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Are corporate balance sheets in Spain and Italy ready for the COVID-19 shock?

EXECUTIVE SUMMARY

Spain and Italy will be amongst the economies hardest hit by COVID-19, contracting by 12.8% and 13.6% respectively in 2020, according to Coface's forecasts. To approximate the potential impact of this contraction on corporate balance sheets, we ran simulations on the evolution of firm solvency, using central bank data that accounts for differences across sectors and firm sizes. Results suggest that some large firms in the automotive and metals sector in Spain could suffer from small liquidity buffers. In both countries, construction and retail will be dragged down by higher debt, as well as textile-clothing SMEs in Italy. Overall, we observed a higher prevalence of vulnerable firms in Italy, a factor that will weigh on the recovery. In 2021, the Spanish and Italian GDPs should rebound by 10.2% and 8.9%, leaving the economies 3.9% and 5.9% below 2019 levels, respectively. While Q2 2020 should be the most challenging quarter of the year, there are now good reasons to think that the road to recovery will be long and arduous. Despite the immediate tax deferrals, liquidity guarantees, payroll subsidies and debt moratoria, it is likely that many vulnerable firms will not survive: for the 2020-2021 period, Coface forecasts corporate insolvencies to increase by 22% in Spain and 37% in Italy, relative to 2019 levels. Furthermore, many companies would survive only at the cost of substantially higher leverage. Even with ultra-low interest rates, higher debt will lead to durably depressed investment¹. Therefore, the temporary COVID-19 crisis could exert durable downward pressure on a country's growth potential, accelerating the "japanization" of the Eurozone. With this in mind, it is worth taking a closer look at the health of Spanish and Italian corporate balance sheets. This should help identify pockets of vulnerability where widespread defaults are more likely to materialize.

TABLE 1
GDP quarter on quarter
(QoQ) % change

GoQ growth rate	Latest reading (Q1 2020)	Lowest previous reading
Italy GDP	-4.7%	-2.7% (Q1 2009)
Spain GDP	-5.4%	-2.2% (Q1 2009)
Spain GDP-Construction	-11%	-8.9% (Q1 2010)
Spain GDP-Manufacturing	-8.8%	-3.7% (Q1 2009)
Spain GDP-Services	-6.2%	-2.3% (Q4 2012)

Sources: INE, ISTAT, Refinitiv Datastream, Coface

1- "Corporate debt overhang and investment: firm-level evidence" by Borensztein et al. (World Bank Policy Working Paper, 2018);
"Corporate debt and investment: a firm level analysis for stressed euro area countries" by Gebauer et al. (ECB working paper, 2017).