Economic Research:

EU Response To COVID-19 Can Chart A Path To Sustainable Growth

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EMEA CHIEF ECONOMIST

Sylvain Broyer
Frankfurt
(49) 69-33-999-156
sylvain.broyer
@spglobal.com

Key Takeaways

- EU policymakers have provided swift and generous measures to allow member states to support their economies and citizens.
- When the EU heads of states meet this week, they have the opportunity to do more by deciding on an EU recovery fund that can help cement the future of European countries.
- If the EU recovery plan is bold, aligned appropriately to other growth-friendly policies including the European Green Deal, and focused on the future, it could help Europe's economies become more sustainable, competitive, and cohesive.

The COVID-19 pandemic has hit Europe hard, and the economic challenges ahead are significant. From a macroeconomic perspective, however, Europe's policy response appears encouraging, with its incentives for sustainable growth, solidarity, and economic stability.

European governments have committed to taking unprecedented fiscal measures in response to COVID-19 (see "Sovereign Ratings And The Effects Of The COVID-19 Pandemic," published April 16, 2020, on RatingsDirect). Importantly, the markets seem to have accepted these measures as appropriate. Recent sovereign debt offerings by Portugal and Italy priced at very low rates and were largely oversubscribed. Across Europe, sovereign bond yields are similar to those at year-end 2019. Although spreads and CDS pricings on certain European government debt have widened, they are nowhere near the levels observed in previous shocks, particularly during the 2008 financial crisis.

There are good reasons to believe that the COVID-19 policy response should play out differently from the 2008 financial crisis, even though the recession might be deeper this time. We indeed forecast GDP to contract by 6% in Germany, 8% in France and 10% in Italy this year, and we believe debt to GDP will soar as a result of the recession and the unprecedented fiscal response to the COVID-19 crisis (see: "Europe Braces For A Deeper Recession In 2020," published April 20, 2020). However, from a macroeconomic perspective, debt-to-GDP levels do not reveal much about debt sustainability if taken out of context and in a static way. A more telling indicator is the often-overlooked three-band interplay between a country's primary budget balance, its interest burden, and its economic growth. Yes, government debt to GDP will rise across the board in 2020, but it stems from a one-off fiscal response to a unique non-economic shock. Unlike the events leading to the 2008 crisis, which was of a financial nature, the origin of the COVID-19 crisis is a health crisis that has potential economic consequences, such as higher unemployment, and financial consequences such as lower asset prices, higher default rates, and higher nonperforming loans.

S&P Global Ratings' current economic base case for the third quarter of this year and throughout 2021 is that once the lockdowns are removed, growth will resume and, once again, exceed real interest rates. We expect the German economy to rebound by more 4% next year, and France and Italy by more than 6%. Primary budget balances will therefore improve, and debt to GDP will decline in most European countries. Since the global financial crisis of 2008, interest rates have dropped by about 400 basis points on European government debt, while GDP per capita is 5% higher. This could be a significant factor in Europe's recovery from COVID-19.

Moreover, the policy response to COVID-19 has been different from previous crises. Commentators have noted that, 10 years ago, precious time was lost debating details like European ring-fencing and new policy instruments. It took over seven years after the U.S. Federal Reserve's first quantitative easing (QE) program and a European debt crisis for the European Central Bank (ECB) to expand its balance sheet and start its QE program in 2015.

By contrast, the policy response to COVID-19 has been much faster, consistent with the best economic theory, and generous. The ECB's balance sheet expanded by €500 billion--a full 4% of GDP--after only one month of lockdowns. Although much remains to be done, this fiscal and monetary expansion could help make COVID-19's unavoidable GDP losses a short-term phenomenon.

Another important difference from previous crises is the EU's proactivity at the policy level. It is true that some observers believe the EU is not giving enough support or closing the divide among EU countries. Admittedly, the EU has not had its "Hamilton moment" yet--and it probably will not happen anytime soon. This time, however, the EU response is not on matters such as auditing of public accounts or managing the stability and growth pact. Indeed, it is very much the opposite: the EU quickly relaxed its budget rules and guidelines on state aid, allowing member states to support their economies and citizens. EU finance ministers also devised a safety net that allows the EU budget to fund national partial employment benefits, thus softening painful fiscal shocks at member-state level. In addition, the EU is considering using the European Stability Mechanism to fund national health-care expenditures, providing short-term relief. The EU response is already miles ahead from its reaction in previous crises, and when the EU heads of states meet this week, they have the opportunity to do more by deciding on an EU recovery fund that can help cement the future of European countries.

COVID-19 will undoubtedly leave its mark on the member-state economies. We will not see the levels of GDP we had at the end of 2019 again for at least two years, and this could have credit consequences. However, if the EU recovery plan under discussion is bold, aligned appropriately to other growth-friendly policies including the European Green Deal, and focused on the future, it could help Europe's economies become more sustainable, competitive, and cohesive.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

This report does not constitute a rating action.