the level of Coface's average oil price forecast for 2020. All the countries to the right of the vertical axis need a higher price to balance their budget. All countries above the horizontal axis need a higher price to balance their current account balances.

Sources: National authorities, IMF, Coface

Kirill Dmitriev, CEO of the Russian sovereign wealth fund and one of the key negotiators with OPEC, said earlier he was open to a new agreement but only if new countries joined. This statement can be interpreted as an indirect reference to the United States, whose energy sector is set to be the main victim of this price war. Although US diplomatic intervention seems certain, the involvement of the world's largest producer in such an agreement remains very hypothetical for two main reasons: (1) Unlike the OPEC+ countries, the US government has no control over the production of its companies. (2) US oil companies would certainly not be able to take part in such discussions under

competition law. Agreement or not, the unprecedented impact on oil demand continue to weigh on prices at the expense of the energy sector in the United States.

Indeed, US exploration and production companies, which were already reducing their capital expenditure for a second consecutive year before the coronavirus pandemic because of an estimated USD 86 billion in debt maturing in the next five years⁹, are expected to reduce their spending even more significantly. Weak prices and limited access to credit should result in the largest increase in corporate insolvencies in the sector since 2016 in North America.

⁹ Source: Moody's - North American exploration and production firms face high debt maturities, tighter access to capital, 19 February 2020. https://www.moody's.com/research/Moodys-North-American-exploration-and-production-firms-face-high-debt--PBC_1215097

COVID-19, a « stress test » for many political regimes

Beyond its large-scale economic consequences, the pandemic should also have many political implications. In the short term, the most obvious one is the exacerbation of existing geopolitical tensions. US President Donald Trump called COVID-19 a “Chinese virus,” while a spokesman for the Chinese Ministry of Foreign Affairs speculated that the US military has imported the virus into his country. In this environment, the risk of a new wave of protectionist measures, targeting particularly the key sectors of the new economic and health situation (limitation of exports of agri-food and/or pharmaceutical products, deemed vital) cannot be excluded. The continuation of the Sino-American “trade war” targeting strategic sectors, in particular electronics, also remains a possibility. This could be reinforced by the presidential campaign in the United States and in the event of a rise in social protests in one or both the countries. Likewise, in the Middle East, Bahrain considers the pandemic to be “Iranian biological aggression”. Furthermore, the rise in political tensions between countries over border closures, particularly if these are decided unilaterally, is a risk to monitor in the coming months.

Internally, the consequences of this health and economic crisis on the national political scenes are difficult to anticipate. The capacity of the regimes in power to effectively manage this health crisis and protect populations from the numerous and various economic and social consequences is a core issue. Whether rather democratic or more authoritarian, those who will have been judged by public opinion as being guilty (rightly or wrongly) of the poor health and/or economic situation, will find themselves in a situation of increased weakness. The regimes most vulnerable to this risk are those that were already the subject of strong internal protests before the pandemic. Iran is obviously the prime example that comes to mind.

In western democracies, periods of armed conflict or natural disasters have historically benefited incumbent governments, the “sacred union” helping to increase their legitimacy. However, the current period - marked by an extreme polarization of public opinion - is different and indicates that this outcome is far from certain. Indeed, opposition parties have not been shy in criticizing the governing authorities since the start of the health crisis. Nevertheless, the dissension did not have a noticeable effect on their popularity ratings at this stage (neither positive nor negative).

In addition, in many countries, laws restricting individual freedoms are decided and often adopted very quickly as emergency to protect the population (ban on assembly, restriction of movement, “state of emergency” laws, etc.). While containment decisions have not raised major objections among populations so far, this exceptional period is conducive to abuse. For instance, in Hungary, Prime Minister Viktor Orban obtained very strong powers from parliament as part of an indefinite state of emergency and might suspend the application of certain laws by decree without a vote of the parliament, despite strong criticisms from the opposition. Therefore, this health crisis is already perceived, in some cases, as a good opportunity to push through controversial reforms.

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