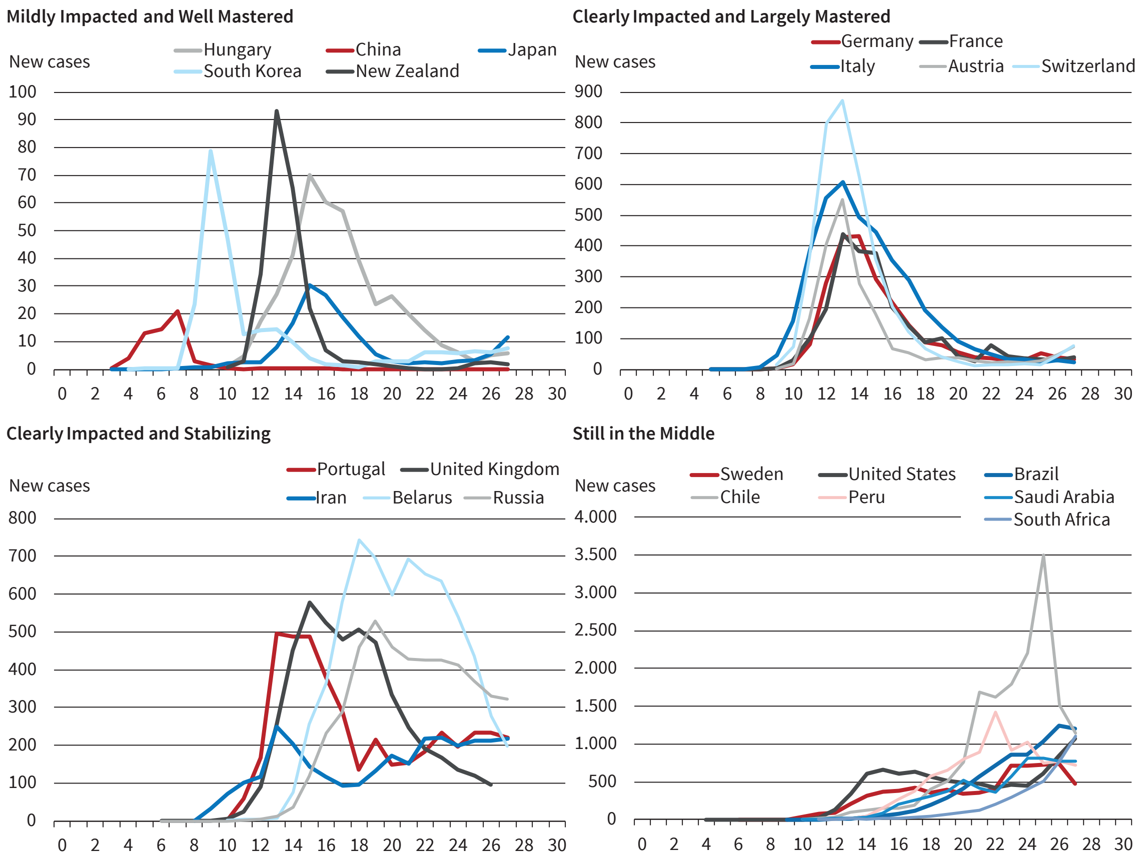
1. Economic Developments around the World: Corona Crisis Leads to Worst Recession in 90 Years

The Covid-19 pandemic and the measures taken to contain it led to massive disruption of social and economic life. What at the beginning of the year looked like a local outbreak in Hubei Province, China, with little impact on the rest of the world, quickly turned into a global pandemic that has so far caused more than 600,000 confirmed deaths and resulted in unprecedented protective measures. There are significant differences among countries, both in terms of the pandemic course and the political and fiscal measures that have been implemented. The number of new infections per million inhabitants shows that the pandemic appears to have been successfully contained in many Asian countries and in e.g., New Zealand (see Figure 1.1). There are still differences in relative new infections between countries such as Portugal or the United Kingdom on the one hand and Germany or Austria on the other. But what many European countries – with the exception of Sweden – have in common is that the pandemic seems to be abating, although discussions and fears of a second wave have arisen. In other countries, such as the United States, Brazil or Peru, the pandemic is still very present. Broadly speaking, the pandemic started in Asia, moved to Europe and subsequently to North America and finally South America and Africa.

Curfews, travel restrictions and border closures were imposed worldwide, non-essential businesses were closed, and social distancing policies were introduced. There have also been, and still are, major differences in these protective measures: Italy and France, for example, have introduced much stricter lockdowns than Germany. The United Kingdom only introduced relatively mild containment measures after a delay, when the first restrictions were already relaxed in China and although Sweden did step up its measures, they remain low by international comparison (see Figure 1.2).

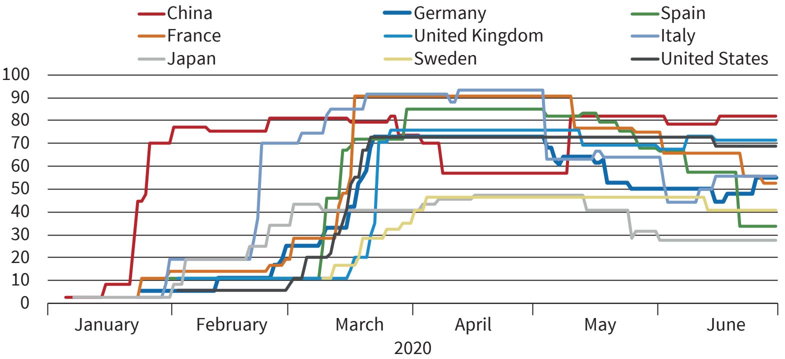
Figure 1.1

Covid-19 Pandemic in Selected Countries: New Cases per Week per Million Inhabitants



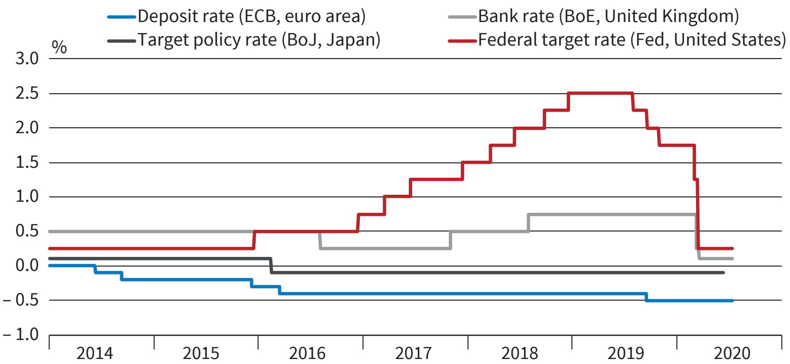
Source: WHO (2020).

Figure 1.2
Containment Measures in Selected Countries
Oxford Covid-19 Stringency Index



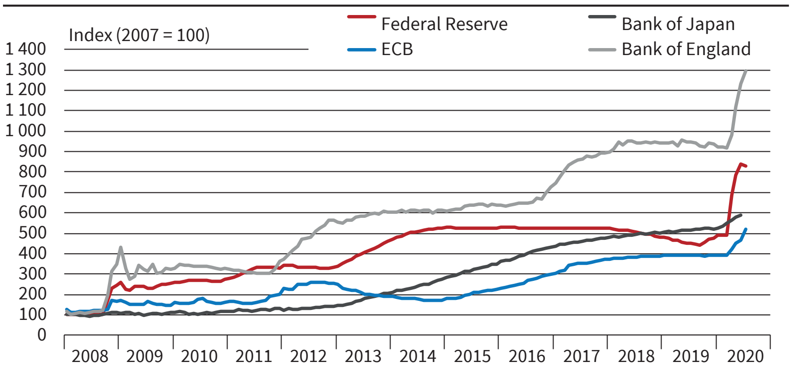
Source: Oxford Policy Tracker (2020). © CESifo

Figure 1.3
Central Bank Interest Rates



Source: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan; last accessed on 11 July 2020. © CESifo

Figure 1.4
Balance Sheet Sizes of Major Central Banks



Source: Federal Reserve; Bank of Japan; European Central Bank; Bank of England; last accessed on 11 July 2020; EEAG calculations. © CESifo

In a reaction to the crisis, central banks around the world increased the degree of expansion of monetary policy by lowering interest rates wherever possible (Figure 1.3). The steady rate hikes implemented by the Federal Reserve since late 2015 were quickly reversed. The limited room for maneuver that the Bank of England had in this respect was also quickly used. For the ECB and the Bank of Japan, the effective lower bound had already been reached – no further interest rate cuts appeared feasible.

In view of the effective lower bound, extensions and new versions of asset purchasing programs have been put in place to provide additional liquidity to financial markets (see Figure 1.4). Of the four major central banks in the western world, the two most active ones in this respect are the Federal Reserve and the Bank of England. This new wave of liquidity is a reason why financial markets quickly recovered from the initial shock and appear to have decoupled from the real economy.

Although the containment measures were only adopted in March in most European countries, together with changes in social behavior, such as social distancing, they immediately led to significant declines in value added. Despite signs of recovery in the months of January and February, after weak economic developments in 2019, the effects of social distancing and the containment measures were so severe that macroeconomic data reflecting the full first quarter, i.e., including March, turned dark red. Final domestic demand, and private consumption in particular, collapsed (Figure 1.5). These few weeks were able to generate European growth rates for the full quarter that were more negative than those of the worst quarter during the Great Financial Crisis. GDP in the Euro area fell markedly by 3.6 percent that quarter. The greatest negative contribution came from private consumption. Households reduced their activities in response to the rising number of Covid-19 infections and on instruction or advice from the government to stay at home and respect the social-distancing rules.

Also, numerous shops were closed, and many services were not available. Further, firms hold back their investments due to liquidity issues and uncertainty about future developments. In addition, external demand was weak and caused exports to plunge. Italy, France and Spain were hit hardest by the Covid-19 pandemic and introduced strong lockdown measures. As a consequence, economic activity dropped by 5.3 percent (Italy), 5.3 percent (France) and 5.2 percent (Spain). Germany was affected less severely with GDP contracting by 2.2 percent.

National accounts data were also negative for the first quarter of 2020 in the United States. The slight delay with which the United States was hit by the pandemic meant that the percentage decline in GDP did not quite reach the level reached at the height of the Great Financial Crisis.

Also, because Asia and in particular China was hit early in this crisis, global GDP fell strongly in the first quarter of 2020 (see Figure 1.6). Although China was already putting a strain on the aggregate figures, the early March release of the Global Barometers still indicated a recovering world economy. This radically changed in the subsequent two months in which both the coincident and leading versions of this composite indicator based upon economic tendency surveys from all over the world dropped massively and reached levels lower than those seen in the Great Financial Crisis.

Recent international trade and industrial production data confirm the extraordinary extent of the crisis. According to these, from the end of last year until April this year, world trade and industrial production plummeted by almost 8 percent and more than 6.5 percent, respectively (Figure 1.7). Although during the first months of the year this decline was largely attributable to the emerging markets, the advanced economies have been hit particularly hard, especially in April. For the advanced economies, the declines over the four-month period amounted to close to 10 percent and around 8.5 percent, respectively, and in April alone the annualized month-over-month growth rate was almost 60 percent for both industrial production and trade.

Not only in Europe, but in many parts of the world, the majority of the measures took effect mainly from mid-March to mid-May this year. The early July values of the Global Barometers, reflecting surveys carried out in June, showed clear signs of recovery as large parts of the world started to leave the lockdown mode. Despite the easing of measures, the situation at the end of the second quarter was still far from what it was before the outbreak of the pandemic at the beginning of the year. With the exception of China, a massive global economic slump is expected for the second quarter.

Until May, unemployment or the number of people in employment who are dependent on support measures rose significantly. In the United States, the unemployment rate peaked at 14.7 percent in April and stood at 11.1 percent in June, compared with 3.6 percent in January. In Germany and France, the rates in May are significantly lower at 3.9 percent and 8.1 percent respectively, but a large number of employees are currently on short-time work. The Ifo Institute estimates that around 7.3 million employees in Germany were on short-time working in May. This corresponds to 16 percent of all employees. In France, a projected 10 million employees were on short-time working schemes (35 percent of all employees).

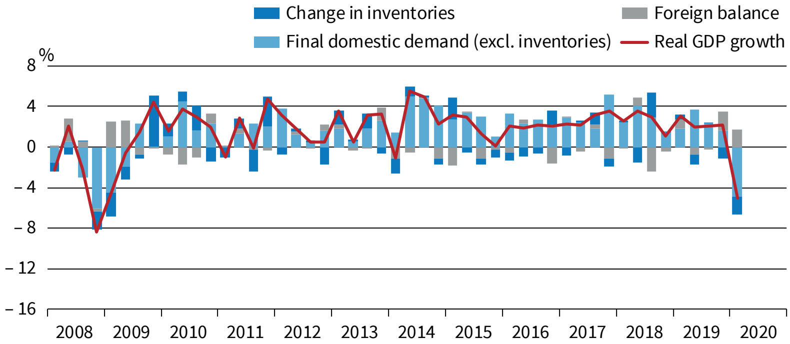
Often the change in the unemployment rate does not fully reflect what is happening to the number of persons employed. In some countries, many have left the labor market or are in the process of doing so, leaving not only employment but also the labor force and therefore are not counted as being unemployed. In Italy and Portugal, this effect is so strong that the unemployment rate has actually fallen in recent months (Figure 1.8). In the United States, the number of people employed fell by about 13 percent between January and May of this year. The rise in unemployment took up about two thirds of this – the remaining third reflects a reduction in the labor force.

Not only are countries affected differently and not necessarily simultaneously, differences across sectors are also extensive. In previous recessions, often only specific parts of the economy, such as construction or industry, were directly and severely affected, with subsequent, albeit mitigated, consequences for other parts of the economy. In the current crisis, protection measures affected almost all sectors directly and simultaneously. Whereas the service sector often played a stabilizing role in previous downturns, this time has been different. In particular, hotels and restaurants, passenger transport, the entertainment industry and retail trade, where human interaction is unavoidable, were hard hit as early as

Figure 1.5

Contributions to GDP Growth[a] in the United States

Seasonally adjusted data

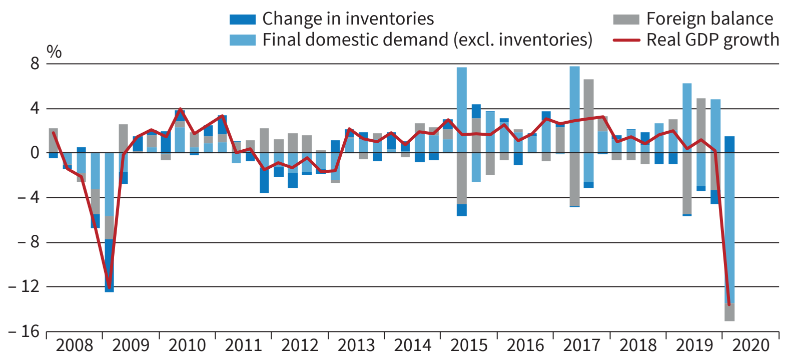


[a] Annualized quarterly growth.

Source: US Bureau of Economic Analysis; last accessed on 13 June 2020; EEAG calculations. © CESifo

Contributions to GDP Growth in the Euro Area

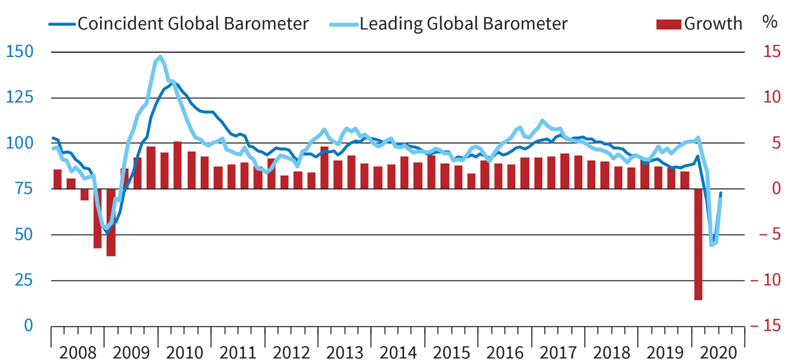
In constant prices, seasonally adjusted and work-day adjusted



Source: Eurostat; last accessed on 13 June 2020; EEAG calculations. © CESifo

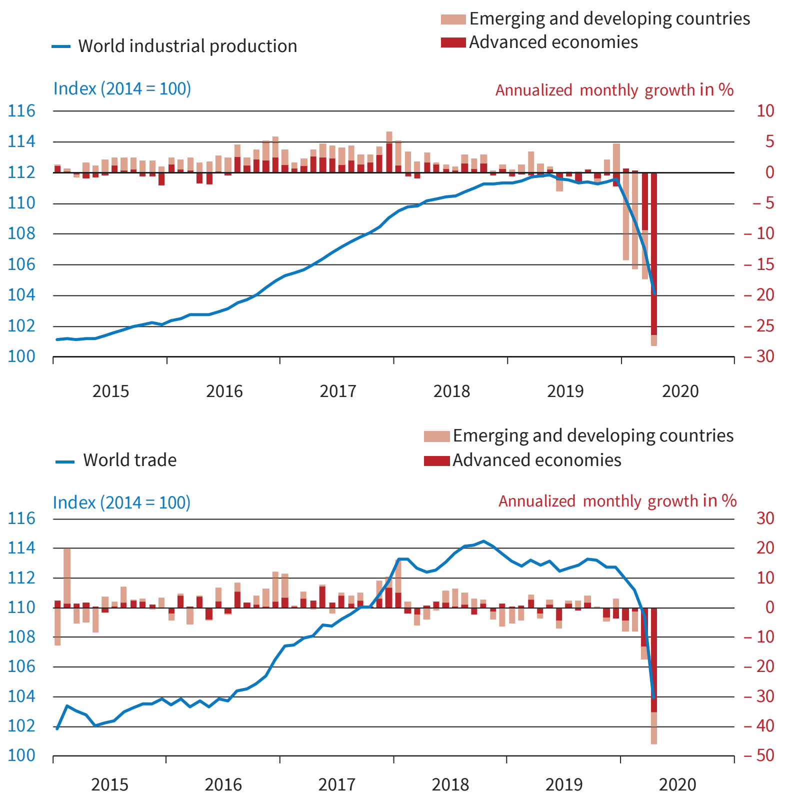
Figure 1.6

World Economic Growth and the Global Economic Barometers



Source: EEAG calculations (2020). © CESifo

Figure 1.7
Regional Contributions to Industrial Production and World Trade



Source: CPB Netherlands Bureau for Economic Policy Analysis; last accessed on 2 July 2020; EEAG calculations.
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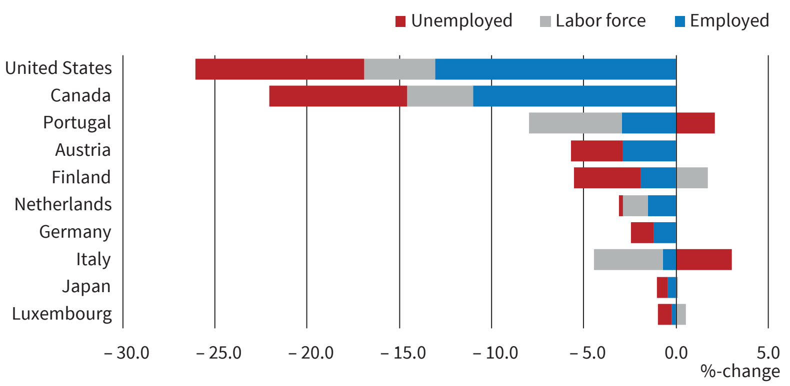
the first quarter of the year (Figure 1.9). Retail sales in the Euro area have fallen by a cumulative 20 percent since February. The losses are particularly large for non-food items such as clothing and furniture. The exceptions are mail order and food retailing, which were able to increase sales during the crisis. The effects also vary from one country to another, depending on the type of containment and support measures taken. The recession in Germany will probably be less severe than in France, which had decided on much stricter measures and provided less financial support. This is also reflected in retail sales. Cumulative retail sales in Germany fell by “a mere” 9.1 percent, while in France they have fallen by 32.6 percent since February. Overall, the Euro area is likely to see a sharp recession in the first half of 2020. GDP already contracted by an annualized 13.6 percent in the first quarter. During the second quarter, the decline of GDP is forecast to be historic (– 40 percent).

Figure 1.8
Decomposing the Decline in Employment between January and May 2020



Source: EEAG calculations.
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Although the construction sector experienced a significant decline in value added in the first quarter, it was previously booming in most European countries. Despite the sharp decline in the confidence indicator for the construction sector in the Euro area as published by the European Commission, it is in a more or less normal situation from a historical perspective. The situation is quite different for companies in the services sector. Here the confidence indicator is about four standard deviations below the normal value and has never experienced such a sharp decline over the course of one month (Figure 1.10). What confidence indicators for the different sectors have in common is that they all plunged in April and recovered somewhat in May and/or June as lockdown measures were partly eased. The overall European Commission’s economic sentiment indicator fell from 94 points in March further to 65 points in April, rebounded somewhat in May and increased strongly in June up to almost 76 points.

In addition to the containment measures and in order to preserve economic structures during this period, many governments adopted support measures for workers and rescue packages and credit guarantees for affected companies. Moving out of the lockdown, they have been discussing and implementing stimulus packages to support the recovery. Overall, the impression is that the “new normal” is going to be a world in which clear structural changes are needed with associated economic and social problems. All of this will lead to a substantial increase in government deficits and therefore debt-to-GDP ratios. The global easing of containment measures since mid-May and the support programs that have been agreed are already leading to a strong catch-up process. Assuming that the remaining containment measures are effective and that a second wave of infection can be prevented by implementing appropriate “track-and-trace” procedures, the global recovery is likely to continue, albeit at a steadily slower pace in the coming quarters (Figure 1.11). Even when taking structural shifts out of the picture, economic activity is unlikely to return to pre-crisis levels in most sectors. Hygiene measures and protective concepts are likely to remain part of the new reality until a vaccine and/or an appropriate medicine is developed. This means that in particular companies in the hospitality, transport and leisure industries will have limited capacity to operate. Factories and offices, however, will also have to make adjustments that will lead to lower capacity utilization and productivity. We expect world GDP to reach only

96 percent of its pre-crisis level by the end of this year.

Also, for the Euro area, the GDP level at the end of last year will be well out of reach by the end of this year. On the demand-side, private consumption is expected to fall further in the second quarter and to rebound in the second half of the year. After plunging, gross fixed capital formation is forecast to recover somewhat during the second half of the year, but weak foreign demand, uncertainty about future prospects and the fragile financial situation of the firms will dampen the rebound in investment.

There is likely to be an increase in insolvencies over the course of the year, and unemployment should also settle at a higher level. Here, too, there will be marked differences between countries. China and Japan were affected by the crisis much earlier and less severely than Europe or the American continent. These two countries are therefore more likely to return to pre-crisis levels than Italy and the United States, for example. Added to this are the differences in fiscal support. Whereas the direct fiscal stimulus in Germany is estimated by the think tank Bruegel to amount to more than 15 percent of GDP, it is only 3.6 percent and 0.9 percent in France and Italy, which have much less fiscal leeway. Here the reconstruction program proposed by the European Commission with a volume of EUR 750 billion will provide some compensation. Although the United States has implemented extensive fiscal measures, it is questionable to what extent the labor market can be stabilized and the loss of household income compensated. The high debt levels of private and public households are likely to make a rapid return to normalcy even more difficult.

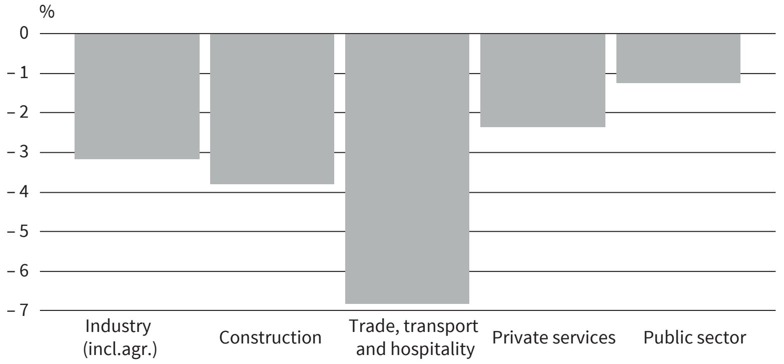
The global economy will only return to its pre-crisis level by the end of next year. The collapse in corporate profits in the wake of the lockdown and lower demand expectations should noticeably dampen investment momentum. In addition, insolvencies and restructuring will initially have a slowing effect. Increased loan defaults and debt service arrears are also likely to weigh on bank balance sheets, thus restricting the scope for lending in some countries. In addition, private households will lose purchasing power as a result of the pandemic-related rise in unemployment and the slowdown in employment growth in many countries, which in turn will have a negative impact on consumption. Even in countries in which the loss of purchasing power has been contained by rapid economic policy interventions (short-time work, economic stimulus programs), the more fragile economic environment compared with the time before corona is likely to strengthen cautionary savings motives and thus dampen consumption dynamics. The new awareness of the fragility of global value chains and the dependence on few production sites also plays a role. This should lead to a gradual repatriation of certain industries and a diversification of value chains. On the one hand, this development implies lower global trade, which is particularly painful for open economies in Europe or Japan, and on the other hand it results in higher costs for consumers. All in all, these factors lead to a world with lower growth.

Because of the current capacity underutilization, core inflation is expected to fall as well. Although the oil price has recovered slightly from its very low levels at the end of April, it is still much below the

Figure 1.9

Reductions in Sector-Specific Value Added in the Euro Area

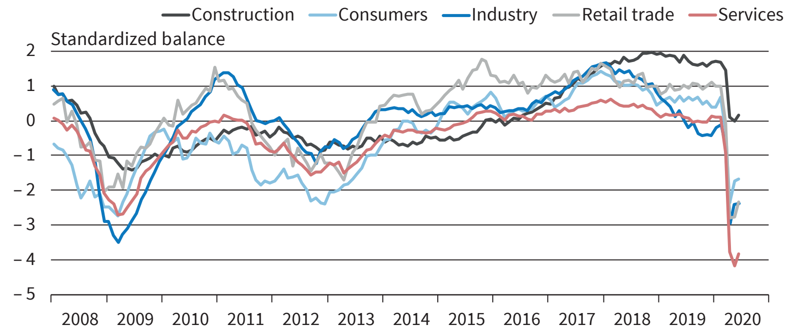
Q1 2020



Source: Eurostat. © CESifo

Figure 1.10

Confidence Indicators[a] for Different Sectors in the Euro Area

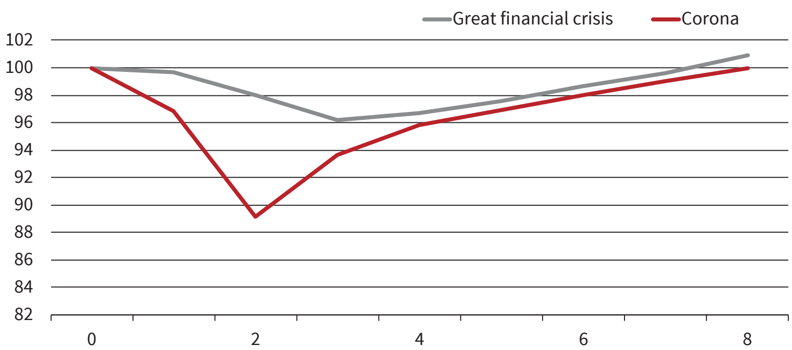


[a] Selected (seasonally adjusted) balances on business and consumer tendency survey questions.
Balances are the differences between the percentages of positive and negative replies. These are subsequently normalized to have an average of 0 and variance of 1 for the period from 1985 onward.
Source: European Commission; last accessed on 13 June 2020; EEAG calculations. © CESifo

Figure 1.11

Comparing World GDP Developments

From year of crisis (t = 0) to 8 years after the crisis



Source: IMF and KOF (2020). © CESifo

price of one year ago. Therefore, the energy price component is currently also pulling headline inflation down. Although there might be price increases for some goods and services due to supply issues related to the containment measures, these are likely to have comparatively small effects on headline inflation. Whereas inflation is likely to remain slightly positive during the first half of the year, in the second half it will decelerate further and turn negative. The forecast assumes a stable oil price and USD/EUR exchange rate.

1.1. MAJOR DOWNSIDE RISKS

Any forecast statements are nowadays subject to even larger risks than usual. In the above it is assumed that there will be no substantial rebound in the number of infections around the world. However, we are still learning about consumer reactions to containment measures and it is still unclear how quickly consumption behavior will normalize. Furthermore, the severity and length of the pandemic are unknown. A second wave of infection with partial, renewed lockdowns is conceivable, which would lead to a further economic slump. On the positive side, many countries will be better prepared for future waves as multiple measures have been or are currently being introduced to decrease vulnerability, such as availability of health protection equipment, testing capacities and measures to increase hygiene. It is also conceivable that the development of a vaccine could be delayed, which would mean that capacities in the affected sectors would remain limited for longer through "social distancing." In addition, the liquidity situation of many companies is deteriorating rapidly. An unexpectedly high number of insolvencies might disturb the economic recovery and cause greater problems than expected for the banking sector. Currently, in many countries new regulations for postponing insolvencies were introduced, which means that these will become evident later than usual, probably not before autumn. Also, numerous private households might run into solvency issues due to lower income and a worsening labor market. Such a sharp increase in insolvencies and non-performing loans could raise doubts about the solvency of individual banks. As in the past, this in turn could lead to skepticism about the solvency of individual states with already high debt burdens in the Euro area. Various emerging markets are also affected by this risk. The imminent development of a vaccine represents an upside risk.