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COVID-19 Growth Scenarios

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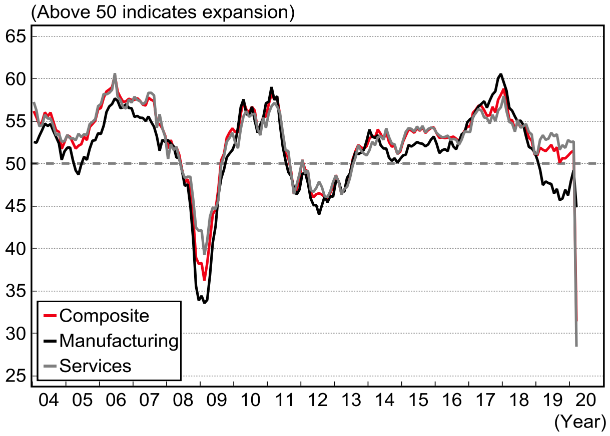
A euro area recession now looks inevitable

As most European countries have imposed stringent restrictions to slow the spread of the virus, the initial supply-chain challenges have now morphed into a severe slump in demand. High frequency activity data (e.g. cinema trips, restaurant bookings, transport) show the extent of the collapse in consumer activity. Business surveys have reached unchartered lows. The euro area PMI fell from 51.6 in February to 31.4 in March, with the services sector most affected. Other surveys such as the Ifo show the damage to retailing. A deep euro area recession in H1 now seems inevitable – we judge that euro area GDP is set to contract in Q1 before collapsing further in Q2.

Any forecasts at this stage will inevitably have a high degree of uncertainty as the extent of any downturn will hinge on how the spread of the virus develops. The experience of the first countries to be affected by outbreaks is a guide – developments in China and South Korea show that aggressive quarantine and testing can be effective in stopping the spread. At the moment we assume that the number of new cases in Europe will peak by the start of May but containment measures will only gradually be eased. Some restrictions are likely to remain in place for most of Q2, causing a sharp fall in output that quarter. We then expect accommodative fiscal and monetary policy will support a rebound in activity at the end of the year.

However, we judge that risks are tilted to the downside – policy mistakes or a failure to contain the spread of the virus in Europe (or indeed elsewhere) could certainly result in a more protracted downturn.

Euro Area PMIs



Source: IHS Markit, MUFG Bank Economic Research Office

Revised GDP Growth Forecasts

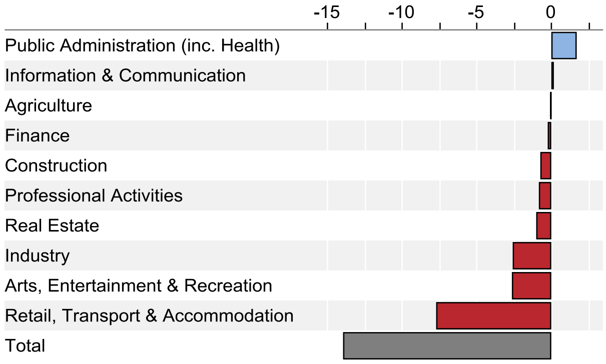
	December 2019	March 2020
Euro Area	1.2	-5.9
Germany	1.0	-6.1
France	1.3	-5.8
Italy	0.6	-6.8

Source: MUFG Bank Economic Research Office

Central scenario: a sharp rebound, but some loss of output

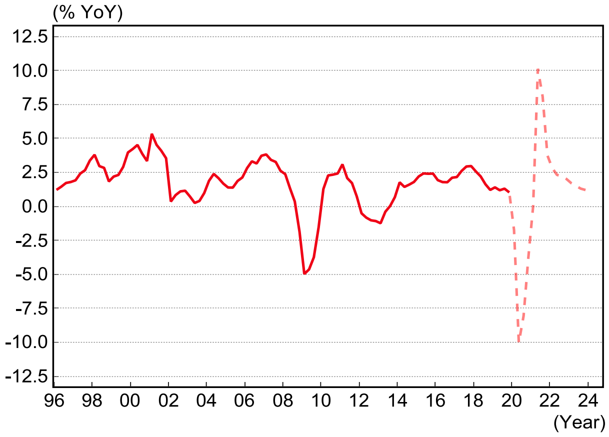
Even with a defined assumption on the spread of the virus it is very hard to judge the magnitude of the resulting economic decline – this is not an ordinary, cyclical crisis. One approach is to consider how different sectors of output on the production side might be affected. Healthcare output will increase, and perhaps IT due to the rushed rollout of remote working for more employees. Otherwise, all areas of the economy are set to feel the drag from disruption, restrictions and increased sickness. Recreation, travel and hospitality will be most affected – we estimate that these sectors could drag activity down by a combined 10pp in Q2 this year. Total Q2 GVA could fall by as much as 15%.

Estimate of Peak Quarterly Impact on Output by Sector
(pp contribution to GVA growth)



Source: Eurostat, MUFG Economic Research Office

Euro Area GDP Growth - Central Scenario

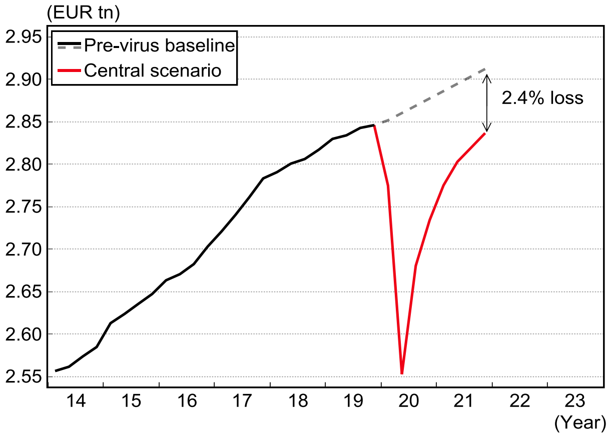


Source: Eurostat, MUFG Bank Economic Research Office

Apart from increasing healthcare provision and incentivising production shifts to equipment such as ventilators there is very little that policymakers can do to boost growth when most people are stuck inside their homes. However, the various policy measures already announced, and likelihood of more to come if required, should support a sharp rebound in activity once restrictions are eased. Fiscal injections in particular are likely to boost demand considerably once the spread of the virus is controlled, while liquidity provisions should prevent widespread bankruptcies. Cheap financing should also support the release of pent-up demand.

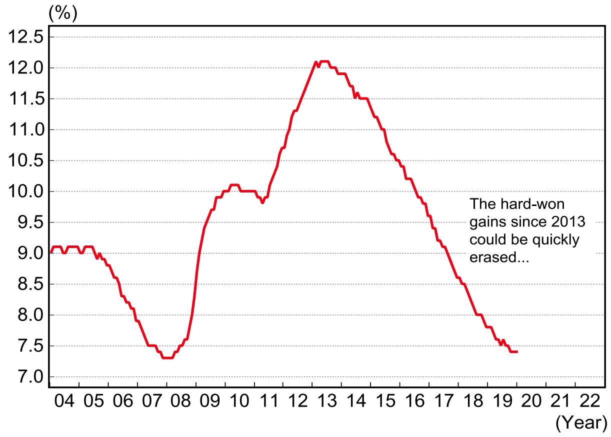
The chart above shows our current baseline path. After the slump in Q2 2020 we are pencilling in growth of between 4 and 5% in 2021. The sharp rebound in growth rates may look positive but we would emphasise that the euro area economy is unlikely to emerge from such a sharp fall in output entirely unscathed. Relative to a pre-virus baseline, we see a loss of output of more than 2% of GDP by end-2021. Travel and tourism industries in particular are likely to experience a long-term drag (with more indebted peripheral euro area economies set to be most affected). Unemployment is likely to rise sharply in coming months. It should then improve as the economy recovers but still remain above current rates, dragging on consumer spending.

Real Output Loss



Source: Eurostat, MUFG Bank Economic Research Office

Euro Area Unemployment



Source: Eurostat, IHS Markit, MUFG Bank Economic Research Office

Any forecast at this stage comes with high uncertainty

With the bulk of the shock likely to be shown in Q2 data, any growth forecasts really should be taken with a pinch of salt at this stage, so we present a range of possible paths below.

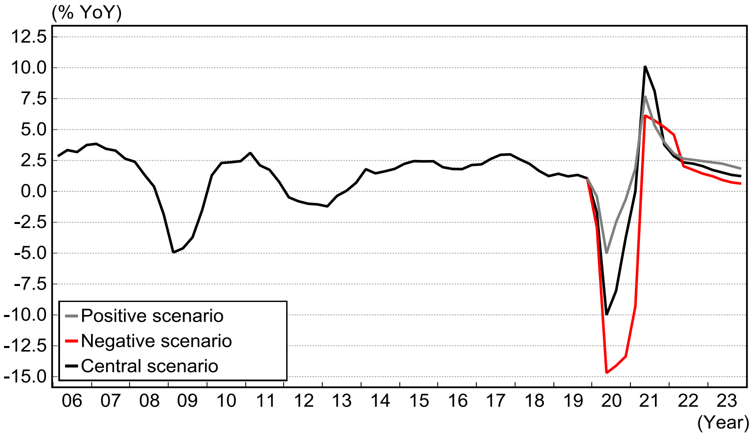
COVID-19 scenarios

Central Scenario	Negative Scenario	Positive Scenario
• *The spread of the virus peaks by early May in Europe. Containment measures are gradually eased but some remain in place through most of Q2.* • *Euro area growth could fall by more than 10% on a quarterly basis as business investment and consumer spending slump. Unemployment rises sharply despite governments' wage guarantee programmes.* • *A strong policy response supports a rebound in activity by the end-2020 but certain sectors, such as travel, face persistent reduction in demand. Unemployment only falls gradually. Some consumers continue to avoid crowded places.* • *There is a loss of output of about 2.5% of GDP by end-2021 relative to a pre-virus baseline.*	• *Efforts to slow the spread of the virus have limited success as the public starts to tire of restrictions. It proves hard to develop effective treatment/vaccines. There are further waves of infections.* • *Inadequate policy support sees a surge in unemployment. Poor containment measures in other countries extend the shock for the rest of the world and weighs on global travel.* • *The protracted downturn exposes other areas of vulnerability in the economy with contagion into financial sectors. Unemployment remains persistently high which reinforces the economic downturn.* • *Accommodative policy changes do support an eventual recovery in activity, but there is a large loss of output relative to pre-virus baseline.*	• *The coronavirus shock to the economy is sharp but short-lived. Measures to slow the spread of the virus are effective with lockdown measures are removed after less than two months. Treatments and vaccines to treat the disease can be quickly developed and produced, or adapted from existing medication.* • *Growth rebounds sharply from as soon as late Q2 2020 as consumers and workplaces quickly return to normality.* • *The virus is the trigger for governments to release long-awaited fiscal easing measures. Combined with a rebounding manufacturing sector, these support demand so that output may approach to the pre-virus baseline by end-2021.*

Source: MUFG Bank Economic Research Office

There are now some encouraging signs that China is already going back to work as lockdown measures are eased. This may encourage other countries to implement persist with more severe restrictions in the knowledge that a) it is possible to contain the virus and b) a rebound in economic activity is plausible. Meanwhile, there are also rumours about possible treatments based on existing drugs, testing for immunity, and the likely effectiveness of vaccines. A significant advance on these lines offers the most plausible route to a genuine 'V-shaped' recovery. But even in the 'positive' scenario, the euro area economy does not escape a deep recession.

Euro Area Growth Scenarios



Source: Eurostat, MUFG Bank Economic Research Office

Risks to our forecast are probably tilted to the downside, however. Europe has less recent experience of epidemics than many countries in Asia and may find it harder to contain the spread of COVID-19 than China, South Korea and others, especially if the public tires of restrictive measures. Once under control, there may be a second wave in the autumn, and it may well take longer than hoped to develop and distribute effective vaccines or treatments. And even if the spread of the virus can be brought under control relatively quickly in Europe, the chances of a swift global recovery may well hinge on developments elsewhere - in particular in the US. The chances of other vulnerabilities in the euro area and global economy emerging will only increase the longer that the downturn continues.

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