



# The Eurozone Faces a Deep Recession, Not a Debt Crisis

Support from the ECB will offset the damage caused by the coronavirus.

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## KEY INSIGHTS

- Despite being hit by Europe's sharpest recession since World War II in the first half of this year, the eurozone economy will likely recover in the second half of the year.
- Aggressive asset purchases by the European Central Bank will support sovereign bonds, causing core and peripheral debt spreads to converge.
- Sovereign downgrades are likely to be rare, and Europe's banking sector looks well positioned to withstand even a severe shock.



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The eurozone economy will be hit by Europe's sharpest recession since World War II in the first half of this year, but it will likely withstand its impact before bouncing back strongly in the second half. Aggressive asset purchases by the European Central Bank (ECB) will help member countries to absorb the fiscal hit from the coronavirus and will provide strong support for sovereign bonds, leading to a convergence of core and peripheral eurozone debt spreads.<sup>1</sup>

Sovereign ratings downgrades are unlikely, at least in the near term, while Europe's banking sector looks well placed to withstand even a severe economic shock. The absence of a banking crisis, combined with low levels of household debt and the availability of income replacement via short-time work schemes, means that a V-shaped

economic recovery remains possible once lockdowns are lifted and life begins to return to normal. The eurozone economy is therefore likely to end the year with a recovery, albeit with a significantly larger debt burden.

## First, the Pain

In the near term, the impact of the coronavirus on the eurozone economy will be severe. Assuming a bloc-wide lockdown period of around eight-and-a-half weeks (two-and-a-half weeks in the first quarter and six weeks in the second quarter), of which two weeks will be a very strict lockdown, we expect the eurozone economy to contract at a seasonally adjusted annualized rate of around 43% in the first two quarters of the year. If the lockdown lasts until the end of June, the contraction over the first half of the year would likely be around 67%.

<sup>1</sup> Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

“Overall, we expect Italy to be hardest hit in the first half of the year...”

Unsurprisingly, the hospitality sector will be hit particularly hard by the lockdown as guests and customers are kept at home, while shutting down factories for weeks at a time will inflict pain on manufacturers. However, the health care, agriculture, and information technology sectors should benefit from increased demand. Overall, we expect Italy to be hardest hit in the first half of the year because it experienced the most significant outbreak in Europe and a prolonged lockdown. Germany should be least affected, having delivered the best health care response to the virus, offering the most generous short-term work scheme, and benefiting from the most fiscal space and a government that will use that space to return the economy to full capacity quickly.

The ECB's response, the Pandemic Emergency Purchase Program (PEPP), gives the bank the flexibility to deploy EUR 750 billion to purchase assets across asset class, time, and jurisdiction. This makes it very different from the ECB's standard quantitative easing program, through which purchases of a given amount a month are made. This degree of flexibility, together with the large size of this program, means that the ECB will be able to keep sovereign bond spreads reasonably tight until at least the late summer.

Although the PEPP will initially be used to purchase government debt, it is likely that it will need to be deployed to support the corporate bond market in time. Although banks have reduced exposure to eurozone firms, nonbank financing to corporates has grown quickly, and credit spreads in the corporate bond market have risen rapidly over the past two weeks. Given the lack of liquidity in this market, this is something that the ECB will likely have to address, meaning the PEPP program will have to expand eventually.

### **Sovereign Downgrades Unlikely Despite Fiscal Hit**

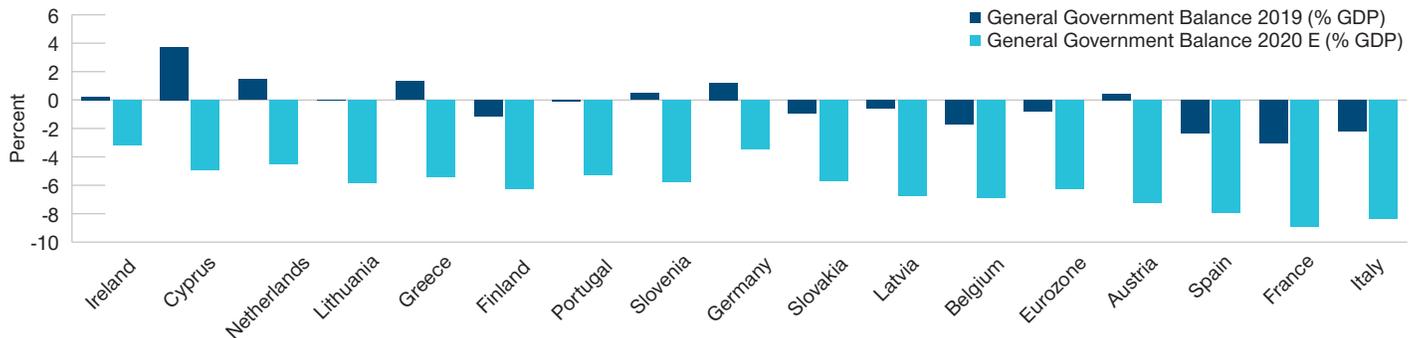
On the fiscal side, the European Commission has already announced that it will suspend the Excessive Deficit Procedure threshold of 3% for 2020. We estimate that business closures and unemployment should reduce tax revenues in the eurozone by around EUR 300 billion, 2.6% of the currency area's gross domestic product (GDP). In addition, we believe that countries providing direct fiscal support to households and businesses affected by the virus may cost a further EUR 30 billion, or 1.4% of the eurozone's GDP. Taking into account the fiscal impact of non-coronavirus factors, we believe the eurozone's budget deficit may widen by 4.2% to 5% of GDP in 2020 and its debt-to-GDP ratio to rise by eight points to around 95%.

Countries with weak underlying fiscal positions are likely to be affected most by this. France, Italy, and Spain entered the current crisis with structural deficits of between 2.5% and 3% of GDP; economic shocks and extra fiscal stimulus measures are likely to push those deficits to 6% or higher. Austria, whose government has announced a direct aid package amounting to 4% of GDP, is also likely to be hit hard. Countries that began with stronger initial fiscal positions will be better placed to withstand the shock, even if they face a greater fiscal hit from the coronavirus. For example, Cyprus will likely see one of the largest fiscal hits (potentially close to 6% of GDP), but as it began with a fiscal surplus of 4% of GDP, it may be one of the few countries that manages to stay within the eurozone's target of a 3% fiscal deficit this year.

Although governments will be borrowing large amounts of money, the amount of marketable debt will likely remain unchanged this year because of the ECB purchases. We anticipate that the ECB will purchase in excess of

## Few Countries Will Expect To Meet 3% Target Deficit

Government deficits, 2019 and 2020 (projected)



As of March 31, 2020.

E= Estimates. Actual outcomes, including the 2020 government balances noted, may differ significantly from the estimates provided.

Sources: European Commission/European Central Bank/Statistical Office of the European Communities/Haver Analytics for historical data, and T. Rowe Price for 2020 estimates.

“... peripheral eurozone debt looks attractive over the medium term...”

EUR 800 billion in sovereign bonds this year, around 150% of the net debt to be issued by eurozone sovereigns, which would result in a lower marketable debt-to-GDP ratio for most countries. The ECB will also likely prioritize the debt of peripheral countries over core countries, to the benefit of the former.

Despite the widening of national fiscal deficits, we do not think that ratings agencies will punish countries for fighting the virus, at least in the near term. Downgrading outlooks from positive to stable or negative is a possibility, but outright downgrades are likely to be rare. Italy's rating has already been downgraded by Fitch to BBB-, and S&P may follow. France and Belgium are also potentially subject to a one-notch downgrade risk, but at a very high level (AA to AA-), which would not have a major impact on the markets. For the rest of the countries in the eurozone, we expect agencies to wait to see the speed of the economic recovery and monitor how governments deal with major deficits in 2021–2022. If economies begin to perform better but governments continue to run extended deficits, agencies may take action in the second half of this year or the first half of next year.

### Core and Peripheral Debt Spreads Likely to Converge

We believe the ECB program will be particularly supportive for peripheral eurozone debt. The ECB will be keeping stock of marketable debt or even pushing it lower in some cases. It is also a rating-insensitive buyer (it buys Greek debt despite it being rated below investment grade), making it more likely to purchase peripheral bonds. Over time, this is likely to result in a convergence of eurozone sovereign debt, reducing spreads between the core and the periphery. As such, peripheral eurozone debt looks attractive over the medium term, particularly that of Greece and Cyprus.

However, given that liquidity may not be present in peripheral markets, investors may consider increasing exposure to Spain, Portugal, and Italy as an alternative way of potentially benefiting from a longer-term convergence of sovereign debt.

Several European governments and regulators have announced a variety of support measures targeted at sectors that are vulnerable to the macroeconomic shock as well as regulatory measures designed to ease

pressure on banks' capital positions. While these measures should be very supportive for the banking sector, in order to test the resiliency of the banks, we ran them through a stress test to determine how they would fare in the worst-case scenario.

Under our very severe stress assumptions, almost all the banks would have enough excess capital to withstand the hit from the coronavirus. The exceptions are some of the smaller banks in Greece, Cyprus, and Portugal, which have already reported capital shortfalls this year, albeit small ones. If the stress assumptions are extended to the full year of 2021 as well, we believe some of the smaller, mid-tier banks in Italy, Spain, and Portugal, and all the banks in Greece and Cyprus, would likely encounter capital shortfalls ranging from EUR 500 million to EUR 1 billion.

The core European banking sectors are likely to remain resilient in 2020 and in 2021—with the notable exception of Germany. Both Deutsche Bank and Commerzbank have reported capital shortfalls, with Deutsche Bank revealing a sizable EUR 8.7 billion capital shortfall. While we do not believe the stress case assumptions are likely to occur given the various

support measures being introduced, this exercise highlights the relative weakness of some German banks compared with other European peers.

### **Underlying Strength Signals a Strong Recovery**

We believe the strength of the banking sector means that the eurozone recession will likely be followed by a V-shaped recovery. Evidence from past recessions shows that when downturns have not been caused by a banking crisis, economies tend to bounce back quickly. The two historical episodes that more closely resemble the current situation are the Hong Kong SARS outbreak in 2002–2004 and the UK's three-day working week recession of 1974—and in both cases, swift recoveries followed.

The eurozone is further strengthened in the present day by very low levels of household debt and a manufacturing sector that has been adjusting to tougher conditions for two years. Overall, we believe a combination of aggressive monetary, fiscal, and employment policies across the currency area will likely set a strong foundation for a V-shaped recovery in the second half of this year.

### **WHAT WE'RE WATCHING NEXT**

We are closely following the policy announcements of eurozone governments as they decide whether to ease the lockdowns in their respective countries. The longer the lockdowns remain in place, the more severe the hit will be to the eurozone economy. The ECB also remains very much in our sights. Will the money set aside for bond purchases this year be enough? What other measures could the ECB take? Will it provide more clarity on what it is buying through the PEPP? Answers to these questions will help to deepen and enhance our view of the likely pace of the eurozone's post-coronavirus recovery.

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