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The third wave of COVID increases European divergence risks

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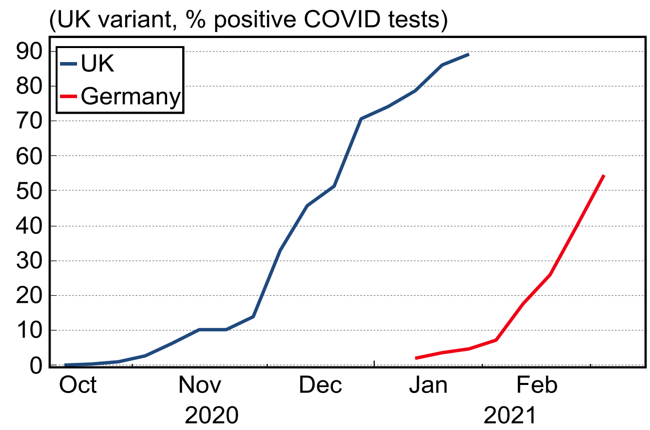
The more transmissible UK variant of COVID has caused the caseload to rise again in many euro area countries, prompting restrictions to be expanded or extended. While EU vaccination distribution can only improve, the delayed reopening means that divergence with the fiscal stimulus-driven recovery in the US is likely to become increasingly apparent. It also raises risks of fragmentation across the euro area as manufacturing-driven economies may still benefit from improving global demand while tourism-driven economies look set to lose another peak summer season. But there has been little in the way of discussions about bolstering the collective fiscal response. In fact, risks of delays to the disbursement of EU recovery funds may be increasing after a challenge from the German Constitutional Court.

The rising COVID caseload will delay a return to normality

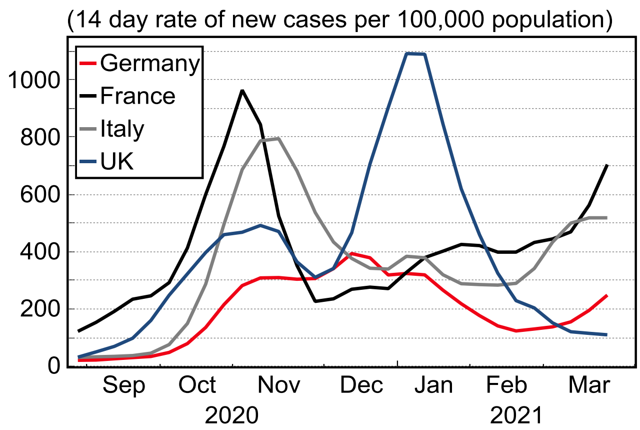
The return to normality in the euro area is set to be delayed by several weeks at least as the COVID-19 caseload increases once more. This 'third wave' of the virus owes to the UK variant (B.1.1.7) strain of COVID which is now dominant on the continent as well, after a lag of around two months. It has become apparent that measures already in place are not sufficient to suppress this new variant, which is significantly more transmissible, in the same manner. The EU's stuttering start to vaccinations is also relevant as this rise in infections is still translating into additional pressure on healthcare systems. Intensive care admissions in France have risen especially rapidly, forcing the government to announce a third national lockdown.

THE MORE CONTAGIOUS UK VARIANT IS NOW THE DOMINANT STRAIN ON THE CONTINENT



Source: PHE, Robert Koch Institute, MUFG Bank Economic Research Office

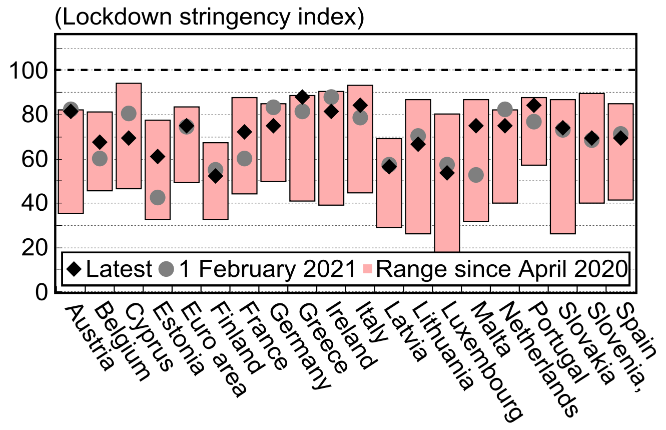
THE CASELOAD IS INCREASING AGAIN IN GERMANY, FRANCE AND ITALY



Source: ECDC, MUFG Bank Economic Research Office

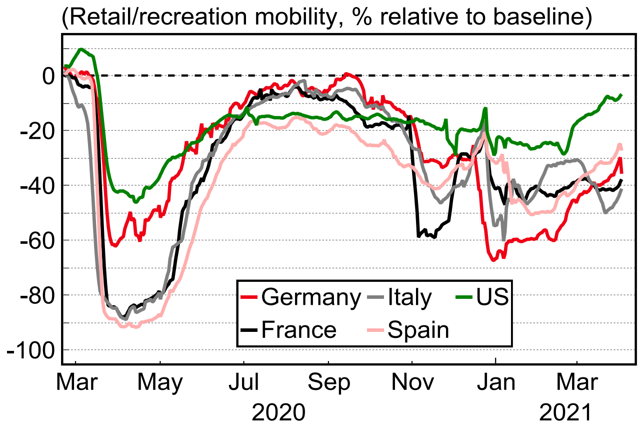
Many other national governments, including those of Germany, Italy and the Netherlands, have also moved to extend or expand lockdown measures in recent weeks. Our GDP-weighted lockdown stringency index for the euro area as a whole has barely changed since mid-December 2020. The euro area is still much closer to 'peak lockdown' of spring last year than it is to unrestricted daily life.

REOPENING PLANS HAVE NOW BEEN DELAYED OR REVERSED IN MANY EURO AREA COUNTRIES



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

A RETURN TO NORMAL LIFE IN EUROPE WILL BE FURTHER DELAYED



Source: Google, MUFG Bank Economic Research Office

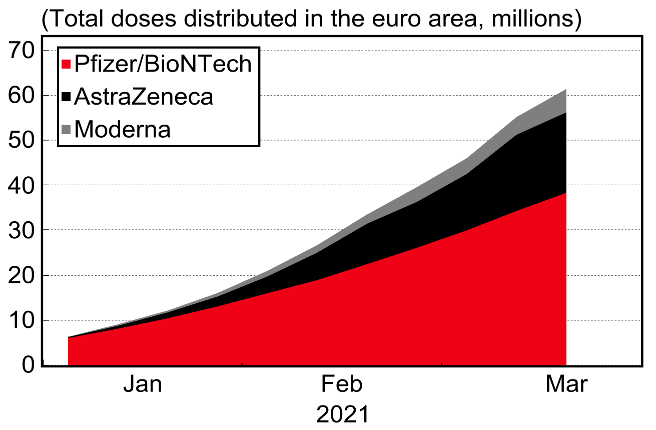
However, as we've noted before, the negative relationship between restrictions and GDP is weakening as businesses and consumers adapt to the possibilities of economic activity in lockdown. Mobility indicators have certainly remained well above the lows of the first wave. But, while the relationship is weaker, the degree of restrictions continues to dominate all else when it comes to euro area GDP. The move to extend or expand measures into Q2 means there are downside risks to our current forecast for growth of around 2.5% Q/Q.

Vaccine supply is set to increase but regulatory changes and concerns about side effects may affect demand

The pace of any rebound through H2 will largely depend on the success of the EU's vaccination programme as a reduction in hospital admissions and fatality rates would allow restrictions to be lifted more quickly. So far the EU's distribution efforts have often been slow and muddled, as well as unlucky with various supply problems. Despite this relatively poor start to vaccinations – certainly when compared to the US and the UK – the EU does have a large and diverse vaccine portfolio. A sustained increase in the daily pace is likely to materialise over coming months. Initial production issues have now faded and the EMA has approved several new manufacturing sites for AstraZeneca, Moderna and BioNTech/Pfizer which should limit the risk of future supply issues. The single-dose Johnson & Johnson vaccine will also be delivered from mid-April. So it seems increasingly likely that supply will not prevent the EU from reaching its target to vaccinate 70% of adults by the end of the summer – and indeed that target could be met well before August.

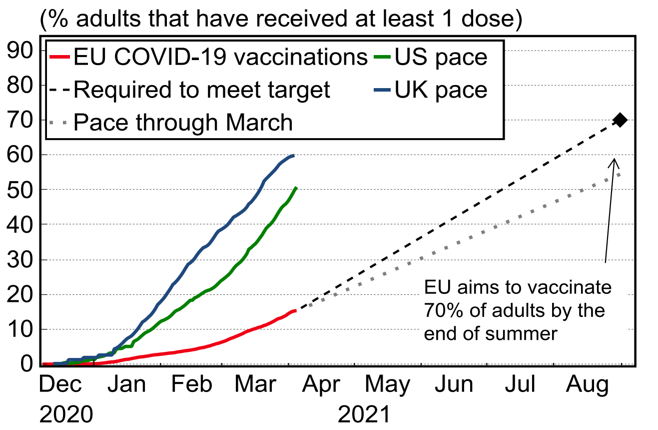
Demand, on the other hand, may become increasingly relevant. There have been complete U-turns on official guidance around the use of the AstraZeneca vaccine in after concerns about potential side effects. After claiming that there was not enough efficacy data on the use of the vaccine for over 65s, the German medicine regulator is now recommending that it should only be used on people over the age of 60.

ASTRAZENECA HAS PROVIDED 30% OF VACCINES DISTRIBUTED SO FAR



Source: ECDC, MUFG Bank Economic Research Office

THE PACE OF VACCINE DISTRIBUTION NEEDS TO IMPROVE FOR THE EU TO MEET ITS SUMMER TARGET



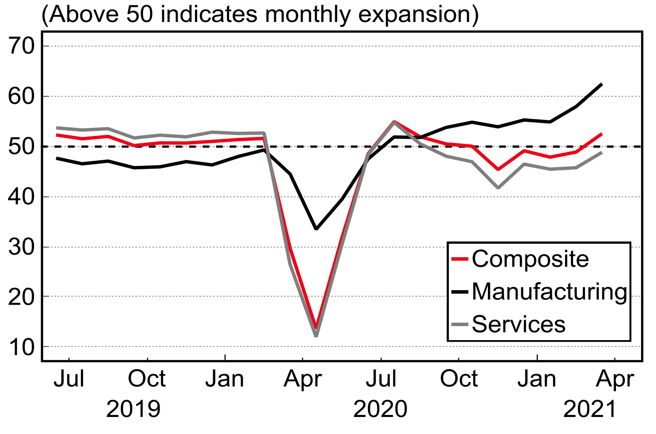
Source: Our World in Data, MUFG Bank Economic Research

YouGov polling now shows that the AstraZeneca vaccine is now seen as unsafe in net terms in Germany, France, Italy and Spain. We are concerned that the clumsy regulatory handling of the AstraZeneca vaccine and subsequent public caution over its use would have spill-over effects onto other vaccines. For now the polling shows that there has been no change in perceptions about the safety of the BioNTech/Pfizer and Moderna vaccines. But as younger, less vulnerable cohorts become eligible for vaccinations, any increase in stories about potential side effects could see vaccine hesitancy become more of a concern over coming months. This could make the population immunity threshold of at least 70% (and most likely higher now due to the dominance of the more transmissible variant) hard to achieve.

The delayed reopening increases fragmentation risks within the euro area

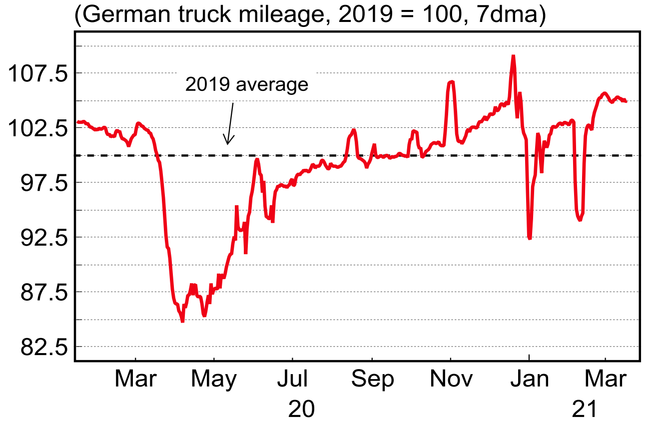
Even if vaccination rates do improve, the third wave of COVID in Europe means that the economic rebound is more likely to be delayed and fragmented.

THE GAP BETWEEN MANUFACTURING AND SERVICES HAS WIDENDED FURTHER



Source: IHS Markit, MUFG Bank Economic Research Office

GERMAN TRUCK MILEAGE HAS LOOKED RESILIENT THROUGH MARCH



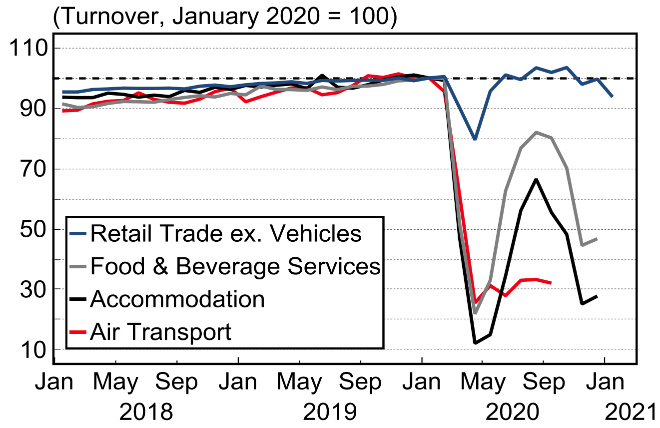
Source: Destatis, MUFG Bank Economic Research Office

Countries orientated towards goods exports are better placed to benefit from earlier recoveries in other regions. European governments have settled on a balance of restrictions that can suppress the COVID caseload while also minimising the economic damage. The manufacturing and construction sectors are increasingly unaffected by lockdown measures.

Meanwhile, the outlook for external demand continues to improve. The robust Chinese economy, with its sharp rebound in domestic demand, is very relevant for euro area exports. China accounted for 8.5% of euro area exports in 2020 and was one of only a handful of countries to show an annual increase in total nominal exports last year. The growth outlook in the US is also increasingly buoyant following vaccination success and the announcement of enormous fiscal stimulus.

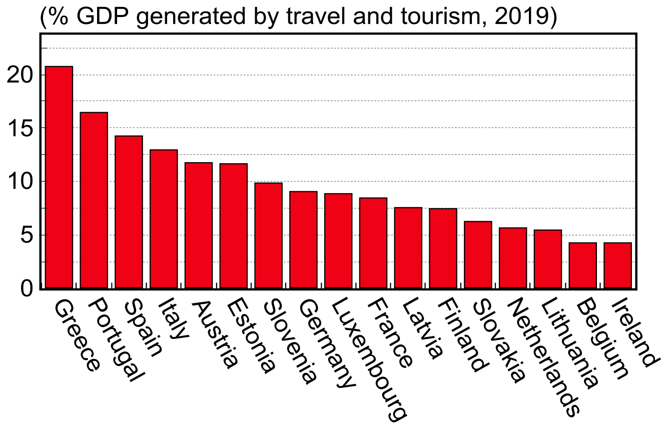
This improving external outlook is supporting the euro area manufacturing sector. The PMI reached a record high of 66.4 in March as the gap to the services gauge widened further. German industry looks especially robust. Truck mileage, which corresponds closely to manufacturing output, is well above the 2019 average, and the ifo gauge of manufacturing business expectations has surged to a 10-year high.

HOSPITALITY AND TOURISM IS VERY RESPONSIVE TO LOCKDOWN MEASURES



Source: Eurostat, MUFG Bank Economic Research Office

SOUTHERN EUROPEAN COUNTRIES ARE MOST DEPENDENT ON TOURISM



Source: OECD, MUFG Bank Economic Research Office

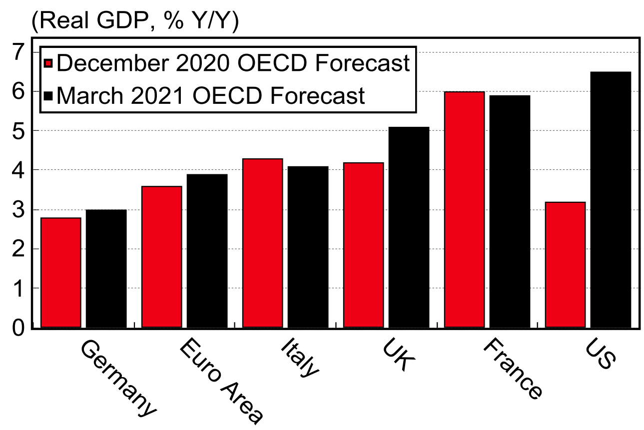
Manufacturing resilience and reduced effect of lockdown measures on domestic demand as consumers and businesses adapt is little solace for those in sectors such as travel and hospitality which now face the brunt of increasingly targeted COVID restrictions. We are concerned about the tourism sector in particular. While governments tried to loosen restrictions for bars and restaurants during the autumn, curbs on international travel have remained in place. The spread of the UK variant will only heighten the focus on risks for new COVID strains, especially those that may reduce vaccine effectiveness, so governments are likely to be hesitant to lift border controls. Countries with large summer tourism sectors such as Spain and Italy are set to suffer from another heavily restricted peak season. The longer that the return to normality is delayed, the greater the risk becomes of more persistent economic scarring such as structurally higher unemployment.

Diverging recovery paths may increase the focus on the EU's fiscal response

As well as the risk of fragmentation within the euro area between manufacturing- and tourism-driven economies, there is also an increasing risk of diverging global recoveries. The successful vaccine distribution and enormous fiscal stimulus in the US has prompted forecasters to hastily revise estimates for US growth. The OECD notably increased its forecasts for US growth by around 3pp this year – while leaving its euro area figure broadly unchanged.

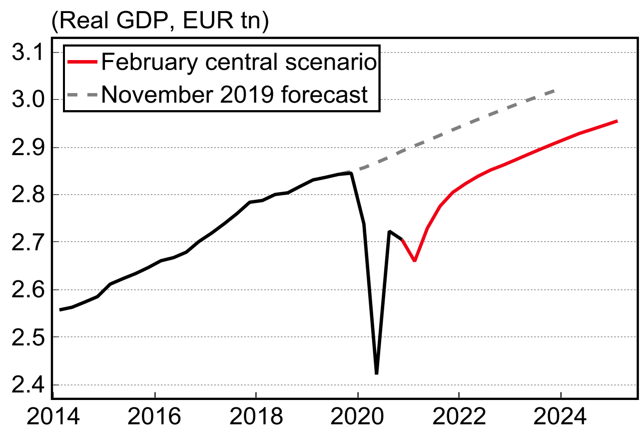
As the US continues to experiment with crisis response policies, the EU's approach is likely to come under increasing focus. The NextGenerationEU recovery plan felt substantial when it was agreed last summer – the €672.5 billion Recovery and Resilience facility, the centrepiece of the plan, is equivalent to 4.8% of 2019 EU27 GDP. But questions remain about its implementation. The most significant part of the scheme was the fact that EU nations agreed to jointly issue debt for the first time. This remains controversial in more fiscally conservative countries, and the recovery plan has still not been ratified. While the ratification process was never expected to be plain sailing, a new challenge from the German Constitutional Court now increases the risk that the disbursement of funds may not occur by this summer as expected.

A MASSIVE FORECAST BOOST FOR THE US - BUT LITTLE CHANGE TO THE OECD'S EURO AREA NUMBERS



Source: OECD, MUFG Bank Economic Research Office

WE THINK IT WILL TAKE OVER A YEAR FOR EURO AREA GDP TO RETURN TO ITS PRE-PANDEMIC LEVEL



Source: Eurostat, MUFG Bank Economic Research Office

The extension of lockdown measures in Europe already means that the euro area economy is likely to lag behind the stimulus-driven rebound in the US, so the possibility of any delay to the recovery fund disbursement is concerning, especially given the investment focus of the Recovery and Resilience facility . The latest IMF fiscal monitor looked at the scope for public investment to support the post-COVID recovery, noting that "preparation typically takes five years or more for large infrastructure projects". Much shorter lead times will be required for the plan to boost the post-pandemic recovery and limit economic scarring risks.

Whether or not the size of the recovery fund remains appropriate is another question given the fiscal response across the Atlantic. The EU managed to agree on the recovery plan during the acute phase of the crisis last year but this still required tortuous negotiation. Politically it will now be much harder to make any bold, effective policy decisions as the pandemic begins to ease. There is certainly a risk that the EU may fall behind the curve on fiscal stimulus over coming years. While we are confident that EU vaccine distribution will improve over coming months, we think that some scarring effects and a persistent drag on the tourism sector will continue to weigh on the recovery. We do not expect euro area GDP to reach its Q4 2019 level until mid-2022, while a return to the pre-pandemic trajectory seems unlikely even for several years beyond that.

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