Special Comment: Covid-19 Risks and Impact on the 2020 Global Outlook

The global spread of Covid-19 has resulted in heavy *global* economic costs in areas of the world that now include China, Europe and the United States. Although the uncertainty is still very large, there is a likelihood of a global recession this year – defined by the IMF as global growth of under 2.5%. The severity of the anticipated downturn will depend on the degree to which the virus spreads further, and to what extent public health, regulatory, monetary and fiscal policy responses are effective in countering. Scope expects the current crisis to also put pressure on some sovereign ratings of countries with pre-existing vulnerabilities.

China's impact on the world: the anticipated sharp downward revision of our 2020 global growth estimate is due to macro-economic and financial sector disruptions rooted in the coronavirus pandemic, which escalated in China in mid-January. In February, we downgraded our estimate for 2020 growth forecast in China (to "around 5.0%", from 5.8% before) while maintaining China's sovereign Outlook at Negative. China is the largest economy on the globe under purchasing power parity (PPP) terms (**Figure 1**, next page) – accounting for 19% of world GDP in 2019 under PPP – and the downgrade to China's growth figures alone lowers the global growth forecast by at least 0.15pp.

Global spill-overs: the impact of the pandemic is much broader now – on global supply chains, impeded economic activity from containment measures and "social distancing", reduced consumer and business sentiment, alongside risks to financial stability. This implies weak and/or reduced growth in major economies around the world including those of the euro area, the United States (AA/Stable) and Japan (A+/Stable).

Monetary policy: We expect *significantly* more accommodative policy in 2020. However, while central banks will play a critical role in ensuring adequate liquidity and the easing of market turmoil, monetary policy can do little now to substantially *raise* real economic growth or inflation.

Fiscal policy: higher spending, tax cuts and targeted emergency fiscal actions like government guarantees on debt issuance are being acted upon or being considered. Significant stimulus has been announced in China, South Korea and Italy, among others.

Neither "V"- nor "L"-shaped recovery: we expect something in between the "V"- and "L"-shaped recovery hypotheses – a gradual upturn beginning in phases depending on countries' exposures to the virus as well as on integration in global supply chains and global markets. A gradual recovery with interruptions in the case of further economic/financial shocks and/or if the virus returns late fall/winter seems more probable.

Downside risks: even more adverse scenarios could be imagined if: i) containment actions bring greater economic damage in the near-term than anticipated; ii) the rapidity of the recovery is slower than expected; iii) the period before the virus is brought under control causes greater strain in financial markets than anticipated; iv) the policy response is ineffective and/or remains more unilateral than multilateral; v) assumptions about the baseline period to "relative containment" prove optimistic; and/or vi) the response should the virus return late in 2020 is ineffective. See here for details on the main risks.

Sovereign ratings: there are both cyclical- and structural-economic-related implications for sovereign ratings from the current crisis. Cyclical implications relate to the severity and duration of the downturn in global economies and financial markets, including risks linked to rising non-performing loans (NPLs), liquidity shortages and financial instability. Structural implications correspond to monetary and fiscal policy responses that raise debt ratios longer-term and weaken balance sheets. Higher borrowing rates and FX depreciation are further rating-relevant risks. Countries whose ratings are the most likely to be affected are those with underlying vulnerabilities relative to rating peers, including China (A+/Negative), Japan (A+/Stable), Italy (BBB+/Stable) and Turkey (BB-/Negative).

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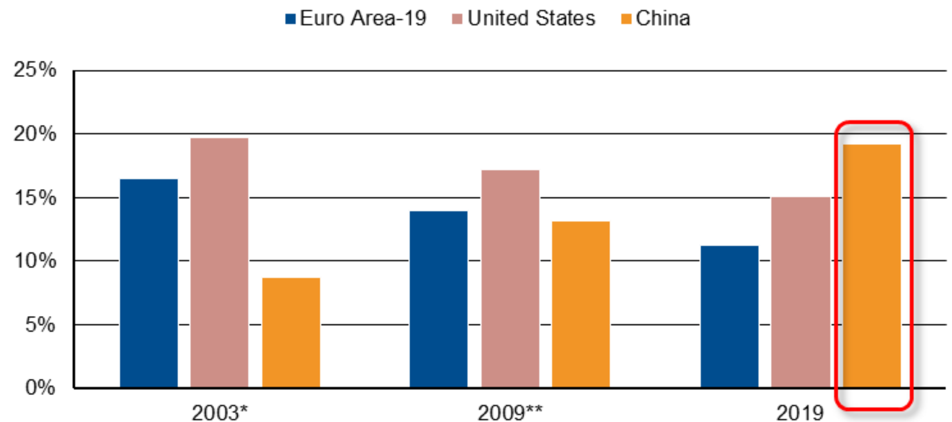
Figure 1: Share of global GDP, by PPP, %



'2003 corresponds to at the time of the original SARS outbreak.
**2009 corresponds to the year of the H1N1/swine flu outbreak. Source: Haver Analytics, Scope Ratings GmbH

Global baseline scenario: *relative* containment, if at least momentary, and gradual recovery

Assumptions in Scope's current baseline economic scenario

- Our baseline scenario assumes the coronavirus pandemic is *mostly* contained *within China's borders* by end-March (after the outbreak escalated in China in January), with *relative* containment reached in affected Western economies of the northern hemisphere (e.g. Europe, United States, etc.) after a further delay (i.e. by around end-spring, after the escalation in outbreaks in these countries started after a lag late-February), with momentary containment starting by the summer. There is, however, significant uncertainty in this area. Pandemics often come and go in waves and hinge on the weather/the season, and early peaks in infections can be followed by later ebbs and new peaks. Scope expects the virus will, under all scenarios, still be being transmitted in the summer, only perhaps slowed down over the summer months in the northern half of the world, even if cases may accelerate during those months in the southern hemisphere (where albeit a lower 10-12% of the global population resides). Scope's baseline includes moreover the likelihood that the virus may return in the northern hemisphere come late fall or winter 2020 as temperatures cool.

- The trough of the impact on quarterly growth in China is assumed in Q1, with the beginnings of a gradual recovery showing up by Q2 GDP data. However, in the euro area, given resilient sentiment indicators in January and February 2020 and the outbreak's significant escalation on the continent only at a later stage (since H2-February), the worst quarter for the pandemic's impact in the euro area is assumed to be Q2, with a technical recession likely in H1-2020. Italy – given already weak potential growth and as the first economy on the continent to be impacted by the Covid-19 pandemic more significantly – is expected to have entered technical recession in Q1.

- As China is the centre of the global supply chain and the starting location of this public health crisis, China's recovery will precede those in trading partners like the United States and Europe.

- A very gradual recovery has already begun in China since mid-February as factories and businesses have started to reopen. Still, we do not expect in our baseline a "V-shaped" recovery in China's or in the global economy as some effects of the pandemic on supply chains and consumer/business confidence will be much longer-lasting. Major 2020 events have been cancelled into the summer, with growth already impacted from Q1 through Q3. The sell-off in financial markets will damage business and consumer

confidence. The return of supply-side capacity and demand could take time as sentiment recovers only gradually from present panic and risk-aversion, even after the worst of the epidemic might have subsided.

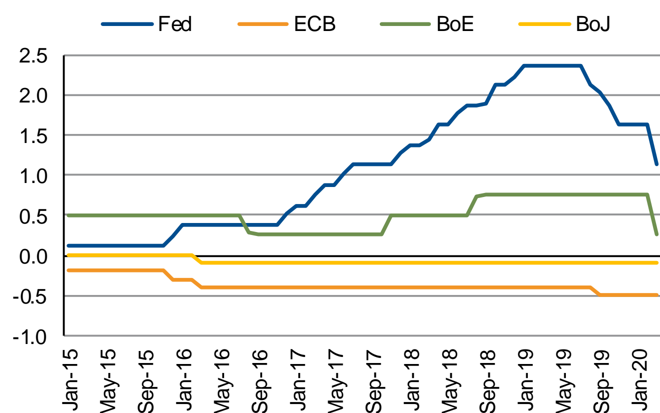
➢ However, neither do we expect an "L-shaped" recovery in which economic activity remains at a *trough* for a very prolonged period. We expect something in between the "V"- and "L"-shaped hypotheses – a gradual upturn beginning in phases depending on countries' cycles with and exposures to the virus, nations' economic structures and degrees of integration in global supply chains and in global services and financial markets, effectiveness of policy responses, alongside pre-existing financial vulnerabilities. While production in manufacturing could begin to rebound as quarantines are relaxed and factories reopen, the shock to retail services, tourism, transportation and other domestic activities may be far more durable. A "U"-shaped recovery, possibly with a lower global growth equilibrium given the loss in global growth momentum, is one outstanding hypothesis[1].

Assumptions regarding the monetary policy response

Sharp easing in monetary policies already well underway

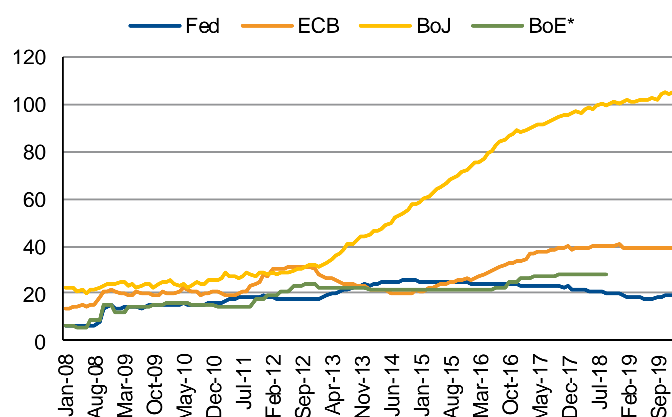
➢ Monetary policy will be *significantly* more accommodative in 2020 due to coronavirus-related economic and financial uncertainty and central banks' mandates to support growth, employment and financial stability. The People's Bank of China (PBOC) has announced multiple actions in recent months. The Big-4 advanced economy central banks have moreover sought to calm markets and support the economy, and the Federal Reserve surprised markets by cutting rates 50bps last Tuesday, with the Reserve Bank of Australia and Bank of Canada also cutting last week. On Wednesday, the Bank of England (BoE) cut rates 50bp, introduced a new Term Funding Scheme targeted at small- and medium-sized enterprises (SMEs) and reduced the counter-cyclical capital buffer rate 200bp to 0%. On Thursday, the ECB announced additional long-term refinancing operations (LTROs) and more favourable terms on forthcoming targeted long-term refinancing operations (TLTROs) directed at those most affected by the pandemic, alongside increased net asset purchases of EUR 120bn over 2020. The Federal Reserve Bank of New York announced Thursday an injection of USD 1.5trn into the financial system via repo operations.

Figure 2: Central bank policy rates, %



Source: Haver Analytics

Figure 3: Central bank balance sheets since 2008, % of GDP



*The BoE stopped reporting weekly total assets/liabilities and other asset/liability components. The Bank will publish a complete balance sheet on a quarterly basis after a delay of five quarters.
Source: Haver Analytics, Scope Ratings GmbH

[1] "Economics in the Time of COVID-19, Real and financial lenses to assess the economic consequences of COVID-19", Mann, L.; VOX EU, March 2020

➢ Monetary accommodation, including central banks' forward guidance policies, we assume will be more effective in mitigating the extent of *downside* risks to growth and inflation stemming from greater turmoil in financial markets and threats to financial stability. However, aggressive monetary accommodation of past years has used up most of the ammunition from central bank toolkits given already very low rates (**Figure 2**, previous page) and stretched balance sheets (**Figure 3**, previous page). There is thus little at this stage monetary policy can do to substantially *raise* real economic growth or inflation via the prevailing toolkit – especially when the current crisis represents both a demand as well as a supply shock. As such, more of the onus to rejuvenate output needs to rest on national governments.

➢ **PBOC:** China has announced actions to support the banking system and borrowers with stretched balance sheets. This includes a 10bp reduction in interest rates, liquidity injections and targeted credit support – including support to provinces/cities most impacted by the pandemic. In addition, extraordinary steps are being rolled out to delay NPL recognition, offer borrowers forbearance and force roll-over of maturing loans. Further reductions in interest rates and cuts to reserve requirement ratios are anticipated. Nevertheless, NPLs will rise significantly in 2020 (from 1.9% of total loans at end-2019) and loan defaults are expected to exceed 2019 record totals.

➢ The **Federal Reserve** is likely to cut rates further from 1.00-1.25%, after a 50bp cut on 3 March in response to financial market instability. Our baseline, set out in 2019, had already been for at least 50bps in cuts this year given the anticipated cyclical and structural slowdown of the US economy.

➢ The **European Central Bank (ECB)** has signalled its readiness to maintain adequate support. Additional liquidity support actions or a further expansion of the quantitative easing (QE) programme are available as tools, including changes perhaps to QE public-sector issuer purchase limits. Another cut to the deposit rate is possible, although the ECB will hesitate here, as it did earlier this week, given this could do more ill for banks and pension savers than good.

➢ The **Bank of England** will maintain a clear easing bias over the remainder of 2020, including with respect to the potential for a further reduction to the 0.25% base rate and/or the use of other tools such as forward guidance of very low rates for longer and/or the re-opening of asset purchases.

Fiscal actions assumed to be significant in response to the crisis

Significant fiscal easing is being progressively activated

➢ Fiscal policy measures, including higher spending, tax cuts and targeted emergency fiscal actions like government guarantees on debt issuance, are being acted upon or being contemplated. In addition to measures announced to date, we expect significant *additional* global fiscal actions in the forthcoming weeks.

Figure 4: Select fiscal stimulus announcements in response to the Covid-19 pandemic

Country	Stimulus size	% GDP	Key measures
Italy	EUR 12bn (up to 25bn)	0.7 (1.4)	Funds for the health system, liquidity to SMEs, increase in social safety nets, tax deadline extension, social security contributions relief, childcare subsidies
France	N/A	N/A	Unemployment benefits, tax relief for businesses, credit guarantee for SMEs
UK	GBP 30bn	1.4	NHS spending, tax relief for SMEs in hit sectors, liquidity to SMEs, sick pay refund
US	USD 8.3bn	0.01	Public health and medical research, payroll tax relief, loans for small businesses
China	?	?	Social insurance relief, VAT waivers, electricity bill discounts, infrastructure projects
Hong Kong	HKD 120bn	4.2	Cash handouts to residents, tax relief
Japan	JPY 1.6trn	0.1	Liquidity to SMEs and self-employed, support relocation of production for large companies, childcare subsidies
South Korea	KRW 11.7trn	0.6	Health system, salary integration for SMEs, childcare subsidies

Source: various news sources, Scope Ratings GmbH

- China has announced intentions to reduce corporate tax rates and reduce or exempt value-added tax rates for specific firms. Sizeable infrastructure spending is moreover expected over 2020 to support economic growth as the government has not given up on achieving a targeted doubling of GDP by 2020 compared to 2010 levels (requiring 2020 growth of at least 5.5-5.6%). Additional details on fiscal support measures are expected at the 2020 National People's Congress. We estimate China's 2020 general government deficit (excluding budget stabilisation fund transfers) to rise to around 6% of GDP, from an estimated 4.9% in 2019, as significant stimulus is implemented to ensure social and financial stability and in the pursuit of government GDP objectives.

- Italy raised "shock therapy" fiscal support actions to as much as EUR 25bn (1.4% of GDP) on 11 of March, with a first package of EUR 12bn to be followed by reserve monies to fund additional actions if needed. The measures include tax credits for companies hardest hit, increased funds for a national wage-supplement fund, an increased guarantee fund for loans to SMEs, extra cash for health services and the civil protection and security, and a moratorium for business and personal mortgage repayments. While we expect Italy's budget deficit to already well exceed 2.5% of GDP in 2020, we also anticipate additional fiscal support measures to be announced.

- The UK and South Korea have adopted significant fiscal expansion in 2020. The UK announced a major GBP 30bn (about 1.4% of GDP) stimulus on 11 of March – the largest budgetary loosening since 1992. Meanwhile, fiscal stimulus from the United States and Japan in 2020 has so far been more modest (**Figure 4**). EU countries with fiscal space, including Germany and the Netherlands (both rated AAA/Stable), will appropriately deploy expansionary budgets in 2020. Ireland has announced a major EUR 3.1bn (0.9% of GDP) package of stimulus. The European Commission (EC) has earmarked EUR 232mn to support disease containment. The EC has moreover indicated that flexibility *will be* granted to national governments with regards to 2020 budgets if spending is in dealing with the virus. In addition, the World Bank pledged up to USD 12bn for countries to improve health systems to address the crisis and the IMF has earmarked USD 50bn in emergency funding for low- and middle-income countries.

What are the risks to our baseline economic assumptions?

Most important downside risks to baseline assumptions

Risk #1: Even if base case assumptions play out and nations in the West follow the logarithmic curve China's Hubei province and China ex-Hubei have experienced (even if a more prolongated version of that curve in the West given less coordinated containment actions) as regards initial escalation of Covid-19 infection to relative peak in net confirmed cases (with our baseline being for a period of relative containment period to be reached in Europe and the United States by around end-spring), there is risk that "draconian" actions now being adopted by nations in achieving those ends bring greater *economic* damage in the near-term (e.g. the complete quarantine of Italy).

Risk #2: Even though a recovery has been underway in China since around mid-February and recoveries will appear in other countries (hopefully soon), both the return of supply-side capacity as well as demand could take even *more time* than the already gradual recovery rate we assume under our baseline. This affects not only Q1 and Q2 but also Q3 GDP. For example, there is discussion that the Tokyo Olympics due to start in late July could be postponed.

Risk #3: The period *before* the virus is brought under control could see greater strain in financial markets than currently anticipated. If the severity and/or duration of uncertainty linked to the pandemic crosses certain thresholds, this could deepen the current self-fulfilling "vicious cycle" of market sell-off behaviour and increasing economic and financial sector damage. Credit spreads could rise even further, equity markets could sink further, volatility could remain elevated, commodity prices could fall further, and rates could move even more negative. Examples of such amplifiers could include, for example, the market response to the OPEC+ collapse, risks around elevated US corporate debt, China's corporate/bank/local government debt sectors, and elevated global asset prices/bubbles.

Risk #4: The most important mitigant to the current market turmoil is the policy response – public health, financial supervisory, monetary and fiscal. However, important risks remain around both the adequacy and effectiveness of this response as well as the rather disjointed policy actions we've seen to date amid a *decline* in multilateralism. As opposed to the needed coordinated global public health, monetary and fiscal actions, there is risk that measures remain more unilateral and protectionist – limiting the effectiveness of the health crisis response and reducing policies' efficacy in restoring market confidence. Moreover, central banks are already near the limits of their effectiveness. Risks relate moreover here to comparative inexperience at the helms of the Federal Reserve, ECB and (soon) the Bank of England.

Risk #5: The assumption for the virus to be (at least temporarily) contained by Q2 is subject to significant uncertainty. As businesses normalise and workers return to workplaces in China, increases in persons at places of gathering risk new infections. Similarly, given the prevalence of the virus globally, renewed infections in China could now also come from abroad while the anticipated slowdown in cases in Europe and the US by around end-spring is not guaranteed. In addition to due to containment actions, the slowing down of transmission rates over the summer assumes "seasonality" in the spread of the SARS-CoV-2 virus. This seasonality assumption has not yet been fully tested – although there has, encouragingly, been signs of slower transmission rates so far in more tropical climate zones. In addition, even though transmissions might slow in the northern hemisphere in the coming period, infections could increase in the southern hemisphere as countries of the southern hemisphere enter winter while the northern hemisphere enters summer.

Risk #6: Finally, even if virus transmission slows by the summertime, the virus could make a return in the late fall or winter as noted under the baseline. There is the *risk*,

however, that policy makers are *not* better prepared by that time compared to this time around (meaningful as there is still very unlikely to be a vaccine for public distribution late in 2020), meaning that there is the risk of additional economic damage late in the year.

Impact on sovereign ratings

Ratings implications most significant for countries with prevailing economic and financial system vulnerabilities entering the crisis

➢ In addition to the economic implications of this crisis, there are also both cyclical- and structural-economic-related implications for sovereign ratings going forward. Countries most likely to be affected by developments are those with underlying vulnerabilities relative to their rating peers.

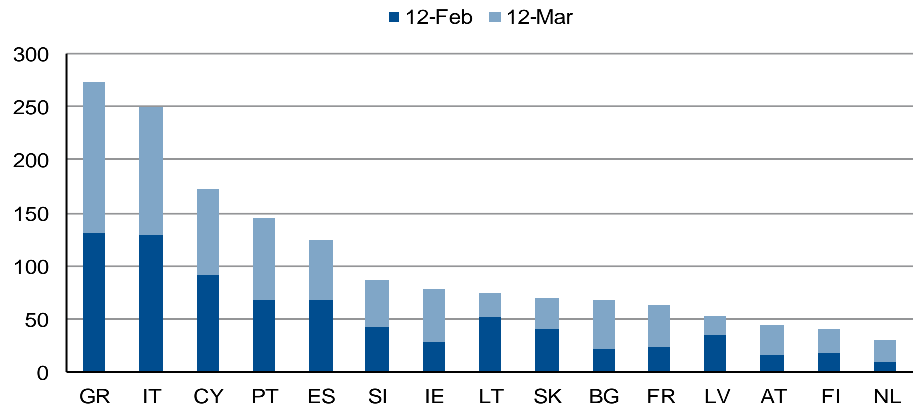
➢ With regards to the cyclical downturn, rating implications will hinge on the severity and duration of disruptions to economic and financial sector activity. Ratings downside to sovereigns including China (A+/Negative) hinge most significantly on whether the economy can get back going again such as to ease threats to financial stability rooted in deteriorating business performance, rising NPLs and loan defaults should the disruption to global value chains last longer than anticipated. Risks to financial stability would ultimately threaten greater spill-over to the government balance sheet.

➢ In terms of structural economic impacts, adverse ratings implications for economies like China, Japan (A+/Stable) and Italy (BBB+/Stable) relate to: i) whether the effects of the economic downturn alongside the associated monetary and fiscal expansionary policies might further structurally aggravate balance sheets vulnerabilities and result in higher levels of public and private sector debt, stressing financial stability longer-term and ii) whether this downturn might reveal greater-than-anticipated vulnerabilities for low-growing economies such as Japan and Italy, with recessions probable this year and already-high public debt liable to edge even higher.

➢ Economies with pre-existing vulnerabilities to risk-off financial market environments in terms of higher financing rates or weaker currencies at such moments of market crisis (like Turkey (BB-/Negative), Italy (BBB+/Stable), Greece (BB/Positive) or Georgia (BB/Stable)) are more exposed to external shocks such as those seen in recent weeks. Recent spread widening in euro area sovereign markets has occurred as investors have transitioned to safe havens, reducing yields on German 10-year bonds compared with those of euro area periphery issuers (**Figure 5**, next page).

➢ Oil exporters like Russia (BBB/Stable) are vulnerable from the collapse in global oil prices, even though oil *importers* will receive a degree of economic support from the energy price decline. Countries with a very open economic structure and heavily exposed to global trade and business cycles and moreover experiencing high and increasing case counts of the Covid-19 virus with associated significant monetary and fiscal loosening and weakening of balance sheets such as the United Kingdom (AA/Negative) and Ireland (A+/Positive) are also impacted.

Figure 5: Euro area 10-year government bond yield spreads to German Bunds



Source: Bloomberg

➢ Upcoming scheduled sovereign rating calendar review dates on more affected credits include reviews for Georgia (17 April), Japan (24 April) and Italy (15 May).

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