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CONTINUING UNCERTAINTY

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As lockdown restrictions were lifted in the summer virtually all the major economies have shown sharp rebounds in activity. The second quarter of this year had seen record declines in GDP in Europe, in North America, in Japan and in most emerging markets. The third quarter, by contrast, should be witnessing record large increases. These, however, with rare exceptions, are unlikely to fully offset the losses suffered in the April-June months. The forecasting consensus is for this V-shaped recovery to continue into the fourth quarter of 2020 and into 2021, but at a more moderate pace. By the end of next year, in this scenario, the level of output should be more or less back to what it was at the end of 2019, before the COVID-19 outbreak, in the U.S. and some 10 per cent above that level in China, but still 1½ to 2 per cent below in the Eurozone and in the United Kingdom.

There are, however, signs that the recovery is losing some momentum. Activity is plateauing in a number of countries and consumers are showing greater caution in both the U.S. and Europe, worried as they are by uncertain job prospects. In the U.S. uncertainty is also fueled by the forthcoming presidential election and in the UK by the possibility of a "hard" Brexit. In addition, there is the danger that the strong fiscal policy measures taken when the crisis erupted will be gradually wound down. What fortunately remains in place is a very accommodating monetary policy. The Federal Reserve has recently announced its intention to apply an even more dovish stance not just in the short run, but also over the medium term. This, in particular, is helping the housing market and both home sales and residential construction are showing signs of renewed strength. The European Central Bank is also pursuing an accommodating monetary stance, if less aggressively that its U.S. counterpart (with favourable effects on house prices which, in several Northern European countries, have been rising despite the recession).

While recovery should proceed in the U.S., provided a supplementary fiscal stimulus package is approved by Congress in the near future, the same is not true in most of the emerging world. China seems to be the major exception. The rebound in the second quarter was strong enough to bring output back to its end-2019 level. The policy stimulus has been effective and exports unexpectedly resilient. A return to the longer-run growth path by 2021-22 is likely. Brazil's economy is also performing reasonably well, despite the high incidence of COVID-19, thanks largely to generous government transfers to the poor. Elsewhere, however, growth is not recovering as strongly as hoped for. India, in particular, is struggling as are also Argentina, Mexico, Russia, South Africa and others.

Within Europe the fiscally stronger North has been performing significantly better than the weaker South and this divergent performance could well continue, potentially fueling political tensions. Economies reliant on tourism, for instance, have seen a sharp slowdown in bookings and travel activity as the number of infections has risen. Spain, Greece and Portugal are being particularly affected. More generally, there are fears that unemployment could increase sharply as domestic support to companies in difficulty fades away. The EU's Recovery Fund should, in principle, be able to help countries such as Italy or Spain to withstand the weakness of private consumption and investment, but there are fears that the disbursement of such funds could be delayed. Since the EU's Stability Pact has been shelved, at least for the time being, countries could continue to use domestic fiscal instruments to prop up activity, but there are limits to the size of budget deficits and public debt-GDP ratios that can be accumulated without triggering financial market reactions. The recession, in other words, could well continue.

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Even these generally modest prospects are clouded by the massive uncertainty linked to the progression of the virus (as was already argued in the April and July notes). Many scientific observers have warned that the Winter months could see a recrudescence of the pandemic and hence a second wave of infections with the danger that new national or local lockdowns may have to be re-imposed. Indeed, a second wave seems to be already occurring in some European economies (e.g. France, Spain and the UK), and this in late summer and early autumn. Even if death rates are declining relative to past levels, the spread of the disease does not bode well for the coming colder months. Nor is there any certainty that a vaccine will be found soon. There is a clear danger, in other words, that COVID-19 could still be negatively affecting our economies through much of next year (and, possibly, even beyond).

Should such an unfavourable outcome materialize, growth rates in 2021 in many countries, rather than rebounding, would remain in negative territory. In one possible second wave scenario, both the U.S. and the Eurozone would see further GDP declines of the order of 1 per cent or more next year (following on the -4½ and -9 percent falls respectively expected for this year) and even China may recover only very sluggishly. The table below sketches out forecasts for the major economies in both the so-called “central” scenario and in a “second wave” scenario that sees worsening health outcomes everywhere. In the latter case world output would still decline next year and recovery would have to wait until 2022.

The longer-run consequences of such large and protracted recessions on levels of unemployment, on debt accumulation and, also, on income distribution could be very serious. Populism could well strengthen its appeal with worrying consequences for the future of international trade. Even European cooperation, particularly in the form of the Eurozone’s common currency, might be in danger. Pandemics, as history has shown, can, unfortunately, have devastating consequences.

GDP GROWTH RATES (%)

	Central Scenario			Second Wave Scenario		
	2020	2021	2022	2020	2021	2022
Eurozone	-7.8	5.7	3.8	-8.9	-0.9	5.2
United Kingdom	-9.5	8.3	3.5	-11.0	-0.9	5.8
United States	-3.7	3.7	2.9	-4.5	-0.7	3.8
China	2.3	7.6	5.0	1.5	1.5	6.2
World	-4.3	5.3	4.0	-5.1	-0.1	5.0

Source: Oxford Economics.

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