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Post-Covid-19 productivity growth is paramount to cope with higher debt

The extraordinary monetary policy response to the Covid-19 crisis has bought time. It averted a liquidity crunch by sustaining the supply of credit and keeping debt markets open. Combined with a massive fiscal response, monetary policy helped preserve economic capital and social cohesion. Illustrating this, investment-grade bond issuance in Europe increased about 180% since the ECB created PEPP, the region's unemployment rate barely increased, and the 12-month speculative-grade corporate default rate rose only slightly to 3.2% in July. Even so, this is nothing like a normal recession. No central bank nor government can fully control the virus's evolution nor when a vaccine will become available. The necessary opening of monetary and fiscal spigots has elevated global leverage to new highs.

This follows a decade of steady increases, weighing further on corporate and government creditworthiness. Global debt reached a record high of 331% of GDP at end-March, up from 320% in 2019 and 200% in 2011 according to the IIF, driven largely by governments and corporates. The GDP-weighted median rating of EU countries weakened from 'AA+' to 'AA-' as the financial crisis snowballed into the Great Recession and sovereign debt crisis.

As for corporates, low interest rates in the past decade have enabled those with weaker credit profiles to access capital markets. As a result, we entered today's crisis with 11% of European non-financial corporate ratings at 'B-' and below, indicating high vulnerability to economic and financial cycles. Most additional COVID-19-related public debt globally has been incurred by countries with wealthy economies, monetary and fiscal flexibility and reserve currency status (G7 countries account for about two-thirds of global direct and indirect fiscal support). At the EU level, S&P Global Ratings estimates the median sovereign debt will peak close to 64% of GDP by year-end, up from 58% at end-2019, but low interest rates will ease the burden. Taking Italy as an example, while general government debt is set to rise by 20 percentage points to 147% of GDP at the end of 2020, the interest burden should remain below its 2018 level (close to 7% of revenues).

The situation is more difficult for lower-rated countries, particularly in emerging markets, more vulnerable to fluctuating capital flows and with less flexibility to cope with the economic consequences of the pandemic. Ultimately, containing the build-up in credit risk across the EU will hinge on the strength of the recovery and the resilience of non-financial corporate, which were hit first and hardest by the recession. Though the effects have been uneven across sectors, it may take well into 2022 or later for certain industries to return to pre-COVID-19 credit metrics, and some like retail face an accelerating secular shift toward digital.

As a result, we forecast the speculative-grade corporate default rate in Europe to rise to 8% in the next 12 months. Although banks entered the crisis with solid balance sheets, they are not immune. We estimate credit losses for banks in Western Europe will more than double this year and next. While preprovision earnings should cover most of those, some banks will unavoidably report net losses. Durably low rates and flat yield curves will exert further pressure for many to undertake a further round of structural reforms.

The pace of withdrawal of extraordinary fiscal support will be critical to the unfolding of the crisis. Policymakers will have to manage the delicate balance between the risk of rising bankruptcies with the long-term costs of greater government intervention. While preserving employment is beneficial in the short term, the survival of companies with unsustainable capital structures or obsolete business models might hinder long-term productivity.

The accommodative monetary policy will buy time, but prolonged, very low interest rates tend to fuel asset bubbles and push investors in search for yield take on greater credit risks. More positively, there is momentum to implement structural reforms and build greater potential growth by funding infrastructure and human capital development to support the digital and green transitions. While government has its role to play, we believe the shape of recovery will depend on how the corporate sector emerges from this crisis. ●