European Union: EU Economy Enters "Deepest Economic Recession" in History – May 2020

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Summary

According to the European Commission, the EU has now entered the "deepest economic recession in its history". The Commission's most optimistic forecast expects EU GDP to contract by 7.5% in 2020 with a gradual recovery in 2021 (U-shaped recovery). Deferred investments, a sustained drop in domestic consumption, and an inability to rely on global economic growth will result in high levels of unemployment (nearing 20% in some member states) and will make the recovery prospects of the EU highly uncertain.

Against this backdrop much of the focus of EU and Member State level policymakers has been on ensuring the continuing stability and viability of the EU's banking sector, which is expected to weather the crisis relatively well despite an expected increase in bankruptcies in the wider economy. Following the recent introduction of modified state-aid rules, member states will also be able to recapitalize national champions, albeit there will be strict conditionality requirements in place to incentivize buy-out of state ownership as soon as possible.

Some member states are better positioned to deal with a recession than others, which will make for an unbalanced or lopsided recovery.

Report/findings

According to the European Commission's latest economic forecast, the EU has now entered the "deepest economic recession in its history" and the EU economy is expected to contract by at least 7.5% in 2020 with severe downside risks that could make the recession even deeper.

Practically no sector of the economy left untouched

1. According to estimates by McKinsey up to 59 million jobs in the EU are at risk of being impacted by the virus across the broader retail, hospitality, manufacturing and services sectors and more than 30 million Europeans have already become under or un-employed as a result of the pandemic. Although some of these jobs are bound to 'reappear' as lockdown measures are lifted, the Commission is forecasting a jump in EU headline unemployment (official, registered unemployment) from 6.7% in 2019 to 9% in 2020. In conjunction with lost GST revenues and deferred or foregone tax income, the burden of maintaining the European social welfare model under these conditions will leave a sizable dent in governments' balance sheets. The EU's

aggregate budget deficit is forecast to balloon from just 0.6% in 2019 to a whopping 8.3% in 2020 and government debt is forecast to increase from 79.4% of GDP to 95.1% of GDP in 2020. It's little wonder than that the Composite Purchasing Manager's index (PMI) – measuring business activity and confidence – has continued to set negative records since March.

2. The virus has left no segments of the economy untouched. Accounting for 10% of the EU's GDP and 12% of EU jobs tourism as a sector (including the hospitality industry) was the first to suffer the economic consequences of restrictions on the free movement of people to and within the EU. In a report published in April, the European Parliamentary Research Service estimated the Tourism sector to be losing €1 billion every month, not including the impact on the aviation and hospitality sectors. The Commission has looked to put in place guidelines to ensure that Europeans can travel and spend money during the upcoming summer holidays while minimising the risk of spreading the virus. Yet it remains to be seen how widely these will be implemented, how effective they will be in containing the virus and as a result how willing Europeans will be to travel. The cultural and performing arts sectors, which accounts for around 4% of jobs in the EU is also particularly exposed to the fallout from the virus as theatres and museums were amongst the first to be closed down. As the European Cultural Foundation (a lobby group for the sector) points out, by the nature of the performing arts, over 30% of people working in the sector are self-employed and "lack adequate social protections".
3. Although online retail activity has surged in some member states the retail and wholesale sector as a whole, which generates 11% of the EU's GDP and accounts for around 17% of EU employment has also suffered large losses. For example the majority of the members of Euratex (EU-level umbrella group for the clothing and textile industry) have reported a drop in sales by over 50% along with serious liquidity problems. The lockdown measures have also affected the construction sector (9% of GDP, 8% of jobs) which has estimated an average expected loss in construction activity between 20% and 25% for 2020 and 2021. The sector has warned that without steps from governments to put in place tailored health and safety measures to allow for a continuation of construction activities the sector could experience a "meltdown of historic proportions", and has asked for a €320 billion recovery fund.
4. Manufacturing, which accounts for 14% of the EU's GDP and around 15% of jobs and which provides the majority of well-paying export oriented jobs in the EU, has been particularly hard-hit. Even prior to the onset of the pandemic, manufacturing was facing strong global headwinds. Now, given similarly bleak economic outlooks for China and the United States (two prime export markets) and the collapse of internal demand in Europe, manufacturing output is expected to struggle for some time to come which will also put a drag on related services (the manufacturing sector purchases 25% of all EU services). The IHS Eurozone manufacturing PMI, which records manufacturing activity, dropped from almost 50 points in February down to just 33 points in April this year (half of where it was at its peak in 2017), showing its steepest ever decline since this indicator was first recorded in 1997. Not only is this already resulting in factory closures in some places, but as the Commission warns, it might also cause more long-term liquidity problems for the sector leading to a deferral of investments and R&D spending slowing down the sector's shift towards more sustainability.

5. The impact to the agricultural sector, which accounts for just 1.1% of the EU's GDP and around 5% of EU jobs, is mixed. The food service sector has borne the brunt of closures of restaurants. This has meant that higher value products like quality cuts of meat, wine, fish, potatoes and some horticultural products have seen a strong reduction in demand, while demand for basic supermarket products has increased. For many sectors increased demand in supermarkets or selling through online channels is not making up for lost restaurant trade and this is causing prices to fall across the board. While the availability of seasonal workers is also a problem, business is otherwise continuing as usual, and the fact that the Commission has already opened a package of support (as well as on average 50% of a famer's income coming from subsidies under the Common Agriculture Policy, means we can expect the EU agriculture sector to remain less affected in comparison to other sectors.

Banking on the banking sector

1. Unsurprisingly, Europe's banks, which fuel both the services and manufacturing industries are expected to feel the effects of the general deterioration of the economy as well. Since the start of the crisis several large ratings agencies (including S&P, Moody's and Fitch) have announced downgrades to the creditworthiness of several EU financial institutions. Not for nothing, the latest Commission forecast envisions a growing number of loan defaults once repayment moratoriums put in place by member states expire. In addition, banks are also expected to generate less business given the gloomy outlook for consumer demand and investment confidence in coming years. A depression of prices of securities on banks' balance sheets resulting in an increase of banks' debt (and business viability) can also be expected. Understandably, one of the central elements of EU level and Member State responses to the crisis has been ensuring the continued stability of the banking sector in the hopes of hedging against a dramatic drop in lending activity as first quarter survey data indicates an uptick in demand for business loans.
2. To keep lending going, several member states have taken advantage of the temporary state-aid framework which allows member states to act as guarantors for corporate loans, in many cases targeting loan programmes at SMEs. The European Central Bank (ECB) has also started lending money to banks at a -1% interest rate, meaning that banks are effectively being paid to lend money. In addition, the Commission has put in place new rules to delay the (onerous) application of new accounting standards in 2020 and has lowered capitalisation requirements for banks. Against these conditions and given that European banks have been building up capital reserves since the 2009 crisis the Commission expects EU banking sector to be "resilient enough to withstand even a massive recession".
3. It remains to be seen whether these policy measures will be sufficient to get money where it is needed the most. In the EU SMEs account for around 55% of the GDP of the non-financial business sector and for around two-thirds of all private sector employment yet are more exposed to the current crisis given their lower capital buffers when compared to large corporations. That considered, it is especially worrisome that survey data has shown a significant deterioration of

SMEs access to finance with SME's external financing gap (the difference between the demand and the availability of external financing) growing from 2% (more financing available than needed) to -4% which is the largest drop since 2014.

Bailing out national champions

1. Member states have also placed an emphasis on bailing-out their large national champions which are in many instances seen both as strategic assets and symbols of national pride. While Member State governments have in some cases already provided effective bailouts to their companies in the form of loans and loan guarantees (for example Air France benefitted from a package of this sort worth €10bn in late April), on 8 May the Commission announced a further modification to its temporary state aid framework which will allow member states to provide direct bailouts to companies through recapitalisation measures.
2. According to the new rules, recapitalisation can be granted to companies when no other appropriate solution is available, and when the intervention serves a common interest (for example to "protect an innovative or a systemically important company" or "an important service"). The new rules also stipulate that the aid must be limited to restoring the pre-COVID19 capitalisation of the beneficiary company. They also set out a series of entry and exit requirements (mandatory restructuring after 6-7 years if the state continues to be a shareholder) and governance conditions for bailouts. Importantly, the new rules stipulate that until 75% of the state recapitalization is redeemed by the company, affected companies have to apply a "strict limitation" on the remuneration of management including "a ban on bonus payments". In addition, bailed out companies have to make sure that they do not use bailout money to benefit subsidiaries that were already facing financial difficulties prior to 31 December 2019.

Europe is already hurting

1. According to the Commission's forecast, member states that are most heavily reliant on tourism are expected to take the largest hits to their economies. While furlough schemes are currently shielding unemployment in many European countries, the Commission has made some damning predictions. Unemployment in Greece is set to soar to 19.9%, in Spain to 18.9%, in Italy to 11.5% and in Croatia to 10.2% in 2020. Although some member states are expected to fare better (several member states are expected to contain unemployment at around the 6% mark) this does not mean that the real-life impacts of the crisis aren't already being felt across the EU.
2. In Spain, the IMF has predicted higher unemployment than the Commission, with joblessness expected to reach 20.8% (up from 14.4%) as a result of the pandemic. Nearly 600,000 additional people filed for unemployment in March and April, the period of the year when employment is usually at its peak. In Italy 40% of parents surveyed by Save the Children said that their economic situation had deteriorated due to the pandemic, workers in Italy's black economy (worth 12% of GDP) are relying on charity, and 7,000 tourism companies have gone out of business. In France,

12 million claims have been made under the wage subsidy scheme, representing almost 60% of the private sector workforce.

3. Northern countries are feeling the bite as well. Despite not entering a full lockdown, in Sweden over 73,000 people have lost their jobs since March, with significant job losses in its manufacturing and restaurant sectors in particular. In Austria unemployment currently sits at rate of 12.5% (compared to 8% this time last year) is the highest level since 1946, while 1.3 million are on short term work schemes (up from just 66,500 during the GFC). In the Netherlands unemployment has thus far been sheltered by its wage subsidy programme (and will therefore be more apparent when this ends in June), but the economy has already contracted by 1.7%. In Germany, car production and exports (Germany's biggest export earner) were down around 95% this April compared to last, and while its Kurzarbeit system is strong unemployment has risen from 5% in March to 5.8% in April. More optimistically, in Poland, while unemployment increases and a drop in private consumption are both expected, previously strong growth is currently expected to support the Polish economy to achieve 0.4% growth this year.

Recovery prospects

1. Given the volatile, uncertain and quickly evolving nature of the current health crisis the recovery prospects of EU economies are also highly uncertain. Although the Commission forecasts EU GDP growth of 6.1% in 2021 (U-shaped recovery) along with a moderation of headline unemployment to 7.9% there are several downside risks that could result in a weaker recovery. Importantly, strong interdependencies within the Single Market will mean that that incomplete or uneven recoveries in one Member State could easily have negative spill-over effects on others, prolonging the downturn.
2. That considered, according to Maarten Verwey, Director General of DG ECFIN (Economic and Financial Affairs) the main focus of member states' efforts should be on avoiding an uneven recovery as that carries the danger of entrenching "severe distortions within the Single Market" by setting different parts of Europe on more permanently diverging financial and social development trajectories. In Schumpeterian fashion, Verwey, like other commentators also highlights the importance of using the recovery to propel forward-looking change with an emphasis on the digital and green transitions. Speaking to the apparent political deadlock that has been plaguing discussions around EU leaders' level of ambition to funding coordinated recovery efforts, Verwey argues that taking joint action is a "question of solidarity and enlightened self-interest".
3. While the nature of the current recession (which was not caused by the systemic failure of a segment of the economy, rather by governments' decisions to shut down economies) gives hope that EU economies could be quickly 'turned-on' again, there are early indications that the unprecedented uncertainty of the health crisis is leading to a dramatic and sustained drop in investments across the EU which according to economists will lead to a rocky recovery in coming years.

4. The Commission's forecast also points to external challenges which will likely make this recession even more severe than the one which ensued following the 2008 financial crisis. In particular, the report highlights that the shock from the pandemic affects the entire planet, meaning that the EU "will not be able to benefit from sustained economic growth in other regions". This will mean that the EU is less able to rely on foreign inputs (such as foreign direct investments) to drive the recovery, and it will also mean that there will be reduced demand for EU exports abroad.

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