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Is Recovery in Sight?

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Official data for the first quarter of this year have confirmed that the world economy is going through a sharp contraction. Given that lockdown restrictions were in place in numerous countries in April and May, the second quarter of this year is bound to show even more pronounced declines in activity. Since, however, some of these restrictions were being gradually lifted in June and July, there is hope that the second half of 2020 and 2021 will see a recovery. Is such hope justified?

Data for May and June show that in many countries activity is rebounding and quite forcefully so at times, aided by an unprecedented policy effort. Indicators that are recovering include, for instance, retail sales in the U.S., power consumption in China, the manufacturing PMI indices in Europe (particularly in France and the UK), etc. Even if these sudden rebounds are likely to give way to more subdued upward trends in coming months since social distancing restrictions will probably linger on, conditions are beginning to return to normal and positive growth rates should be recorded in the third and fourth quarters of this year. Though the rise in output expected for the second half of 2020 will not be sufficient to fully offset the losses in output suffered during the first half, the direction of change would point to positive year-on-year growth in 2021.

As argued in the April note, however, forecasts remain highly uncertain. The main reason for such uncertainty lies in the unpredictability with which the COVID-19 virus spreads. China provides a recent example of this. Having announced that the country had defeated the pandemic, authorities were forced to reintroduce lockdowns in a section of Beijing at the end of June. Renewed outbreaks are also being seen in parts of the U.S. Waves like this are virtually impossible to foresee but could occur elsewhere. Should this be the case, countries would probably be forced to reinstate lockdowns at either the local or the national level, with renewed negative effects on activity. Growth rates could then turn negative for 2021 as well, as shown in the table below which presents forecasts for both a central and a "second wave" scenario.

A second reason for uncertainty is the nature of the present recession. This is very different from what recessions looked like in the past. Traditionally, countries would see output falls following either tighter monetary policies designed to curb inflation (e.g. 1974-75, 1981-82, 1992-92), or the bursting of financial bubbles (e.g. 2001-02 and 2008-09). Such recessions would have their primary negative impact on business investment, on the manufacturing sector and on male employment. On this occasion, the recession is almost entirely due to lockdowns and precautionary household behaviour. The main effects are on private consumption, on the services sector and on female employment (but also on manufacturing firms dependent on global supply chains). Given the absence of such shocks in the past, assessing their size and duration at present is much harder.

On the assumption that a second wave does not occur or does not lead to renewed and major lockdowns in most countries, the profile of the recovery that is now in full swing should resemble that of the letter V: a sharp recession in the first half of this year followed by a sharp pick-up in the second. In the world's two major economies (the U.S. and China), output in 2021 should be back at its 2019 level (the U.S.) and 10 percent above that level (China). A loss would still have been suffered since, absent COVID-19, both economies would have grown over these two years by some 2 and 6 percent per annum respectively, but, at least, the shortfall would have been short-lived.

The same, unfortunately, would not be true for Western Europe. Output in 2021 could lie some 2 percent below the 2019 level and would be only marginally above that level in 2022. Germany and the UK are forecast to fare best, growing by perhaps 2 percent between 2019 and 2022, while Italy (among the major countries) may see a decline of close to 2 percent, only returning to 2019 GDP levels by 2023. Many of these differences are due to the different reactions of economic policy. Monetary policy is acting in similar ways across Europe since both the European Central Bank and the Bank of England have taken strong expansionary measures. The size of the fiscal policy effort, on the other hand, is not uniform. Germany, for instance, has much more space to raise government spending and reduce taxation than has Italy. And, in addition, the efficiency and speed with which spending is being allocated to households and firms in difficulty is also greater in Germany than in Italy.

Should there be a significant second wave the picture worsens significantly, and the eventual recovery's shape will be closer to that of the letter U rather than the letter V. In this hypothesis 2021 sees further negative growth rates everywhere, including China, and the 2022 recovery is only modest if seen in the light of the two previous years' declines in GDP. The US economy returns to 2019 levels of output in 2024, the Eurozone and the UK only in 2025, while Italy may have to wait until 2028 to return to that level. For the advanced countries, COVID-19 would have created both the longest and deepest recession seen since the Great Depression. As for emerging markets, their growth over the 2019-25 period would have been curtailed from the yearly 5 percent recorded in the previous decade to barely 3 percent per annum.

In both scenarios, the Southern European Eurozone member countries (and especially Italy) suffer more than do their Northern counterparts. Across the whole of Europe budget deficits and public sector debt levels are expected to rise sharply, but the outcomes will be asymmetric. The public debt/GDP ratio, in particular, is already much higher today in Italy or Greece than it is in Germany or the Netherlands. These differences are likely to increases further in coming years and this could well rekindle tensions on financial markets. A Euro breakdown still looks unlikely thanks largely to the firing power of the European Central Bank, but the likely combination of rising spreads between, say, German and Italian bond yields, continuing economic stagnation in some countries and not others, as well as the presence of populist and Eurosceptic politicians, could be fertile ground for claims to leave the single currency.

	GDP GROWTH RATES (%)					
	CENTRAL SCENARIO			SECOND WAVE SCENARIO		
	2020	2021	2022	2020	2021	2022
Eurozone	-8.0	6.3	3.2	-8.6	-3.8	5.5
United Kingdom	-10.8	10.2	3.5	-11.5	-2.5	8.4
United States	-6.1	6.3	3.8	-6.7	-4.1	6.2
China	2.0	8.1	5.1	1.0	-1.7	7.7
World	-5.0	6.5	4.1	-5.6	-2.3	6.4

Source: Oxford Economics.

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