ECONOMIC OUTLOOK AUTUMN 2020

PROTECTING EUROPE'S FRAGILE RECOVERY

Economic situation

- Following the deepest falls in output since the great depression in this spring, the EU economy began its recovery during the summer, but the path back to pre-COVID levels of output is likely to be long and uneven, with uncertainty unusually high.
- We expect the EU economy to fall by 7.3% in 2020 as a result of the COVID-19 epidemic and associated lockdowns, followed by growth of 5.0% in 2021.
- The situation has deteriorated in recent weeks with a second wave of lockdowns and faster spread of the COVID-19 virus than expected. This poses a downside risk to the forecast.
- Underlining the challenges ahead, we forecast that even by Q4 2021, the level of economic activity will be around 3% below the precrisis level.
- The economic impact is divergent across both sectors and geographically. Some EU member states face double-digit GDP drops this year, as opposed to a fall of around 3%-4% in other member states.
- Business investment has been particularly hard hit, evidenced by both strong falls in businesses sentiment and capital good production
- Whilst official data shows only marginal increases in unemployment, falls in hours worked are equivalent to 18 million full time jobs in Q3. We expect official EU unemployment to increase to around 9% in 2021.

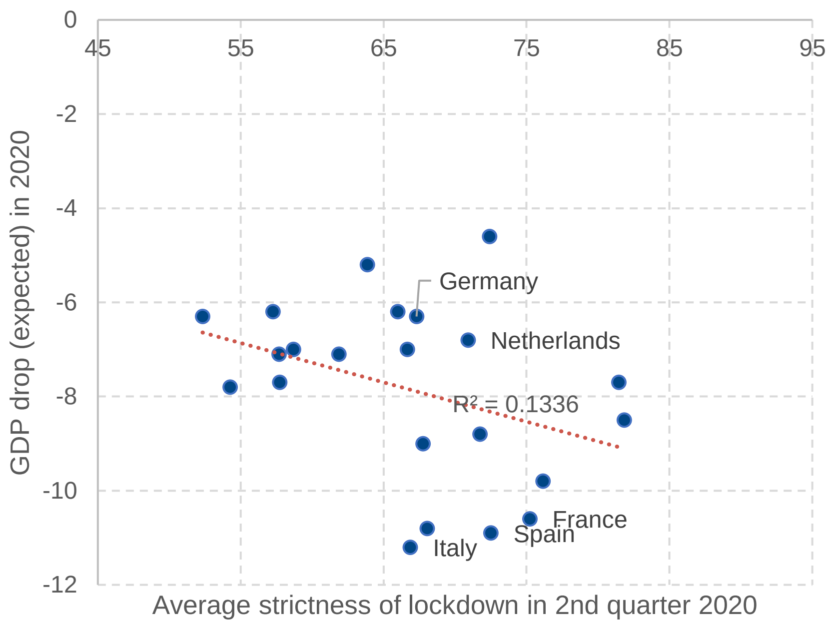
Policy recommendations

- Given the resurgence of the virus, policy-makers must avoid any premature unwinding of measures to support business and workers, such as wage subsidies and tax holidays, which would risk a new recession and greater long-term economic scarring.
- Policymakers must support overall investment levels in the face of the massive fall in private investment. In particular, rapid agreement and implementation of the EU's Next Generation EU Recovery instrument is essential. The funds must support investment and reforms that can help transform EU growth, productivity and competitiveness.
- Given the risk of increased losses on loans impacting banks' balance sheets and ability to perform new lending, any changes regarding the regulatory requirements for bank capital in the context of the transposition of the final Basel III agreement must be carefully calibrated to ensure they do not lead to a sudden reduction in lending and investment.
- Following the latest developments in the EU-UK negotiations, it is imperative that both sides remain committed to do everything in the weeks ahead to deliver an agreement that provides a sound competitive environment for our companies combining good market access with level playing field provisions.

1. Introduction

Following the deepest falls in output since the great depression the spring, the EU economy is now recovering, but the path back to pre-COVID levels of output is likely to be long and uneven. As COVID-19 transmission numbers have increased in recent weeks, governments are reintroducing lockdown measures which are likely to dampen activity due to both the direct legal restrictions on activity and the indirect impacts on consumer confidence. Moreover, as well as uncertainty over the course of the pandemic, including the development and distribution of potential treatments and vaccines, both the US presidential election and ongoing negotiations over a UK/EU trade deal are adding to broader economic uncertainty.

Graph 1: GDP growth and level of strictness of lockdown measures in 2020



Own calculations based on Oxford Stringency Index (Higher values=more strict) and European Commission summer forecast.

Ultimately, our economies will only be able to fully recover when the virus is contained and businesses across a full range of sectors have the confidence to undertake long-term investment.

Until then, alongside appropriate health-related measures, it is essential that the EU and its Member States continue to undertake measures to protect workers and businesses and ensure the long-term scarring to our business infrastructure is as limited as possible. In particular, rapid agreement between EU institutions regarding the EU's Next Generation recovery instrument will be essential to ensure investment can start to take place as soon as possible, filling the current gap created by falls in private investment.

2. Current situation and outlook

2.1 GDP forecast

Our central forecast is for the EU economy to fall by 7.3% in 2020, followed by positive growth of 5.0% in 2021. However, particularly for 2021, this forecast is surrounded by exceptionally high uncertainty and dependent upon the path of the pandemic, as well as broader geopolitical developments. Even in the best case scenario, we expect the EU economy to be operating well below its precrisis level throughout 2020 and all of 2021. As long as the COVID-19 necessitates lockdowns and other countermeasures in the EU as well as among global trading partners, a full recovery will be impossible.

Despite such uncertainly, our autumn forecast is broadly in line with our spring Outlook, when we expected -7.9% growth in 2020, followed by a 5.8% rebound in 2021. For 2020, we saw slightly better-than-expected output figures in some member states during the spring, whilst the fact that we have been able to largely maintain our growth outlook for 2021, despite the apparent second wave of the pandemic in Europe, reflects both the necessary prolongation of furloughing schemes in a number of large member states, as well as a strong commitment to a European economic response to the epidemic through the so-called "Next Generation EU" recovery instrument. As governments have rapidly stepped up measures against the epidemic in recent weeks risks to the forecast have increasingly become tilted towards the downside.

Graph 2: Central economic forecasts, EU27

	2019	2020 f	2021 f
GDP growth (real)	1.5%	-7.3%	5.0%
Unemployment	6.6%	7.7%	8.8%

Source: 2019: Eurostat, f: BusinessEurope forecasts[1]

Uncertainty extends beyond issues related to the pandemic, particularly the extent of the second wave and associated measures, and development and distribution of a vaccine. In addition, we do not know whether the impending "Brexit" will be "hard" (i.e. most-favoured nation conditions of trade) or a "softer" negotiated deal[2]. Further adding to the uncertainty is the upcoming United States election, as the trade policy pursued by the US administration could have significant ramifications for global trade[3]. Finally, there is also still a risk that a key legal act that is needed to commence the EU Recovery Instrument ("Next Generation EU") cannot be ratified in all 27 European Union member states successfully or without delay, which would hamper the ability of some member states to effectively use fiscal policy to sustain their economies, and could also reduce financial market confidence in EU sovereign bonds.

In terms of the detailed path of the recovery, graph 3 shows the significant falls in output in the first quarter of 2020 as lockdowns were imposed, and global trade started to contract. The EU27 saw GDP drop by -2.7% in the first quarter of 2020 and -13.9% in the second quarter of 2020, relative to the same quarter in 2019.

[1] The cut-off date for the final forecasts was October 23; subsequent developments are therefore not factored in

[2]To illustrate, Oxford Economics Research Briefing | US How Bidenomics could boost the economy concludes: "Joe Biden's fiscal policy proposals would provide the US economy with a booster shot as it recovers from the Global Coronavirus Recession. While his $4tn tax increase proposal and his $7tn spending blueprint wouldn't pass the Senate, we recalibrated a "Biden-lite" proposal that could. We estimate such a compromise package would boost GDP growth by 2.1ppts to 5.8% in 2021, allowing the economy to regain its Covid-related output loss by mid-2021"

[3] To illustrate the thinktank RAND predicts a -0.7% GDP effect of EU-UK trade reverting to WTO Most Favoured Nations rules i.e. a "hard" Brexit https://www.rand.org/randeurope/research/projects/brexit-economic-implications/calculator.html

This fall in output corresponds to significant shocks to all components of aggregate demand in the EU economy. EU exports in particular have suffered, seeing a -2.6% drop in the first quarter and a 21% drop in the subsequent quarter. Domestic consumption has held up better, with household consumption[4] falling 15% in the second quarter, and investment dropping 19% after a 1.2% increase in the first.

Graph 3: Change relative to same quarter previous year (chain-linked, seasonally and calendar days adjusted)

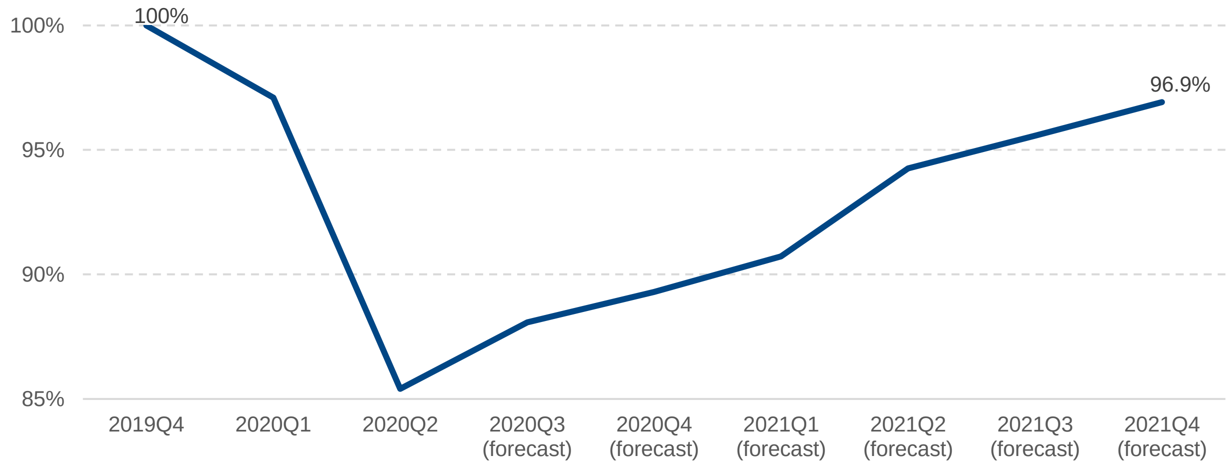
	20120Q1	2020Q2
GDP	-2.7%	-13.9%
General government consumption	0.8%	-2.0%
Household consumption	-3.3%	-15.1%
Investments	1.2%	-18.9%
Changes in inventories	11.3%	-53.4%
Exports of goods and services	-2.6%	-21.0%
Imports of goods and services	0.1%	-20.2%

Own calculations based on Eurostat

Looking forwards, notwithstanding the uncertainty outlined above, as graph 4 shows, we expect a continuing resumption of economic activity, with quarter on quarter growth of 3.1% in the third quarter of 2020, and more moderate quarterly growth as the economy gradually approaches pre-crisis levels in 2021. Underling the challenges ahead, we still expect the EU economy to be operating 3% below its pre-crisis level at the end of 2021.

Whilst there is a strong possibility of exceeding pre-crisis EU output levels in 2022, this is not a given, and would in any case represent a significant fall in growth relative to if the pandemic had not occurred. We see a significant risk of permanent scarring to our economy, as businesses that are viable in normal times are forced into insolvency, and workers that are currently redundant can suffer permanent “hysteresis effects” (i.e. gain no new competencies or upskilling whilst unemployed, and may fail to keep up with changing demands on the labour market).

Graph 4: Quarterly real GDP level (seasonally adjusted, indexed, same quarter in 2019=100%)



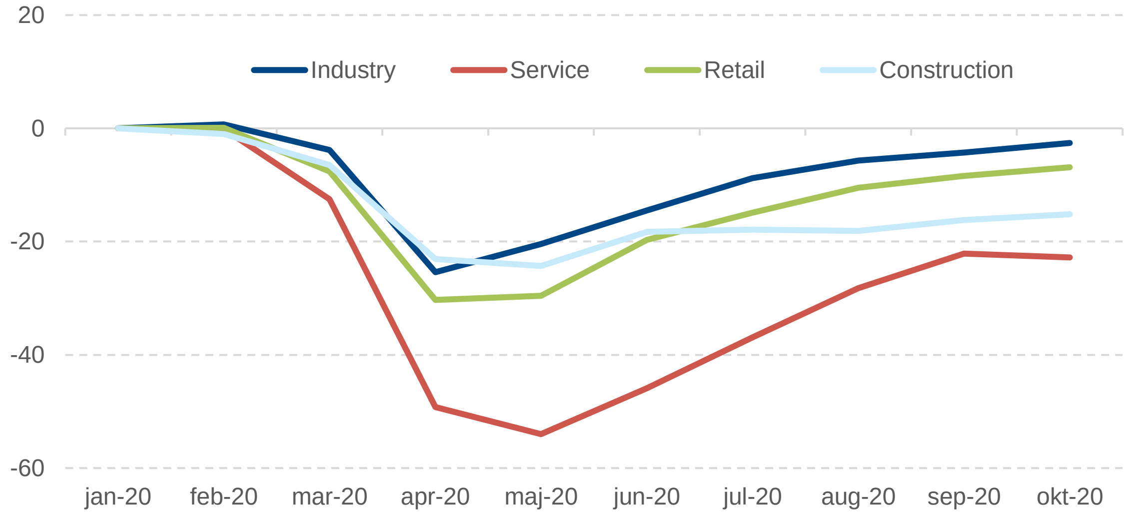
Own forecast and Eurostat/European Commission

[4] Including NPISH

2.2 Overall output levels hide vastly different sectoral fortunes

Sectoral output comparisons are particularly crucial to understanding overall economic output levels at the current juncture. As graph 5 shows, all sectors have experienced a sharp drop in sentiment during the COVID-19 epidemic and lockdown, and then undergone a subsequent recovery, but the depth of the plunge and strength of the rebound varies significantly. The service sector saw a particularly large decline in business sentiment in the spring, as travel and tourism activities were interrupted, and bars, restaurants and similar businesses forced shut.

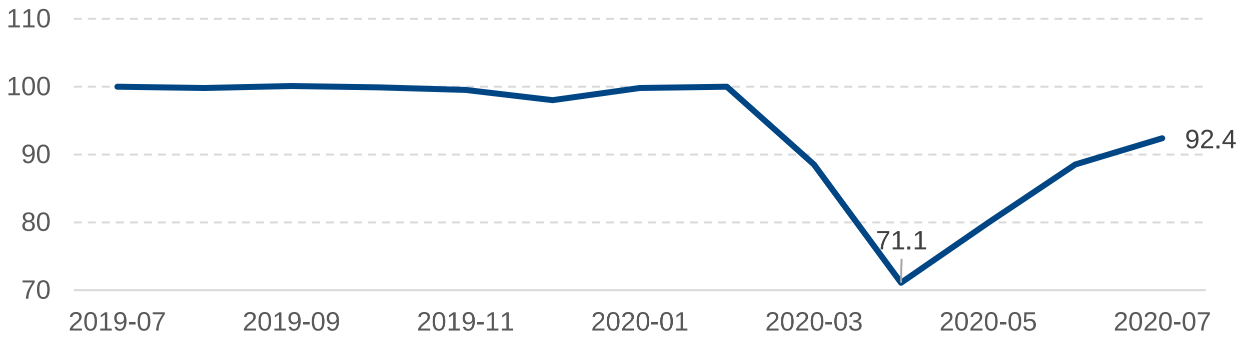
Graph 5: Economic sentiment indicators across sectors, 2020, absolute change from January 2020. Seasonally adjusted, no calendar days adjusted.



Own calculations based on European Commission. Business sentiment is calculated as net % of businesses giving positive (negative) replies to 5 questions

More detailed output data is available for the industrial sector, with chart 6 showing the sharp drop in EU industrial production to only 72% of the precrisis level in April, followed by a gradual recovery through the summer. In July it had recovered only partially to 92% of the precrisis level, although the data for August, largely unchanged from July, illustrates the likely more gradual pace of recovery to normal output levels in the months ahead

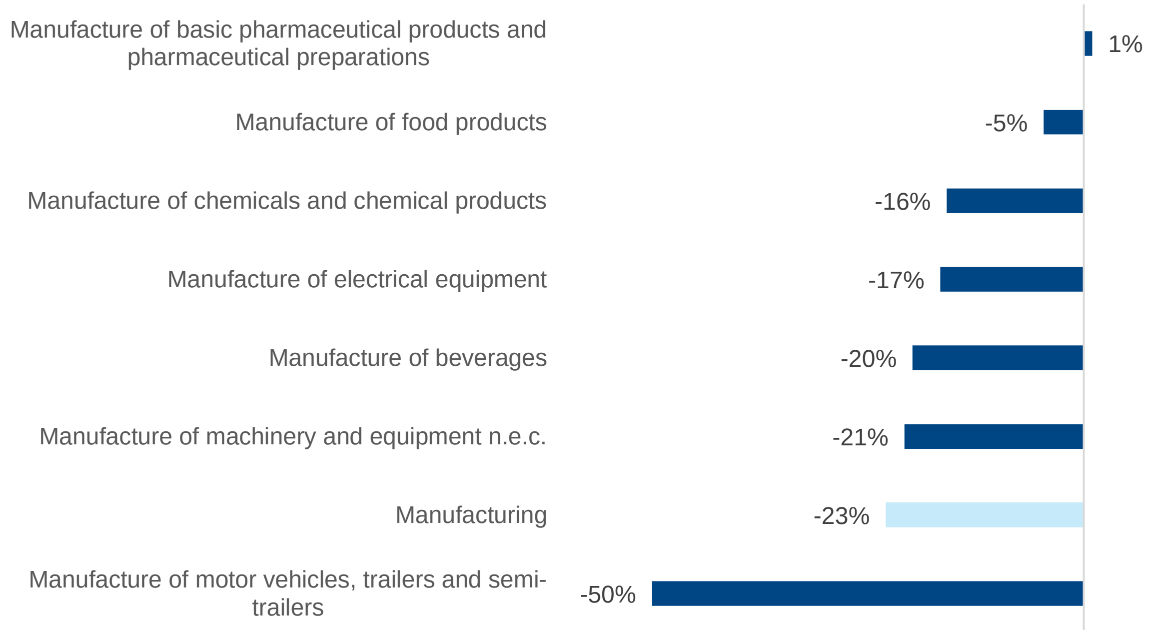
Graph 6: Industrial production, last 12 months, seasonally and calendar days adjusted. Index July 2019=100



Own calculations based on Eurostat

However, as Graph 7, which shows changes in manufacturing turnover at a disaggregated level, illustrates, even within the manufacturing sector, there are strong sectoral differences. Turnover falls have been largest in the in the automobile sector where sales were halved, whilst manufacturing of food products in contrast only experienced a 5% drop. Tellingly the automobile sector is heavily export-reliant, and at the same time sale of durable consumer goods routinely drop in a recession as households defer purchases.

Graph 7: Change in turnover from 2nd quarter 2019 to 2nd quarter 2020 in EU27 manufacturing and selected manufacturing sub-sectors



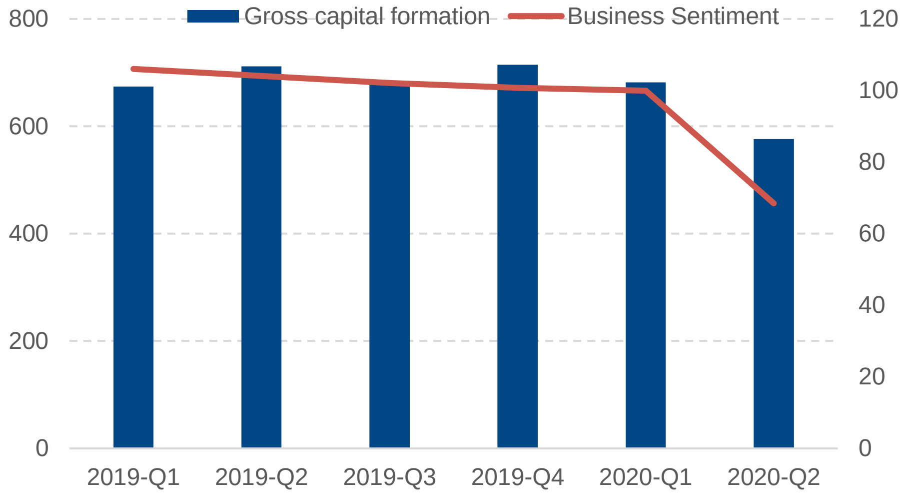
Own calculations based on Eurostat

2.3 Investment

Investment has unsurprisingly dropped dramatically in the second quarter of 2020, as lockdowns and collapsing world trade caused investors to delay or suspend investment activity. With uncertainty still very high and many sectors of the economy risking a reimposition of government-mandated shutdowns in response to the COVID-19 flareup we have experienced in the autumn, the investment climate is still very troubled.

To illustrate, if gross capital formation had remained at the (seasonally adjusted) 2019Q4 level, instead of nosediving in the second quarter of 2020, then the EU economy would have seen an additional €172 bn investments in the first half of 2020. Instead, the level of capital formation fell by almost 20% from the fourth quarter of 2019 to 2020Q1, as shown in graph 8.

Graph 8: Gross capital formation (left axis), bn euro in 2010-chain linked prices, seasonally and calendar days adjusted, and Business Sentiment (right axis)



Own calculations based on Eurostat

Manufacturing output data provide a further insight into the fall in investment, with manufacture of capital good still over 12% below pre-crisis levels in August (contrasts with consumer durables which were 5% above). This in turn emphasises that whilst investment remains constrained, the EU economies will struggle to return to pre-crisis output levels, underlining the importance, as we explore in part 3 below, that the EU's 'Next Generation' recovery instrument is able to start without delay, enabling public investment to temporarily fill the gap created by lower private investment until pandemic is behind us and business confidence is restored.

2.4 Unemployment

EU Member States have put in place comprehensive short-term work furlough schemes to shield their economies and workers from the economic fallout of government-mandated lockdowns. That means that unemployment figures do not currently reflect the actual level of economic activity in the EU27. Notwithstanding this, we expect the official unemployment rate to increase by more than two percentage points, from 6.6% in 2019 to 7.7% in 2020 and 8.8% in 2021.

More detailed labour market activity data indicates the hidden unemployment current existing in the EU and likely to be revealed once short time work programmes come to an end. For example, the ILO calculate that 18% of working hours were lost in Q2, falling to 11% in Q3, equivalent to 28 and 18 million jobs respectively[5]. Similarly, Eurostat calculate that hours worked in Q2 this year were around 15% lower than in the Q2 2019.

The key policy question in the medium term will be how government recalibrate worker and business support schemes in a way that continues to provide targeted support to those affected by continuing restrictions, but also incentivises businesses to increase activity and reduces the impact on public finances. But the recent resurgence of the virus across the EU

[5] ILO Monitor: COVID-19 and the world of work. Sixth edition https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/briefingnote/wcms_755910.pdf

means such decision will need to be postponed, with the IMF noting that, 'scaling back of such lifelines, especially while infections are surging (...) risks pushing the economy back into the recession'. The IMF also note the importance of appropriate labour market policies at the current juncture, suggesting that, 'Measures to reduce labour market rigidities that deter firms from hiring can also help reallocate employment towards growing sector'.

2.5 Geographical differences pose risk to Single Market

While all EU member states have experienced a recession, the magnitude of the economic drop due to the COVID-19 pandemic varies dramatically across countries. For example, we forecast that Italy, Greece and Spain will see a double-digit or close to double digit negative growth rate in 2020. At the other end of the spectrum, Ireland (-2.6%), Estonia (-3.0%), Denmark (-3.5%) and Poland (-4.3%) have experienced much milder recessions.

This divergence stem both from, on the one hand, the severity and length of lockdowns, and on the other, the sectoral structure of the economies, with in particular, countries with large hospitality sectors – such as Spain, Greece and Italy - having seen a greater drop in economic activity as (particularly international) travel and tourism has been disrupted.

The economic divergence carries with it a substantial risk that badly affected countries cannot sufficiently stabilize their economies due to fiscal constraints. This would lead to permanent scarring of the economy and put strain on the Single Market, as businesses would increasingly experience very different conditions for doing business depending on whether the country in question has the fiscal space to support its firms and workers or not in a downturn.

Graph 9: Country-level differences in real GDP growth forecasts (and 2019)

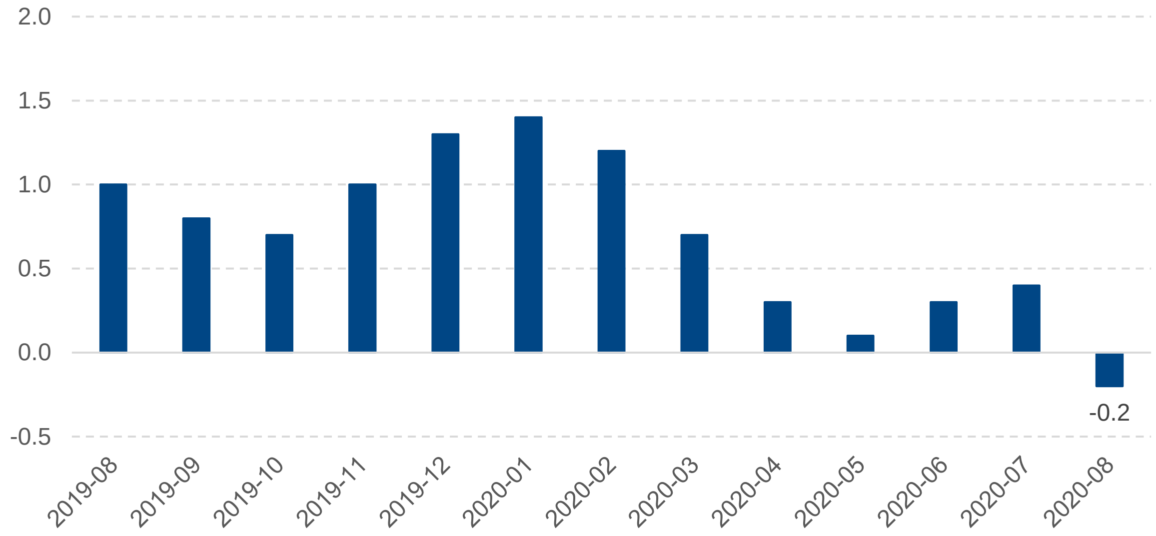
	2019	2020f	2021f
Austria	1.6%	-6.7%	4.7%
Belgium	1.4%	-7.4%	5.5%
Bulgaria	3.4%	-5.0%	4.0%
Croatia	2.9%	-8.0%	5.0%
Cyprus	3.2%	-7.4%	6.1%
Czechia	2.6%	-7.8%	4.8%
Denmark	2.4%	-3.5%	1.4%
Estonia	4.3%	-3.0%	1.0%
Finland	1.1%	-4.5%	2.5%
France	1.5%	-9.0%	7.0%
Germany	0.6%	-5.4%	4.0%
Greece	1.9%	-9.7%	7.9%
Hungary	4.9%	-7.0%	6.0%
Ireland	5.5%	-2.6%	3.1%
Italy	0.3%	-10.0%	4.8%
Latvia	2.2%	-6.0%	5.2%
Lithuania	3.9%	-7.9%	7.4%
Luxembourg	2.3%	-3.7%	4.5%
Malta	4.7%	-5.8%	6.0%
Netherlands	1.7%	-5.0%	3.5%
Poland	4.1%	-4.3%	4.1%
Portugal	2.2%	-8.1%	5.2%
Romania	4.1%	-6.0%	4.2%
Slovakia	2.4%	-8.4%	6.5%
Slovenia	0.4%	-7.5%	5.1%
Spain	2.0%	-11.5%	7.0%
Sweden	1.2%	-6.0%	4.3%

f: Own forecast, BusinessEurope and Eurostat

2.6 Monetary policy must keep deflationary pressure and euro appreciation under control

Despite the ECB restarting asset purchasing through a new Pandemic Emergency Purchase Programme (PEPP) in response to the COVID-19 epidemic, the Euro Area has exhibited a falling inflation trend over the past months culminating with deflation (-0.2% HICP) in August.

Graph 10: Price developments, all-item HICP (annual rate of change, pct.) past 12 months, Euro Area



Eurostat

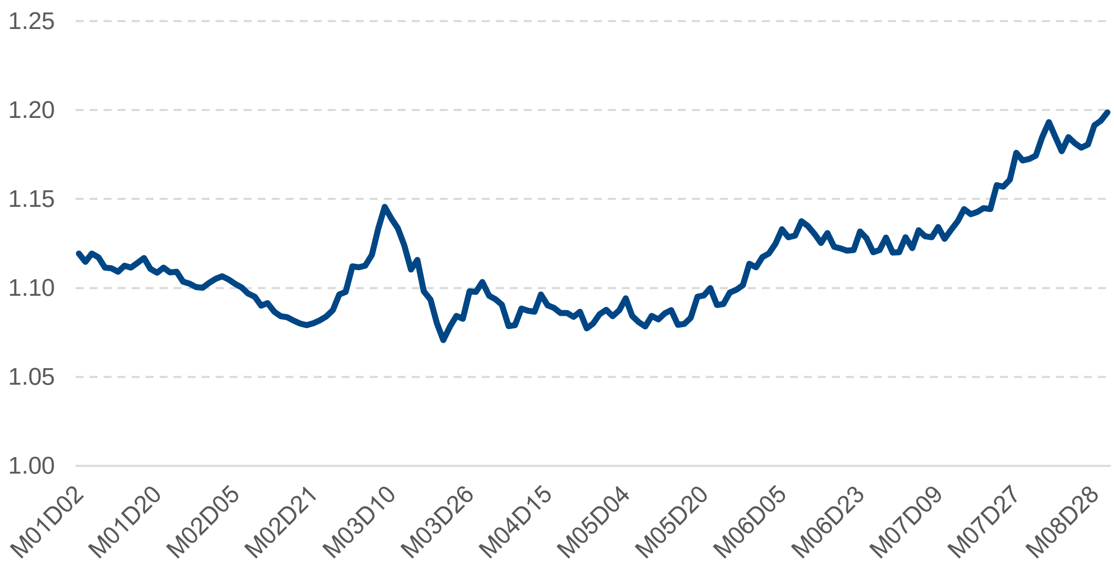
It is likely that widespread disruptions of supply chains and store closures during the lockdown will have had perverse effects on price developments and even the ability to correctly measure HICP[6]. Nevertheless, it is important that the ECB continues to take appropriate action to ensure that inflationary expectations amongst businesses, investors and consumers alike are in line with its long-term 2% inflation target.

In recent months there has been much attention to the appreciation of the euro vis-à-vis the dollar, moving from a euro purchasing around 1.1 USD to purchasing around 1.2 USD, as shown in the graph below. Although this is in part a positive sign of trust in the euro, and particularly the July agreement on the MFF and recovery instrument, it nevertheless has the potential to put European exporters under pressure at a time where export sales are already suppressed due to the pandemic. Our outlook presumes that the euro remains around its current international value and does not exhibit a rise the places further pressure on EU exporters.

In policy terms, whilst many EU based companies produce high quality products which are less sensitive to changes in their (dollar denominated) price than lower quality products, it nevertheless emphasises that policy-makers will need to pay particular attention to how their policy decisions impact European competitiveness in the coming months.

[6] https://www.ceps.eu/measuring-price-stability-in-covid-times
https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202003_04~537bb1d72e.en.html

Graph 11: Euro:USD exchange rate



Eurostat: X-axis shows month and days in that particular month

2.7 Crisis unrelated to financial sector, but risk that regulatory changes and winding-down of support schemes cause credit contraction

Whilst the 2008 crisis had at its heart financial imbalances which spread to the real economy, the recession of 2020 is clearly caused by very different factors unrelated to the financial sector. In particular, in part due to government lending guarantee schemes, the crisis of 2020 has only played out in the real economy, although we are now seeing worrying indications that similarly point towards a contraction in bank lending. This is shown in the table below.

Graph 12: Net percentage of banks reporting tightening lending conditions to enterprises in the first and second quarter following a major crisis – The Financial Crisis and the COVID-19 recession

	2008Q3	2008Q4	2020Q1	2020Q2	2020Q3
Euro Area	25%	40%	4%	1%	19%

Bank Lending Survey results, (net percentages of banks reporting a tightening of credit standards)

In this context, there is a clear risk that as governments wind down business support schemes and business insolvencies increase, banks will see increased losses on loans, weakening their capital positions and thus ability to perform new lending. In this context it is important that any changes regarding the regulatory requirements for bank capital in the context of the transposition of the final Basel III agreement do not lead to a sudden reduction in lending and consequent fall in investment and broader business activity. And before taking forward transposition, it will also be important that we reflect on the continuing appropriateness of existing standards in the very changed global financial situation we now find ourselves in.

3. Making the most out of the Next Generation EU Recovery Plan

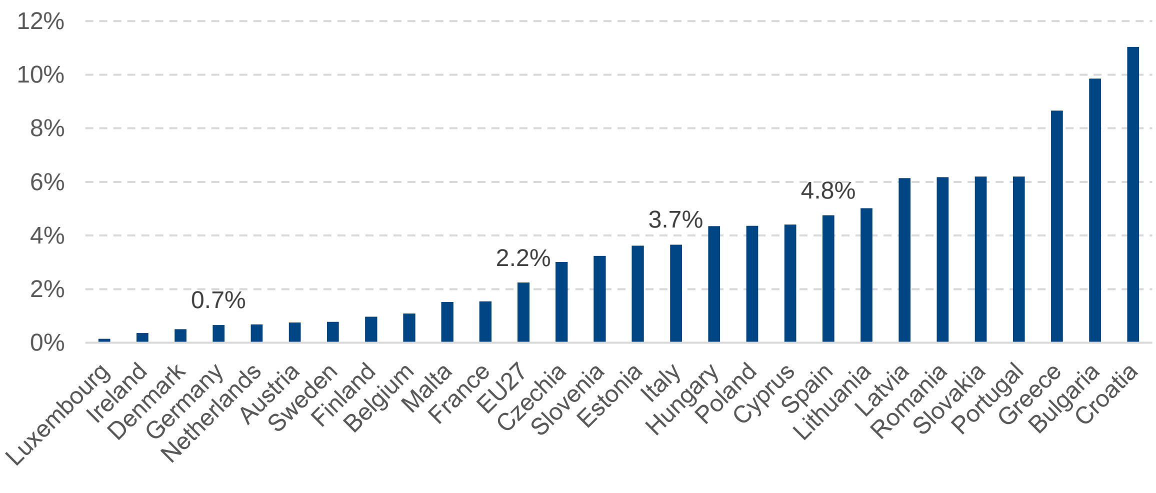
3.1 The Next Generation EU Recovery Plan can make a macroeconomic difference if implemented swiftly and money is well spent

On July 21 the European Council agreed on a comprehensive €750 bn Recovery Instrument dubbed the “Next Generation EU” comprising €390 bn loans and €360 bn grants to be disseminated to member states from 2021 to 2023 (cf. infobox below). Crucially the Recovery Instrument will be large enough to have a significant macroeconomic impact at the EU27 level, and in particular in the member states where a larger proportion of the funds will be concentrated.

Most of the funding from the recovery plan (€312.5 bn grants, €390 bn loans) will be distributed through the so-called Recovery and Resilience Facility (RRF) following an allocation key based on a number of statistical criteria. Graph 13 below shows how the grants component of the RRF is distributed between member states. This is shown as a percentage of the country’s precrisis (i.e. 2019) GDP. The total grants envelope of the RRF constitutes 2.2% of EU27 (pre-crisis) GDP. Since the allocation key is designed to concentrate money in member states facing more severe economic strain, the allotted amount corresponds to, for instance, 4% of Italian and about 5% of Spanish GDP, as opposed to 0.7% of German GDP. Note that the RRF funding will be committed to project over a three-year period from 2021 to 2023, and paid out gradually over the course of a project lifecycle upon reaching certain predetermined milestones. If considered on an annual basis, the fiscal magnitude of the grants awarded to each member state will therefore be considerably less than the percentage shown.

Provided the programme can become operational without delay this will help maintain investment levels in the face of the massive downturn and at least partly compensate for the drop in private investments, and also help restore investor confidence that governments will be able to take decisive action so that the European economy can recover swiftly.

Graph 13: Expected* grant sums from the Recovery and Resilience Facility, % of national GDP (note: to be committed to projects over three years, project cycle may be longer)



*Own calculations based on Eurostat GDP data *70% of the total is fixed, 30% will be determined in mid-2022 based on actual GDP drop. Graph shows allocation based on current Europeasn Commission forecasts*

Another way of considering the economic impact of the spending programmes that will be set up through the Recovery and Resilience Facility is to consider the sums relative to total precrisis investments. The €312.5 bn grants correspond to 10% of (precrisis, i.e. 2019-) investments in the EU27. In some member states the proportion is much higher. In Greece, for instance, the RRF-financed investments will correspond to 75% of its total 2019 investments (gross fixed capital formation), and in Bulgaria and Croatia the RRF grants will correspond to more than 50% of its 2019 investment level. In Italy and Spain, the figure is 20% and 24%, respectively.

With the EU embarking on an unprecedented recovery programme with considerable macroeconomic significance in crisis-ridden member states it is now crucial that the funding in the Recovery Instrument is well spent on investments and reforms that will have a substantial positive impact on growth, productivity and competitiveness. And looking further ahead, as the Next Generation EU recovery instrument will be financed by the European Commission through borrowing on international financial markets, it is important that future political agreements on debt repayment do not lead to higher burdens on business, which would zap competitiveness from the EU economy.

Next Generation: EU Recovery Instrument

The European Commission will borrow €750 bn (€360 bn as grants, €390 bn as loans) on international financial markets.

The money will be used to provide temporary “top-up” funding for a number of programmes on the EU’s Multiannual Financial Framework, and finance two extraordinary recovery initiatives, the REACT-EU (€47.5 bn grants) and the Recovery and Resilience Facility (€312.5 bn grants, €390 bn loans).

The Recovery and Resilience Facility will disseminate the money to member states in 2021, 2022 and 2023 according to an allocation key based on GDP, GDP change during the pandemic, unemployment rate and population size, although countries may use the funding to finance projects with a longer project lifecycle, and the money will then be paid out in installments upon reaching certain pre-agreed milestones, i.e. the full fiscal effect will likely take place over a longer timeframe.

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