The long path out of the coronavirus slump

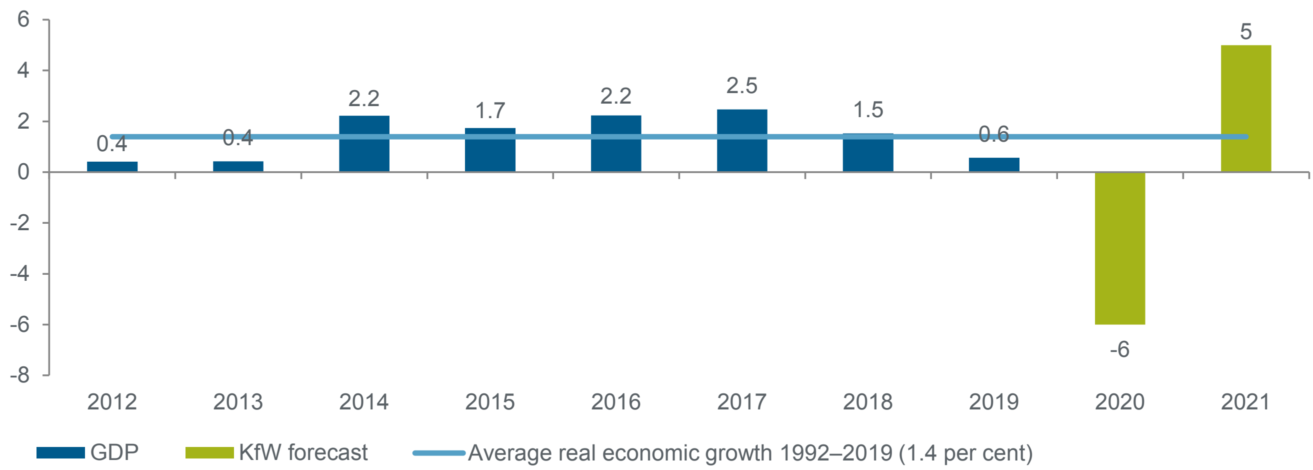
12 May 2020

Author: Dr Philipp Scheuermeyer, phone +49 69 7431-4017, philipp.scheuermeyer@kfw.de
Press contact: Christine Volk, phone +49 69 7431-3867, christine.volk@kfw.de

- The pandemic has hit the global economy like a bolt of lightning and the recession is unprecedented in breadth and depth.
- The German economy is expected to contract by 6% in 2020. If a second wave of infections can be avoided, a recovery should begin in the second half of the year that will bring catch-up growth of 5% in 2021. Output will thus return to its pre-crisis level in autumn of 2021. Aggregate output loss will then be around EUR 300 billion.
- Gross domestic product in the euro area is expected to shrink by at least 7% this year (2021: +6%). France, Italy and Spain were hit particularly hard by the pandemic and the structural environment is unfavourable as well.
- Monetary and fiscal policy measures are mitigating the impact of the crisis. Still, significant downside risks remain and forecast uncertainty is extremely high.

Germany's gross domestic product

Variation on previous year in percent, adjusted for prices



Source: KfW Research, Destatis

A virus has shut down Europe

The coronavirus pandemic has hit Europe with full force since the beginning of March and radically worsened the economic outlook. Within a matter of days, infections recorded in Italy were on an exponential growth curve and Spain, Germany and France followed soon after. In response to the spectre of an overwhelmed healthcare system, all euro states scrambled to impose strict containment measures that brought much of public life and business activity to a standstill. The timing and intensity of the measures, however, differed from one country to another. A lockdown in the form of mandatory restrictions on contacts and considerable interference with economic activity was not imposed in Germany until the last week of March. The orders to close businesses affected traditional retail stores in particular (with the exception of supermarkets and pharmacies), many personal services and the hospitality industry. In other euro states, containment measures even went as far as to ban all non-essential business activity for a period of time. As the virus spread across the globe, well over 100 countries imposed either full or partial lockdowns.

Germany's economic output was 20–25% below normal levels during the partial lockdown

The unique character of the coronavirus outbreak and its global spread have created extremely high forecast uncertainty. A major factor is the near impossibility of estimating the duration of the pandemic or the occurrence of multiple waves of infection. In addition, only a rough estimate of its immediate impact on economic activity is possible for now. It is true that sentiment indicators such as the ifo Business Climate Index or the Purchasing Manager's Index show historically unprecedented drops and previously unthinkable lows in April, reflecting a picture of the magnitude of the economic slump. But they have limitations when it comes to enabling a quantitative estimate of the current state of the economy, which is quite easy to obtain in normal times. A more promising method is what is known as the accounting approach, which was last used for the ECB's economic scenarios, for example. It involves deducing aggregate economic activity on the basis of an estimate of disruptions in individual economic sectors. Mandatory restrictions, initial economic indicators and anecdotal evidence can serve as a source of information. The ECB estimates that economic output in the euro area has been reduced by around 30% as an immediate consequence of the lockdown. In Germany, we believe a slightly lower drop of 20–25% to be realistic.

In contrast to the global recession that followed the financial crisis of 2008/2009, the coronavirus crisis directly stalled service sector activities in particular. This applies primarily to services that rely on personal customer interaction. By sector, it has hit the group of retail, transport and hospitality particularly hard, which combined account for 16% of value added in Germany. However, sharp drops were also recorded in the manufacturing sector, which generates 23% of value added but has been affected only indirectly by containment measures. Although the first global wave of the pandemic did not start until March, industrial output already fell 11.6% and incoming orders dropped as much as 15.6% on February. Hopes for an imminent end to the industrial recession that has lasted for nearly two years were emerging at the end of 2019 but were abruptly shattered by the coronavirus crisis. Problems such as the structural transformation in the automotive industry and global trade conflicts remain but they appear small when compared with the consequences of the global pandemic. International supply chains were disrupted by production outages in many countries. At the same time, domestic and international demand collapsed.

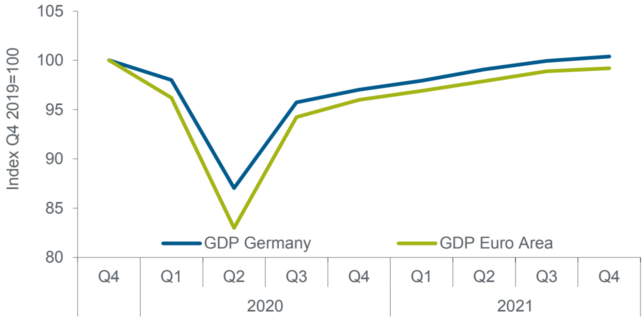
The economy will stage a strong recovery ...

Even so, what is positive is that the strict containment measures were able to stop the first wave of the pandemic. The rate of reported new infections in Europe and, in particular, Germany has been falling noticeably since April. Governments have therefore decided to allow a gradual relaxation of restrictions, starting with reopening small retail outlets since 20 April. If a second wave of infections can be avoided, the decline in economic activity should now have bottomed out. The lockdown will thus be reflected primarily in the second quarter. Germany's GDP is expected to shrink by just under 15% in the first half of the year. As many restrictions are lifted, economic activity will partially return to normal by the summer and that will almost automatically lead to very high growth in the third quarter.

… but only until the fourth quarter

From the fourth quarter, however, the rate of normalisation is expected to drop again significantly. On the one hand, there is potential for a relatively swift recovery because the coronavirus crisis is not a balance sheet recession, a type of recession in which businesses or households have to cut down on consumption for a prolonged period of time in order to reduce debt levels. On the other hand, the return to normal economic activity will be a slow process until a vaccine or very effective treatment is available. Above all, consumers will exercise considerable restraint for fear of contagion until rapid tests are available, infection chains can be traced and widespread behaviour protocols for a range of economic sectors are in place. High economic uncertainty and safety measures such as distancing rules that limit capacity in some sectors are further factors. Furthermore, industrial output is likely to remain impaired for a prolonged period as a result of disruptions to supply chains and collapsing demand. As long as the crisis has not been sustainably overcome by all major trading partners, many firms are unlikely to invest in the face of enormous uncertainty. Rising private-sector and sovereign debt across the globe will have a similar effect.

Figure 1: Basic scenario KfW Research



Source: KfW Research

No return to pre-crisis level until the end of 2021

Germany's GDP is expected to shrink by around 6% this year. In 2021, however, exceptionally high economic growth of +5% can be expected, although much of it will result from the catch-up movement in the second half of this year. Output may not return to its pre-crisis level until autumn of 2021. This year and next, the crisis will cost the country around EUR 300 billion in economic output (relative to trend growth). This is similar to the gross domestic product of Denmark or 9% of Germany's economic output in 2019.

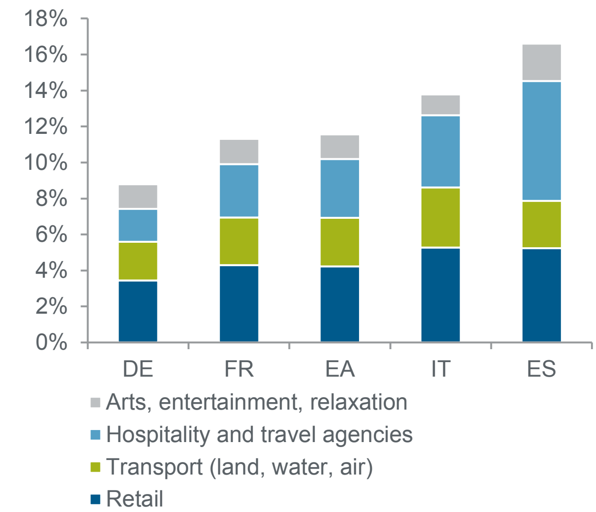
Euro area is shrinking even more

In the other major euro states (France, Italy and Spain), the recession is likely to be even deeper than in Germany. As the pandemic has had a more devastating impact there, stricter containment measures were adopted earlier. Restrictions are also being eased at a slightly slower pace. First-quarter growth offers a foretaste of what is to come. While GDP contracted by 3.8% quarter-on-quarter across the euro area, France even reported a slump of 5.8%.[1] Spain recorded a 5.2% drop and Italy just 4.8%, although it was the first country to impose a national lockdown. In general, the data collected as part of the first rapid estimate so far is probably

[1] Already at the end of March, the French Bureau of Statistics estimated an immediate drop of 35% in economic activity as a result of the lockdown. This appears to be quite realistic given a quarterly decline of 5.8%, two affected weeks from mid-March and assumed moderate growth through to the end of February.

extremely susceptible to revision because statistical measurement during the coronavirus crisis faces particular challenges. Besides being severely impacted by the pandemic, Spain and Italy are very vulnerable, as the sectors most affected by the containment measures have great significance. Foreseeable broad cancellations by international summer holidaymakers this year are sure to burn a deep hole in gross national product and, above all, lead to job losses. Italy in particular was in a difficult situation before the crisis. The high government debt and low potential growth rate will significantly hamper the recovery even if a repeat of the euro crisis of 2011/2012 can be prevented through appropriate policy responses. A collapse in economic output by around 10% in Spain and Italy in 2020 is realistic. France should fare one or two percentage points better. We expect gross domestic product for the euro area as a whole to fall by at least 7% this year. The emerging recovery should translate into around 6% growth in 2021, but that means the pre-crisis level will not be achieved until mid-2022.

Figure 2: Sectors hit particularly hard as a percentage of gross value added



Source: Eurostat, KfW Research

Policies are stabilising the economy but downside risks predominate

Although we expect the deepest recession in Europe in 2020 since World War II, the impact of the coronavirus pandemic would be even more devastating without the swift fiscal and monetary policy response. Grants and bridging loans, a range of adjustments to banking regulation as well as rental and insolvency legislation should enable most businesses to survive the crisis. The short-time allowance reduces fixed costs, preserves jobs and bolsters domestic demand. Nevertheless, the downside risks to our forecast predominate. Most obvious is the threat of a second wave of infections. But economic second-round effects are also possible if sovereign debt or banking crises should emerge in Europe as a result of rising debt levels. What is important in this context is the stabilisation function of monetary policy, which, however, has been made more difficult by the ruling of Germany's Federal Constitutional Court. Positive surprises resulting from fast medical advances are conceivable.