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Activity is likely to fall in Q4, but there are now some reasons for optimism

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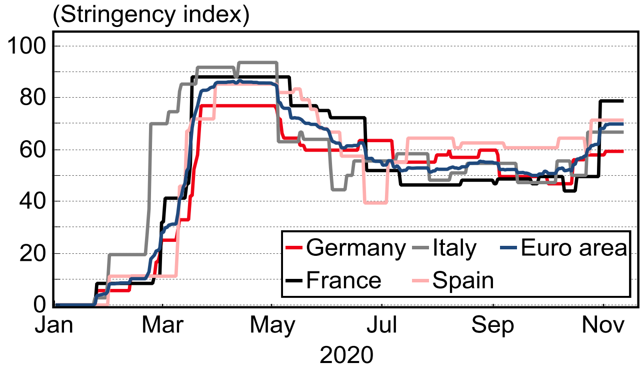
Euro area GDP comfortably beat expectations with a 12.7% QoQ bounce in Q3. But the autumn resurgence of COVID-19 infections has put paid to any hopes of a full 'V-shaped' recovery as national governments have re-imposed some virus containment restrictions. Output is likely to slip back a bit again in Q4.

There is now some good news, though. First, there are signs that the measures are working in many countries as confirmed cases have either stabilised or started to fall. The news that an effective vaccine is possible is even more important. While we are still waiting for details on its distribution, it now represents the most plausible exit strategy from economically damaging restrictions and social distancing policies in European countries. This should remove any temptation for governments to withdraw fiscal support prematurely and boost business and consumer confidence.

'Lockdown light' seems to be working

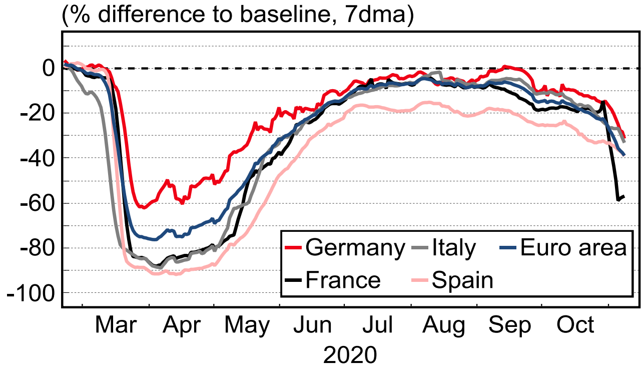
An autumn resurgence of the virus has prompted national governments across the euro area to re-impose virus containment restrictions. It is probably hospital admissions rather than discovered COVID cases that force the toughest restrictions as governments try to limit the risk the healthcare services could be overwhelmed. France has seen both the sharpest rise in hospital admissions and the toughest new restrictions out of the major euro area countries. But even in France and other badly affected countries, the restrictions are not as tough as 'peak lockdown'. The Oxford stringency tracker suggests that the current restrictions tend to be more akin to May, when governments had started to unwind measures, than March or April.

LOCKDOWN STRINGENCY TRACKER



Source: Oxford COVID-19 Response Tracker, MUFG Bank Economic Research Office

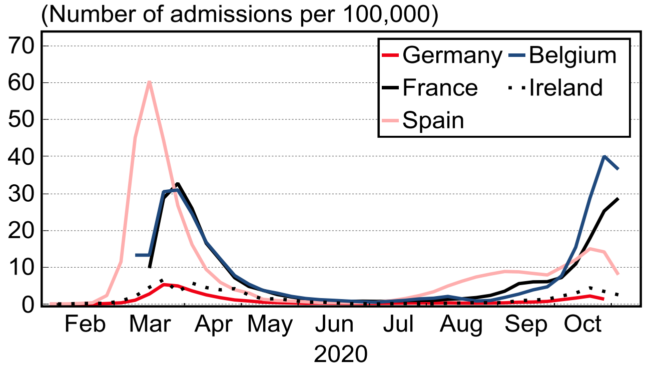
MOBILITY – RETAIL & RECREATION



Source: Google, MUFG Bank Economic Research office

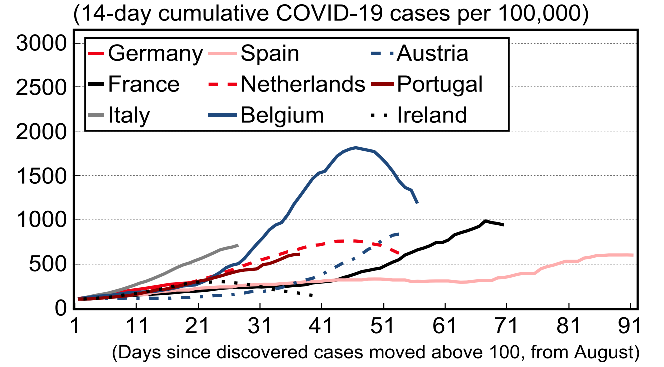
There are signs that even this 'lockdown light' has been effective at suppressing the virus, despite the fact that the weather is cooler and we are now moving into the traditional flu season. Mobility trackers show that people are spending less time in workplaces and retail/recreation locations, and more time at home. The infection curve is now clearly bending downwards, most notably in Belgium which experienced the sharpest increase in case, but also in countries such as the Netherlands and Ireland. There are some hints that the numbers may be stabilising in France, too. In turn, the hope will be that hospital admissions, which tend to lag discovered cases, will start to decline as well.

EURO AREA – COVID HOSPITAL ADMISSIONS



Source: ECDP&C, MUFG Bank Economic Research Office

DISCOVERED COVID-19 CASES



Source: ECDP&C, MUFG Bank Economic Research Office

Possibility of 'on/off' restrictions until the vaccine can be widely distributed

The European Commission has authorised a contract for up to 300 million doses of the BioNTech/Pfizer vaccine. We are waiting for details of its distribution and timing but the *fact* that a vaccine is even possible – previously this was unclear – is hugely significant. The development of large testing and contact tracing programmes since the initial wave was not enough to stop this autumn increase in infections. Europe was faced with the prospect of ongoing restrictions with no clear end in sight.

There is now a plausible path back to normality. The challenge for governments is to maintain compliance and social distancing practices until the vaccine can be widely distributed. We suspect that reduced compliance due to lockdown fatigue and the vaccine news, combined with increased household mixing over the Christmas period, may mean that infection numbers remain fairly high as we go into the new year. This could mean continued 'on/off' restrictions through spring in many countries. Our assumption is that some degree of restrictions will remain necessary until at least H2 2021.

RESTRICTIONS IN RESPONSE TO RISING INFECTION NUMBERS

Germany	"Lockdown light" in place during November. Restaurants, bars and other 'non-essential' services closed. Gatherings restricted to max. 10 people from two households. Non-essential travel discouraged.
France	A partial lockdown began on 30 October. Non-essential retail and services closed. Travel between French regions is banned, extra-European borders closed. Regional night curfews in place.
Italy	Nationwide night curfew in place. Cinemas, museums and gyms closed nationwide. Bars, restaurants and non-essential businesses closed in areas with high infection rates. No travel between regions.
Spain	Bars and night clubs were ordered to close again on a nationwide basis in August. Most regions have re-imposed restrictions on other non-essential activities. A national plan was agreed on 30 September to introduce regional measures if certain triggers are met. A new state of emergency was declared on 25 October.

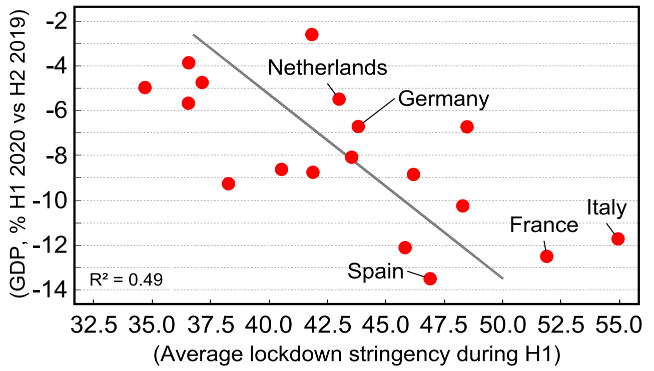
Source: IMF COVID-19 Policy Response Tracker, MUFG Bank Economic Research Office

In terms of the economy, lockdown measures will continue to be the key determinant of activity in the near term. But the vaccine news is certainly important. The news is likely to pass through to business and consumer confidence. Further ahead, it may also be relevant for the policy response as it is easier to justify the fiscal cost of income support schemes, for example, now there is a plausible end to restrictions.

GDP to slip back in Q4

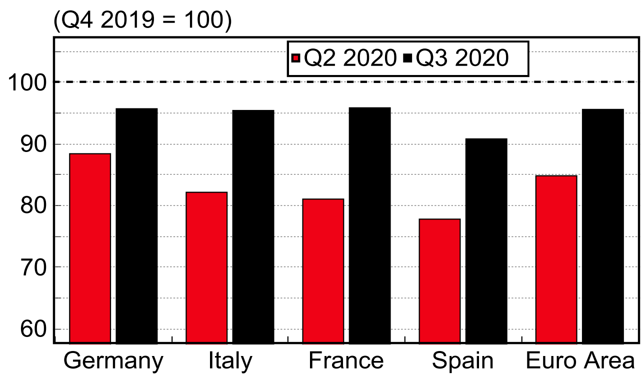
Euro area GDP expanded by almost 13% QoQ in Q3 – well above the consensus – but output is likely to slip back again in Q4. The negative relationship between lockdown stringency and GDP growth was fairly clear during the first half of the year, while the decline in mobility indicators is a reliable indication that activity is declining as virus containment measures are tightened.

GDP GROWTH VS. LOCKDOWN STRINGENCY IN EURO AREA COUNTRIES



Source: Oxford COVID-10 Government Response Tracker, Eurostat, MUFG Bank Economic Research Office

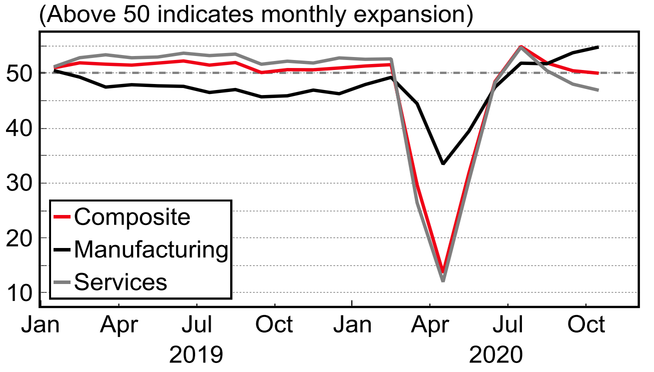
GDP IN THE EURO AREA AND SELECTED COUNTRIES



Source: Eurostat, MUFG Bank Economic Research Office

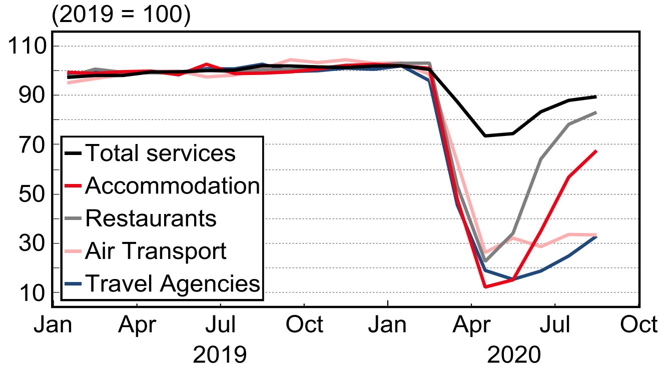
The Q4 fall may be more limited though and we expect the level of output will remain above the lows seen in the first half of the year. As mentioned above, it is generally more of a 'lockdown light' than a return to the stringent measures imposed in the spring. Governments are reluctant to shutter anything but 'non-essential' retail and services. Industry and construction have escaped any tighter restrictions. Indeed, business surveys now show clear divergence between manufacturing and services, and it is the services sector that will likely drive the fall in Q4 GDP.

EURO AREA PMIS



Source: IHS Markit, MUFG Bank Economic Research Office

TURNOVER IN SERVICES



Source: Eurostat, MUFG Bank Economic Research Office

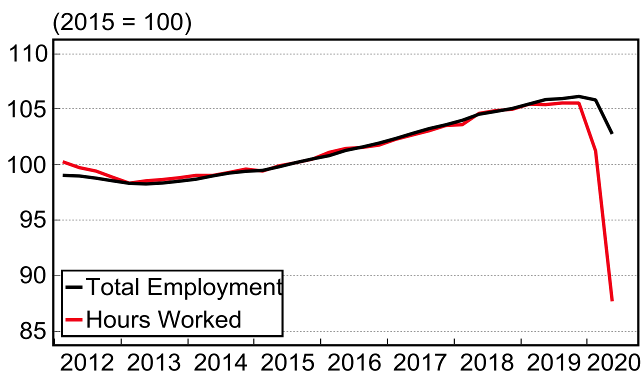
Some parts of the service industry such as tourism will continue to struggle in the face of border restrictions and travel bans. But we expect that contingency planning – this time the lockdown is not a shock – will cushion the blow for other sectors. Restaurants, for example, may pivot back towards home delivery services if forced to close for seated diners. There are also likely to be behavioural differences. We suspect that many people will be less inclined to stay at home now there is more knowledge about the virus and its risks than in the spring, so businesses that are permitted to remain open may see higher footfall this time. Confidence is also likely to be boosted by the vaccine news, as mentioned above, which could reverse some of the recent trend towards precautionary saving.

So, while a negative GDP print for this quarter is now very likely, we think that the level of activity will remain comfortably above the Q2 low. Based on our models, we are pencilling growth of in the region of -3% QoQ for the last quarter of the year which, after the Q3 bounce, could still leave a positive carryover into the 2021 annual average.

A swift return to the pre-virus growth path is unlikely, even with a vaccine

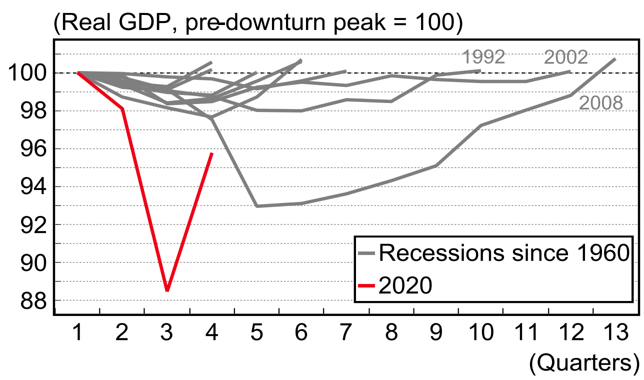
The outlook beyond Q4 will initially depend on whether lockdown restrictions remain in place into 2021 and then on the speed and scope of the vaccine distribution. As mentioned above, we expect that some restrictions will remain in place through H1 2021, perhaps on an 'on/off' basis as mentioned above. This means that GDP growth is likely to remain muted in Q1 and Q2. Assuming some pick-up up in activity as the vaccine is distributed, growth may still average around 5% in 2021. This would still leave output around 1.5% below its Q4 2019 level.

EMPLOYMENT AND HOURS WORKED



Source: Eurostat, MUFG Bank Economic Research Office

ECONOMIC RECOVERIES IN GERMANY

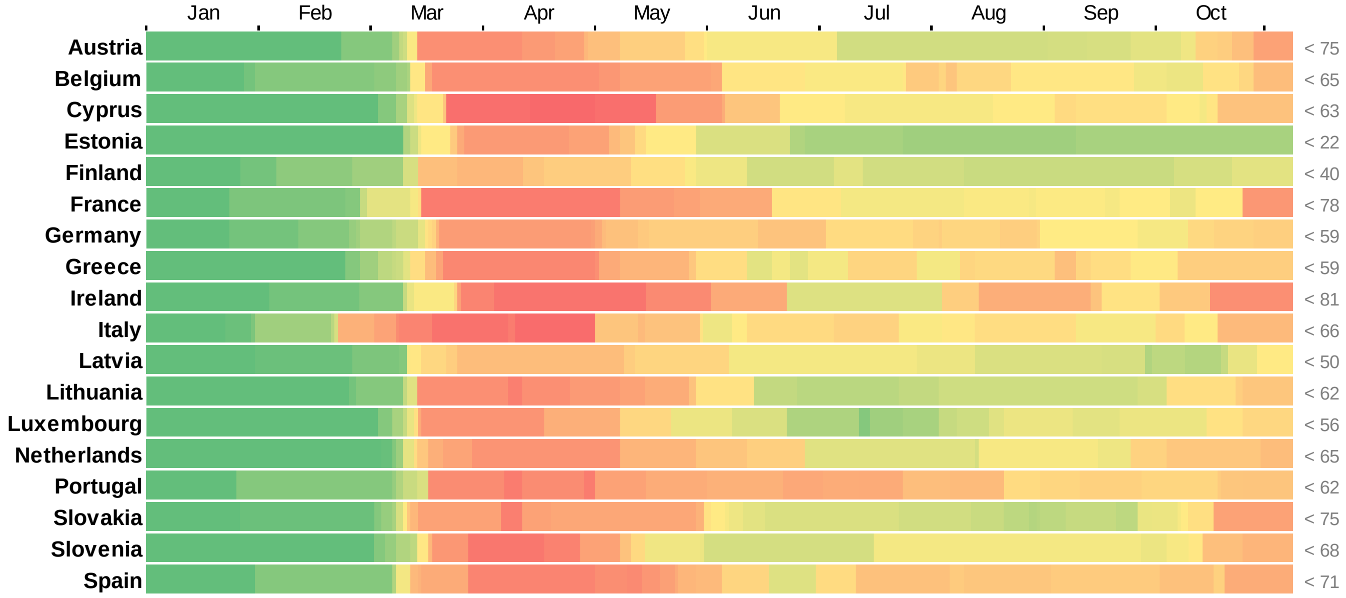


Source: Destatis, Macrobond, MUFG Bank Economic Research Office

Further ahead, we remain dubious that the availability of a vaccine will see GDP rebound sharply back to the pre-virus growth path. Yes, the vaccine will allow a lot of demand in most-affected sectors such as travel and hospitality to come back online. But there are likely to be scars from the historic fall in activity and what is likely to be more than a year of restrictions. Despite their best efforts, governments will not have been able to save all jobs and businesses. We still expect that hysteresis effects on employment, investment and productivity, as well as a persistent drag on external demand, will to weigh on euro area GDP growth for several years to come.

Appendix: COVID trackers

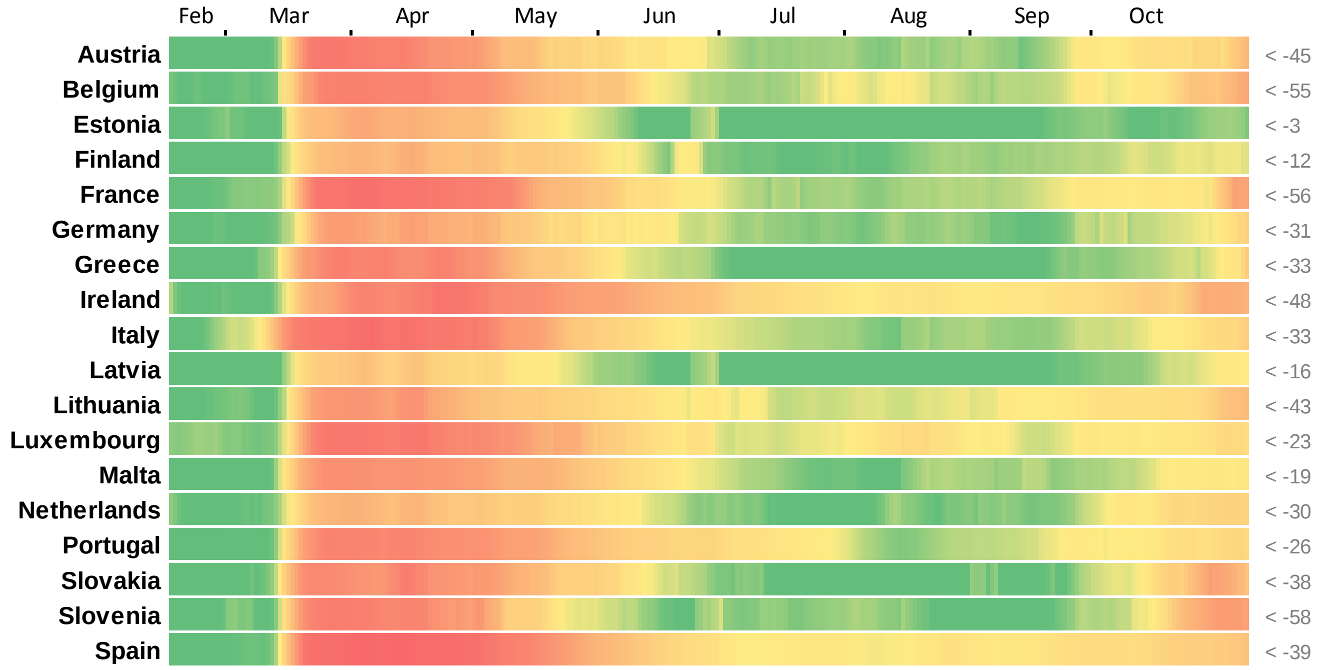
LOCKDOWN STRINGENCY TRACKER



Note: The graphic shows the coronavirus government response tracker produced by Oxford University's Blavatnik School of Government which collates information on official measures to reduce the spread of the virus (e.g. school closures) to produce an index which ranges from 1 (no measures) to 100 (total lockdown). The figures on the right are the latest values.

Source : Oxford COVID-19 Government Response Tracker, MUFG Bank Economic Research Office

RETAIL AND RECREATION MOBILITY TRACKER



The graphic shows public movement relative to a 'normal' baseline in the retail and recreation sector. It uses smoothed daily data, with the figures on the right showing the latest seven day moving average (% difference to baseline). Any value equal to or above the baseline is shown as dark green. Red is used for 100% deviation from the baseline (i.e. no movement at all). The figures on the right are the latest values.

Source : Google, MUFG Bank Economic Research Office

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