BUSINESSEUROPE

ECONOMIC OUTLOOK SUMMER 2021

SECURING THE RECOVERY

Economic situation July 2021

- The EU economy is picking up strongly, but the path back towards a full recovery after the COVID-19 induced recession will be long and fraught with downside risks. **We expect the EU27 economy to grow by 4.4% this year, followed by 4.6% next year.**

- The massive disruptions caused by the pandemic will take some time to shake off. **The unemployment rate at 7.2% remains significantly above the 6.5% precrisis level**, corresponding to **around 2 million more unemployed** than at the start of the pandemic, with 5% of all jobs dependent on government support at the end of 2020.

- **EU exports have bounded back strongly** as our larger trading partners have recuperated faster than Europe, with net exports close to 10% higher over the past three quarters than the 2019-average.

- **Domestic consumption, despite rising consumer confidence, remains suppressed, in the first quarter 2021 close to 10% below the precrisis level. Investments is rising, albeit slowly,** following a more than 7% decline in gross fixed capital formation in 2020.

Policy recommendations

- While the increasing deployment of vaccination in the EU is now leading to the gradual withdrawal of restrictions on economic activity, it is essential that a premature unwinding of supportive measures to businesses and workers is avoided.

- Increased long-term growth and employment in the EU is dependent upon proper implementation of a wide range of structural reforms. It is crucial the EU institutions should ensure the national recovery and resilience plans are sufficiently linked to the implementation of structural country-specific reforms, as designated under the European Semester.

- In the medium term Member States must return to fiscally sustainable positions, reflecting the situation in the aftermath of the COVID-19 pandemic, and ensuring there is no “debt explosions” leading to negative financial market reactions.

- Lessons should be drawn from the Covid-19 crisis to ensure that sufficient safeguards are designed and implemented now to permanently guarantee the free flow of goods, people and services in the future.

Scene is set for economic recovery

The EU economy is picking up strongly, but the path back towards a full recovery after the COVID-19 induced recession will be long and fraught with downside risks. The massive disruptions caused by the pandemic will take some time to shake off, with the long-term consequences continuing to be impacted by our present policy responses.

Most positively, **EU exports have bounced back strongly** with our larger trading partners recuperating faster than Europe. But exports alone are not enough to return the European economy to its full potential; **domestic consumption remains suppressed**, and restoring spending is key to achieving a strong economic recovery. As chart 2 shows EU net exports increased strongly in the last quarter of 2020 and were well above the pre-crisis level, whilst private consumption remained well below.

The roll-out of vaccines has recently allowed EU governments to begin reopening our economies, meaning we can finally begin to see a way forward back towards pre-crisis levels of economic activity. For example, consumer confidence is back to its pre-crisis level, suggesting households see better times ahead and expect to resume more normal spending patterns. **The EU is now set to experience some restoration of its domestic demand in the second half of 2021. This should set the scene for a full economic recovery next year.**

Reflecting these developments, we expect exports to continue to spearhead the economic recovery, gradually complemented by domestic consumption picking up in the summer. **Our expectation is for the EU27 economy to grow by 4.4% this year, followed by 4.6% next year.**

Chart 1: GDP Forecasts

	2020	2021f	2022f
EU27	-6,1%	4,4%	4,6%
Euro Area	-6,6%	4,3%	4,4%

European Business forecast

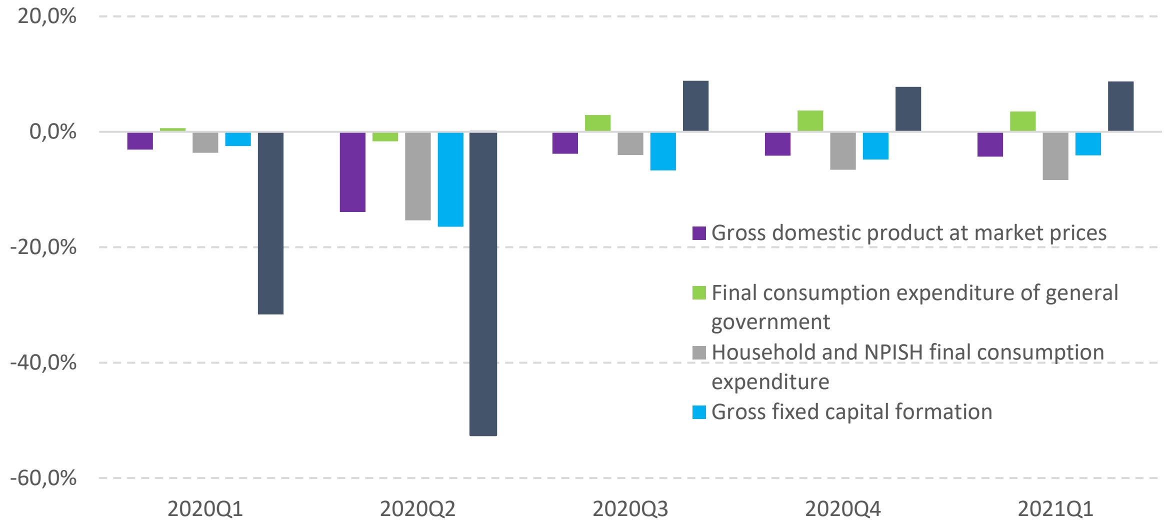
The implication of our growth forecast growth is that **the EU will recover from the pandemic recession sometime in the beginning or first half of next year.** In contrast China has already recovered to its precrisis GDP level and the United States is expected to do so at the end of second quarter 2021. The EU is thus on track to repeat the experience of the Great Recession, where Europe suffered a deeper and more protracted recession, followed by weaker growth, than other large economic economies.

A number of **significant downside risks to the forecast** exist that if they materialize would further weaken the EU's economic recovery:

- Inflationary pressures are growing, and if higher than expected could potentially prompt central banks in Europe and elsewhere to tighten monetary policy before the recovery is robustly entrenched.
- On the fiscal side there is a similar risk that the comprehensive government support put in place during the lockdowns is unwound prematurely, which would be damaging to the recovery.
- Government support may have contributed to keeping a number of businesses alive during the pandemic that will not prove long-term sustainable. When that support is withdrawn the EU economy will likely face a rise in insolvencies which if it manifests before the economic recovery is sufficiently strong enough to absorb it could weaken the upturn.
- Finally new more transmissable COVID-10 variants are a clear downside risk to our forecast

In the following, we first consider the implications for the employment situation of these economic developments and consider the highlighted components of GDP in turn in greater depth, before turning to the downside risks which we analyze in greater detail.

Chart 2: Quarterly change from 2019-average (seasonally and calendar days adjusted)



Own calculations based on Eurostat

Employment situation

Unemployment is now falling, although there is still some way to go before the employment situation has fully recovered from the pandemic.

In the first quarter of 2021 the EU27 unemployment rate fell to 7.2%, down from 7.5% at the peak of the lockdowns, but still significantly above the 6.5% reached before the pandemic. This corresponds to around 2 million more unemployed than at the start of the pandemic.

However, assessing the employment situation including the "real" level of unemployment is difficult in the presence of widespread furlough schemes. For example, the European Commission has estimated that the share of jobs reliant on government support was 5% in the last quarter of 2020, after peaking at around 15% at the height of the lockdowns[1].

While many workers have been kept on furloughs or short-time work schemes because the firms expect to survive and need them in the future, some companies will inevitably have to adjust to new realities including some having to close and others having to cut down on workers on the other side of the furloughs. The use of furloughs in the EU countries have further derailed adjustments in the labour force, with many countries imposing no-firing clauses to their schemes. As a result we may see considerable adjustments once the labour market unfreezes.

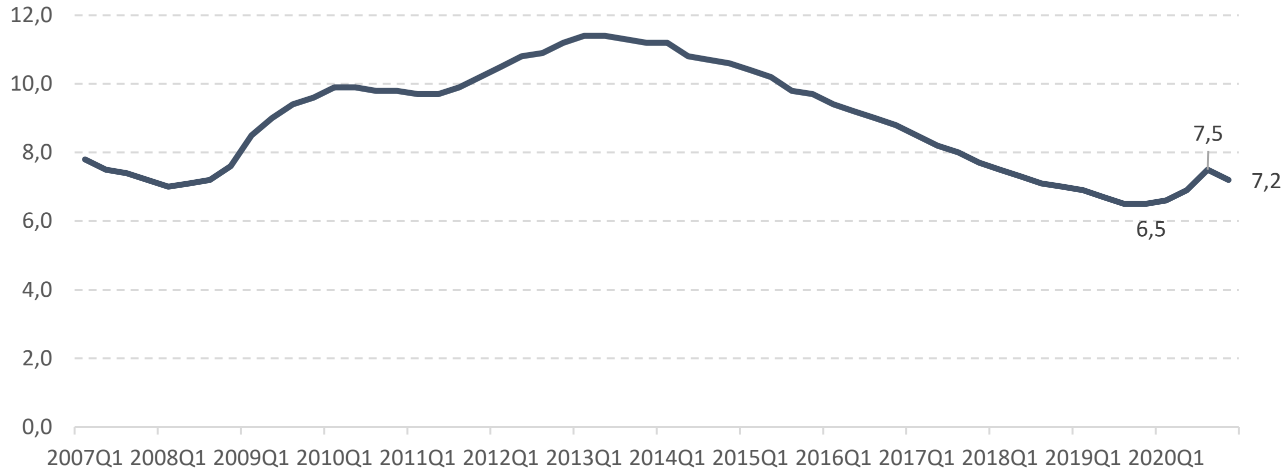
More generally, the pandemic will likely result in both permanent changes in the labour force, including higher demand for ICT related and online retailing services, and temporary timing issues when all companies resume hiring almost simultaneously once lockdowns are ended, which can result in labour market bottlenecks.

So far the EU has only seen its job vacancy rate rise slightly from 1.8% in first quarter 2020 to 2.0% in the first quarter of 2021. But in the United States there are widespread reports of such bottlenecks, and there is as risk that the same will be seen in Europe once our recovery becomes as advanced

[1] https://ec.europa.eu/info/sites/default/files/economy-finance/ip149_en.pdf p. 30.

as in the US, and as the labour market unfreezes. In some sectors we may see rising unemployment, whereas there will be increased demand for workers in others. As the requirements and skill sought after may not match with redundant workers we will likely see rising problems with labour shortages as the recovery gains strength.

Chart 3: Quarterly unemployment rate in the EU27, seasonally adjusted



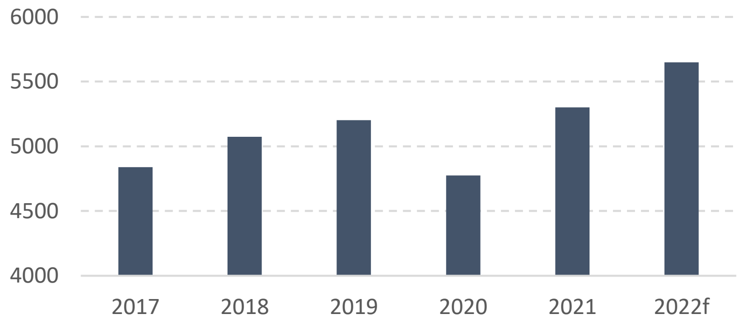
Eurostat

Exports

EU exports had experienced a difficult period over the past years with global trade tensions and uncertainties around Brexit, as well as the effects of the COVID-19 pandemic, creating massive disruptions to value chains, causing global demand to plummet.

This situation has now been reversed. The global economy is picking up fast with our main trading partners having recovered faster than Europe. EU exports are growing strongly, and as shown in the graph above net exports have above have consistently been higher in the past quarters than in 2019. European Commission forecasts suggest total goods exports could be around 2% higher this year than in 2019.

Chart 4: Total EU goods exports, bn euro



AMECO f: AMECO/European Commission forecast

EU trade remains affected by the disruptions and uncertainties caused by Brexit. While still early days to consider the long-term impact of Brexit, EU exports to the United Kingdom fell 13% in 2020, in contrast to a 3% export drop to Switzerland and 6% drop in exports bound for Norway. Meanwhile there has been a significant surge in trade between Ireland and Northern Ireland, with Irish exports up 40% in February 2021 relative to February 2020[2].

Private consumption

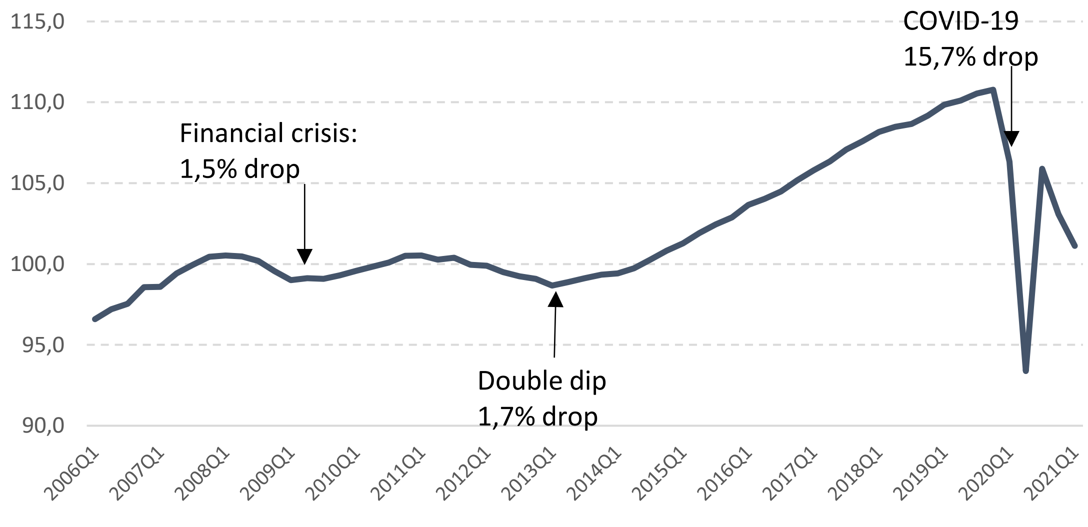
Consumption in the EU has been heavily suppressed as a result of the imposition of lockdowns. As shown in the graph below in the first quarter of 2021 it was 9% below the level seen in the fourth quarter 2020 before the pandemic hit.

On the side of private consumers, several million Europeans have lost job their jobs, and many more have been put on furlough. This has caused many households to experience a drop in income. The situation has also created an acute sense of economic uncertainty in the labour force that makes many consumers less prone to spend. At the same time lockdowns have led many households to defer purchases of goods and services, as it has been impossible or impractical to carry out many normal purchases. As a result of these factors the savings rate has risen from 12.9% in 2019 to 19.5%% in 2020.

There is on the one hand a potential for a very strong consumer-led resurgence, since households can tap into the large savings they have accumulated during the pandemic where many purchases of goods and services were deferred. However, on the other hand, 2 million Europeans have lost their jobs and therefore have less disposable income to spend than they did before the pandemic hit. Business investments is on the rise but only slowly amidst still-high economic uncertainty.

On the side of businesses, some sectors have suffered a dramatic loss of revenue due to lockdowns, and others have been indirectly affected by lower propensity to spend among consumers and businesses alike. Continuing normal business operations have also been difficult with supply chains disrupted and a need to function using remote work. These practical issues as well as lower demand also mean that the past year has seen less business investments.

Chart 5: Quarterly household and NPISH final consumption expenditure, seasonally and calendar days adjusted, constant prices, index 2010=100

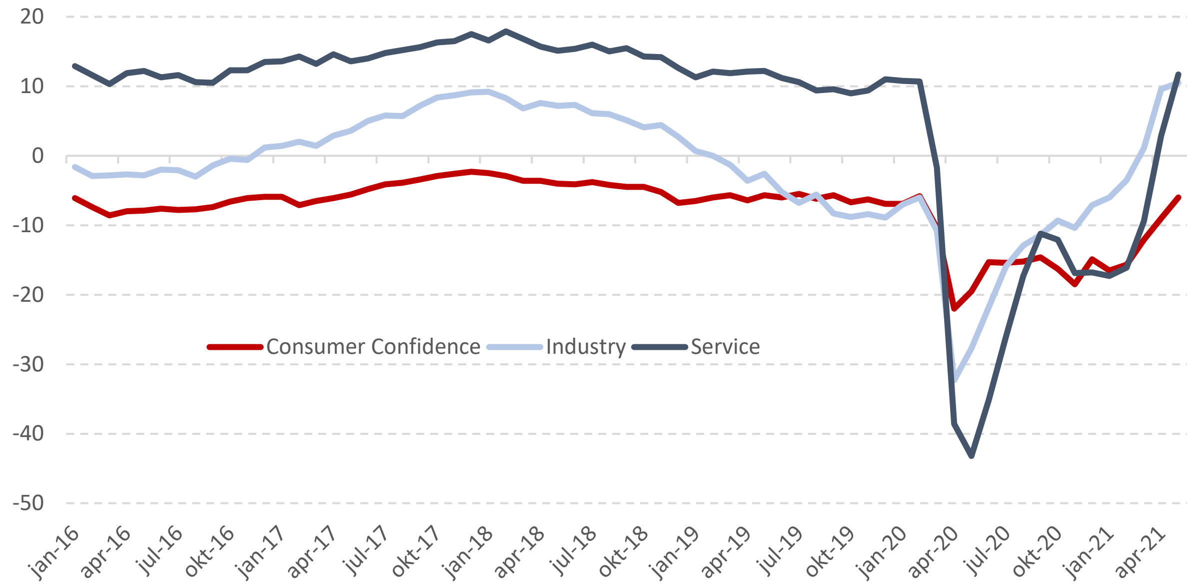


Own exposition based on Eurostat

[2] https://www.bbc.com/news/uk-northern-ireland-56760634

Reflective of the easing of lockdowns we have seen in recent months, consumer confidence and business confidence are now back at least to their pre-crisis levels. The PMI showing the highest level recorded since February 2018 following three months of expansion[3], and the IFO index showing the highest value since 1992[4].

Chart 6: Confidence indicators (Between -100 for extremely negative and 100 for extremely positive)



Own exposition based on European Commission surveys

Government spending

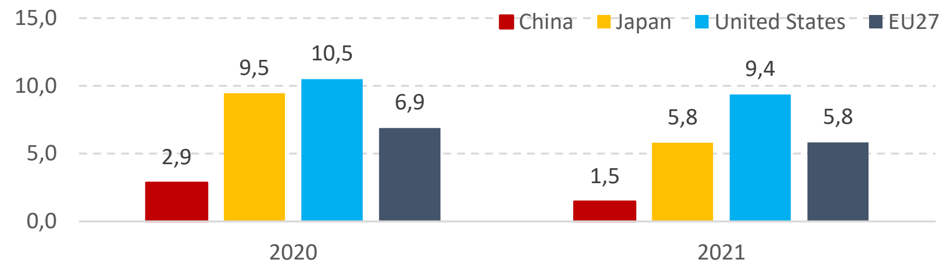
Government expenditure has increased in response to the pandemic, reflecting both automatic stabilizers (in particular expenditure for unemployment benefits) and discretionary initiatives aimed at cushioning the shock. Member States have implemented wideranging measures including extensive state aid, whilst the EU has embarked on an unprecedented Next Generation EU recovery initiative, expected to increase GDP by 1.2% by end of next year[5]. Other governments around the world have also undertaken large stimulus programmes, including the United States with a 1.9 trillion USD recovery package and a large infrastructure bill.

On the one hand, **the immediate concern is for policy-makers to avoid any premature unwinding of measures to support business and workers, while ensuring the rapid implementation of the EU's Next Generation EU Recovery instrument**. The funds must support investment and reforms that can help boost EU growth, productivity and competitiveness. **On the other hand, in the medium term countries must return to fiscally sustainable positions.**

Getting the timing and pace right when winding down government support will therefore be crucial. There is already some concern in the United States, where the upturn is more advanced than in Europe and government support has been more pronounced, that we may see "cliff edge" reversal effects once the unprecedentedly large US government support expires.

[3] https://www.markiteconomics.com/Public/Home/PressRelease/435685c859494511b9e6de2d825b1173
[4] https://www.ifo.de/en/node/63421
[5] https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_21_2826

Chart 7: General government expenditure as % of GDP, Percentage points change from the pre-pandemic (i.e. 2019) level



Own calculations based on IMF. Figures show total general government expenditure ie include automatic stabilizers and discretionary spending.

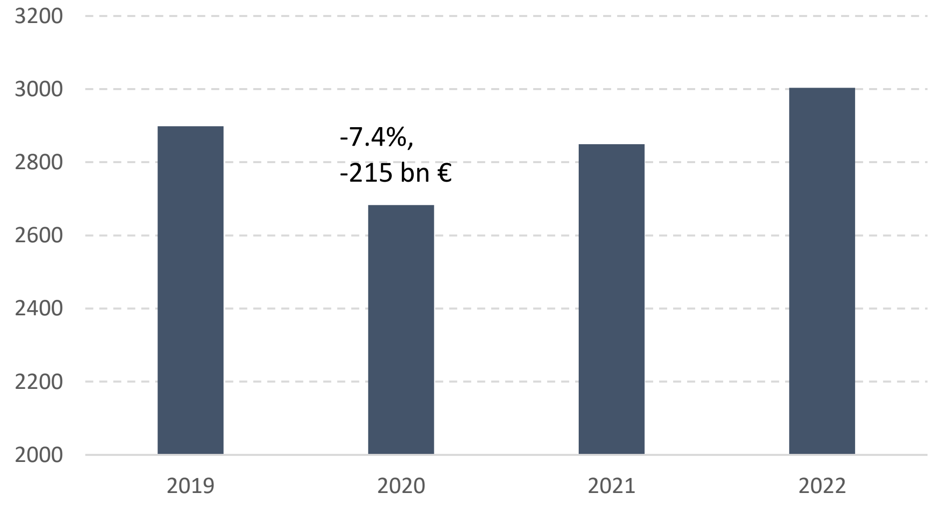
Investments

Unsurprising the pandemic lockdowns caused investments to tumble, with gross fixed capital formation falling more than 7% in 2020. As long as investments remain suppressed the EU economy will not be able to make a full recovery.

Business investments is rising, albeit slowly. The European Commission expects this year's investment levels to remain 1.7% below the 2019 level. Even next year the Commission only expects GCFC to be 3.6% higher than it was in 2019. While positive, this hardly entails the significant bounce-back in investments that would have been needed to make up for the dearth of the two previous years.

To illustrate the magnitude of lost investment, the norm over the pre-crisis years has been annual increases of at least around 100 bn euro. If EU investments had continued their trajectory, therefore, it is not unreasonably to assume the level of investments in 2020 would have been more than 300 bn euro higher, in 2021 around 250 bn euro higher, and in 2022 almost 200 bn euro higher, than what is currently expected.

Chart 8: Change in gross fixed capital formation, EU27, constant prices (bn euro)



AMECO

Country differences

The pandemic has caused widening economic divergences within the EU with a number of Southern economies suffering particularly large GDP drops.

The EU's Next Generation EU recovery instrument is concentrated among countries that experience economic strain. Amounting to 4-5% of GDP in several of these Member States, and even more in a few cases, much will depend on the ability of governments to make the most out of the historic opportunity. Key is to ensure it is implemented without delay, emphasizes projects with high value added, and is complemented with the appropriate economic and structural reforms.

Chart 9: Real GDP growth forecasts

	2020	2021f	2022f
EU27	**-6,1**	**4,4**	**4,6**
Euro Area	**-6,5**	**4,3**	**4,4**
Austria	-6,3	3,4	4,3
Belgium	-6,3	5,5	3,3
Bulgaria	-4,2	3,8	3,9
Croatia	-8	5,4	6,1
Cyprus	-5,1	3,6	3,8
Czechia	-5,6	3,3	4
Denmark	-2,7	2,5	3,5
Estonia	-2,9	2,8	5
Finland	-2,8	2,7	2,8
France	-7,9	5,5	4,2
Germany	-4,8	3,4	4,1
Greece	-8,2	4,1	6
Hungary	-5	5	5,5
Ireland	3,4	4,6	5
Italy	-8,9	4,1	4,2
Latvia	-3,6	3,5	6
Lithuania	-0,9	2,9	3,9
Luxembourg	-1,3	7	4
Malta	-7,8	4,9	5,4
Netherlands	-3,8	2,3	3,6
Poland	-2,7	4	5,4
Portugal	-7,6	4,8	5,6
Rumania	-3,9	5,1	4,9
Slovakia	-4,8	4,8	5,2
Slovenia	-5,5	4,4	3,3
Spain	-10,8	5,9	6,8
Sweden	-2,8	3,8	3,9
Norway (non EU)	-0.8	3.3	3.4
Switzerland (non EU)	-2.9	2.7	2-5
United Kingdom (non EU)	-9.8	8.2	6.1

Risks to the forecast are strongly on the downside

Our forecast makes a number of assumptions about the growth impetus and additionality from the Next Generation EU funding. We also build on a number of other assumptions including around the developments of **a number of risk factors that constitute clear downside risks to the economic recovery**, such as rising inflationary pressures and the spread of more transmissibe virus strains. In the following we analyze these risks in greater detail.

Risk of company insolvencies

In contrast to other recessions the bankruptcy rate has fallen dramatically, as shown in the graph below.

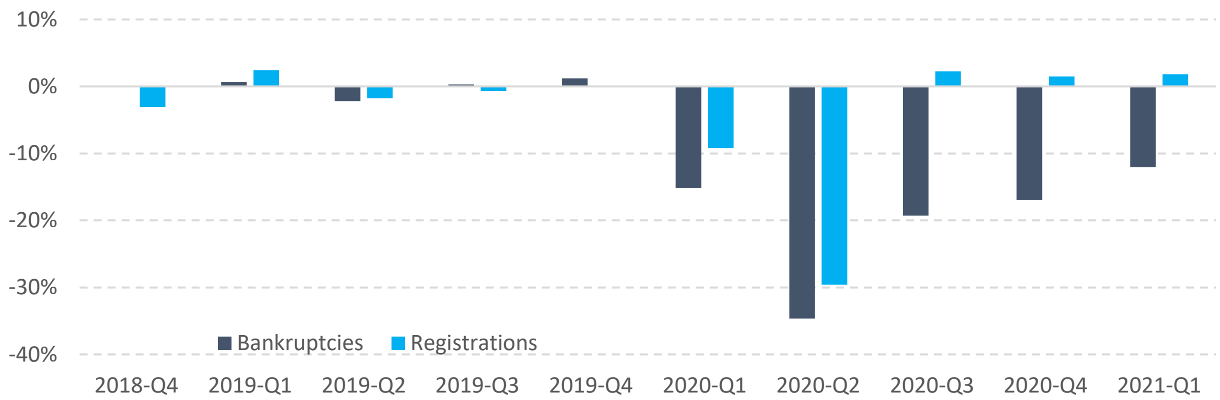
While necessary to lessen the shock from the COVID-19 pandemic and prevent insolvencies among viable businesses, it is also the case that massive fiscal expansions and state aid schemes across the EU may have helped companies survive in some cases regardless of whether or not their business will ultimately prove sound in the long term under more normal economic circumstances. The ECB recently warned[6] that government support "to a moderate degree"[7] has kept unviable companies alive.

Once government support is withdrawn, therefore, some businesses that prove unviable under more normal economic circumstances may eventually have to be closed down. This carries the risk that a premature withdrawal of government support could set off a rapid wave of insolvencies before the recovery is sufficiently robust to absorb it, and before lenders can fully assess which firms are truly long-term viable in the post-COVID economic environment.

This concern is echoed by other economic analyses. For example, in December 2020 the Bank of Spain issued a warning that one-fifth of Spanish companies might be on the verge of bankruptcy[8], and the advisory firm McKinsey published a report suggesting that in five large EU economies 1/10 of the SME's expected to have to file for bankruptcy within six months[9].

The European Systemic Fiscal Board, charged with overseeing financial stability in the Euro Area, in April noted that "In a worstcase scenario, the postponed insolvencies would suddenly materialise and trigger a recessionary dynamic, potentially causing further insolvencies. The current low rate of insolvencies would then be similar to the sea retreating before a tsunami[10]".

Chart 10: % change from 2019 seasonally adjusted average



Own calculations based on European Commissions surveys *Total number of bankruptcies declared*

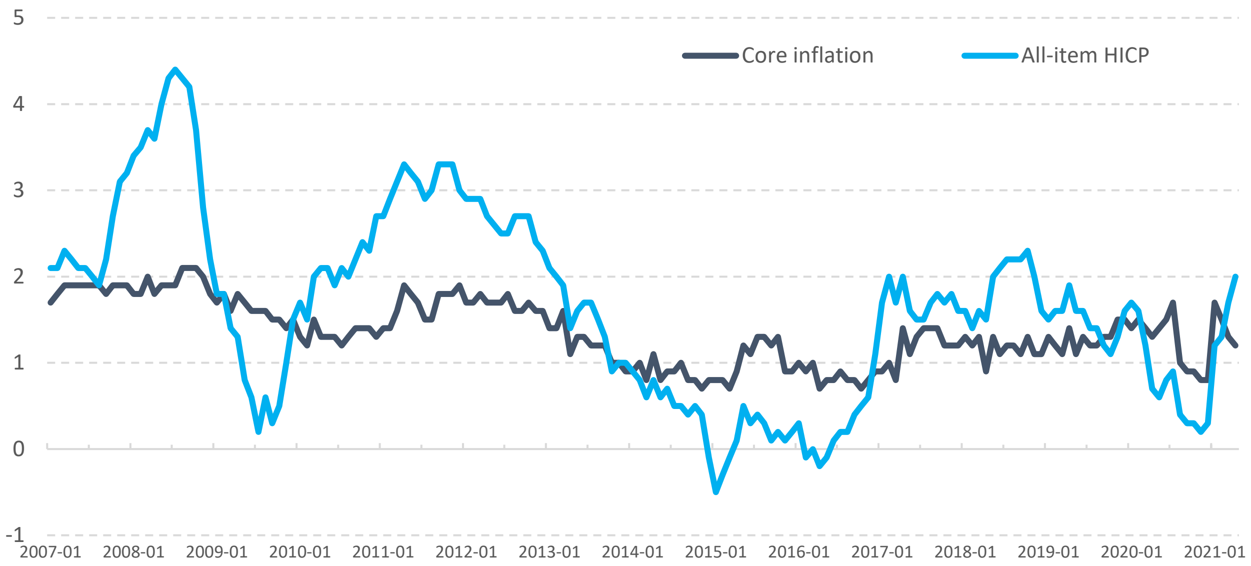
Risk of rising inflation

Another risk to our forecast is rising inflationary pressures that, if they exceed current expectations, might prompt the ECB and other central banks into beginning monetary tightening earlier than currently foreseen.

[6] https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart202105_01~f9b060744e.en.html
[7] https://www.ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202105~757f727fe4.en.html#toc37
[8] https://www.reuters.com/article/uk-health-coronavirus-spain-economy-idUKKBN28B4TC
[9] https://www.mckinsey.com/industries/public-and-social-sector/our-insights/covid-19-and-european-small-and-medium-size-enterprises-how-they-are-weathering-the-storm
[10] https://www.esrb.europa.eu/pub/pdf/reports/esrb.report210428_PreventionAndManagementOfALargeNumberOfCorporateInsolvencies~cf33e0285f.en.pdf

In Europe, after a period of low inflation, the Harmonized Index of Consumer Prices (HICP[11]) has shot up recently, reaching 2% in April, in principle exceeding the ECB's "close to, but below 2% in the medium-term" target.

Chart 11: All-item HICP and core inflation, EU27



Own exposition based on Eurostat

However, as seen in the graph, core inflation (HICP excluding food and energy) remains subdued at 1.2% in April.

In fact the significant increase in the HICP mostly reflects movements in energy prices. During the pandemic global demand slumped, causing energy prices to fall. Now that the global economy is picking up steam they are returning to their pre-crisis levels.

A number of other factors that are also temporary in nature also contribute to higher inflationary pressures:

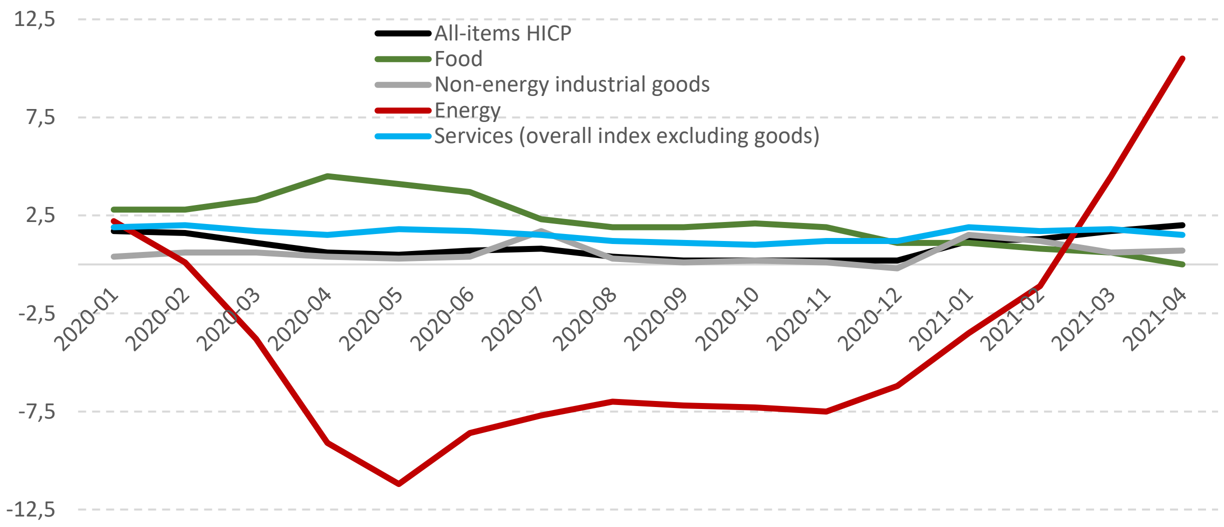
- Some EU countries including Germany have passed temporary VAT decreases to help boost private consumption during the pandemic, and as they now expire the result is upward pressure on prices[12].
- Consumers may be willing to pay higher prices for services such as haircuts and eating out after a long period where they were unavailable during lockdowns. We have already seen a 4-6% increase in the prices for hairdressers' services, and 2% in restaurant prices, in April (annual rate of change) in the EU27.
- Transportation costs[13] have increased, reflecting higher energy prices and greater demand, as well as temporary bottlenecks including due to the Suez Canal blockage.
- Businesses experience various supply constraints (including a much-reported shortage of semiconductors), and higher production and transportation costs are likely to be passed on at least in part down the supply chain and ultimately to consumers. In the United States, recent inflation data for instance pointed to the highest core inflation (3.8% in May 2021 relative to May 2020) registered since January 1992[14],

[11] Measuring the HICP inflation during lockdowns, when many of the components such as restaurant prices are not being traded, requires a number of important assumptions. For an exposition see https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202007_03~e4d32ee4e7.en.html
[12] https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202006_06~8a537e86c2.en.html

[13] https://www.bloomberg.com/news/articles/2021-04-12/higher-shipping-costs-are-here-to-stay-sparking-price-increases
[14] https://www.wsj.com/articles/us-inflation-consumer-price-index-may-2021-11623288303

- Another factor generating inflationary pressures is US President Biden's exceptionally large 1.9 trillion USD (around 8% of GDP) stimulus package passed in the spring. Some economists have warned that the temporary stimulus unleashed will overheat the US economy, triggering price and wage rises that could spill over into Europe.
- We are also likely to see a timing issue in that with lockdowns now being lifted many companies are seeking to hire at the exact same time. This can give rise to temporary bottlenecks that put upward pressure on wages.

Chart 12: % Inflation, in EU27, annual rate of change, components



Eurostat

ECB president Lagarde has repeatedly stated that the ECB's assessment is that the inflationary pressures are temporary in nature, and reiterated the ECB's commitment to maintain its asset purchase programme, Pandemic Purchase Emergency Programme PEPP, until "the Governing Council (..) judges that the COVID-19 crisis phase is over, but in any case not before the end of March 2022"[15].

However, the risk persists that these temporary factors *permanently* shift inflation expectations among economic actors (labour unions negotiating wages, businesses setting their prices etc.), necessitating a stronger response from central banks than what is currently foreseen. The key question to be asking, therefore, is how inflationary expectations are developing.

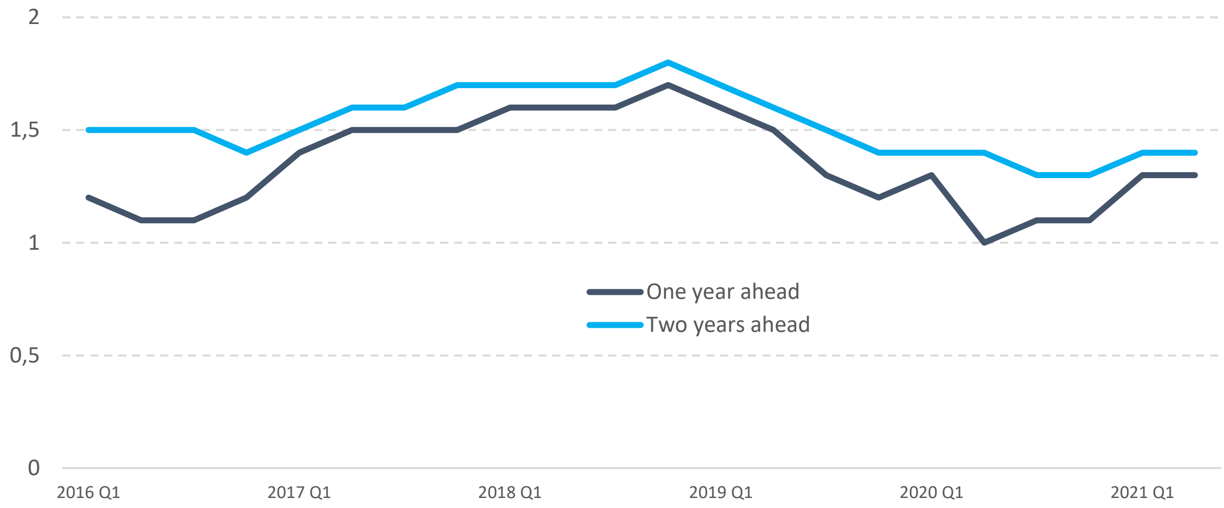
Looking at current expectations, the survey of professional forecasters for instance suggests that HICP inflation will remain well below the 2% target one and two years from now. The ECB's macroeconomic projections from June similarly suggested 1.5% HICP inflation in 2022 and 1.4% in 2023.

As President Lagarde recently highlighted, the EU economy comprises of 60% services, and service sector wages have not shown signs of excessive rises. At the same time, with unemployment still considerably above its precrisis level and a significant proportion of the working force still on furlough, there is considerable "slack" in the EU economy. As long as that is the case we are unlikely to see massive wage rises that could force the ECB to act.

Nevertheless, the prospect of what some call a "regime change" in the form of permanent upward shifts to inflation expectations, forcing central banks to tighten monetary policy in response, remain a key risk to our forecast and to the economic recovery.

[15] https://www.ecb.europa.eu/press/pressconf/2021/html/ecb.is210610~115f4c0246.en.html

Chart 13: Inflation expectations, HICP, percent

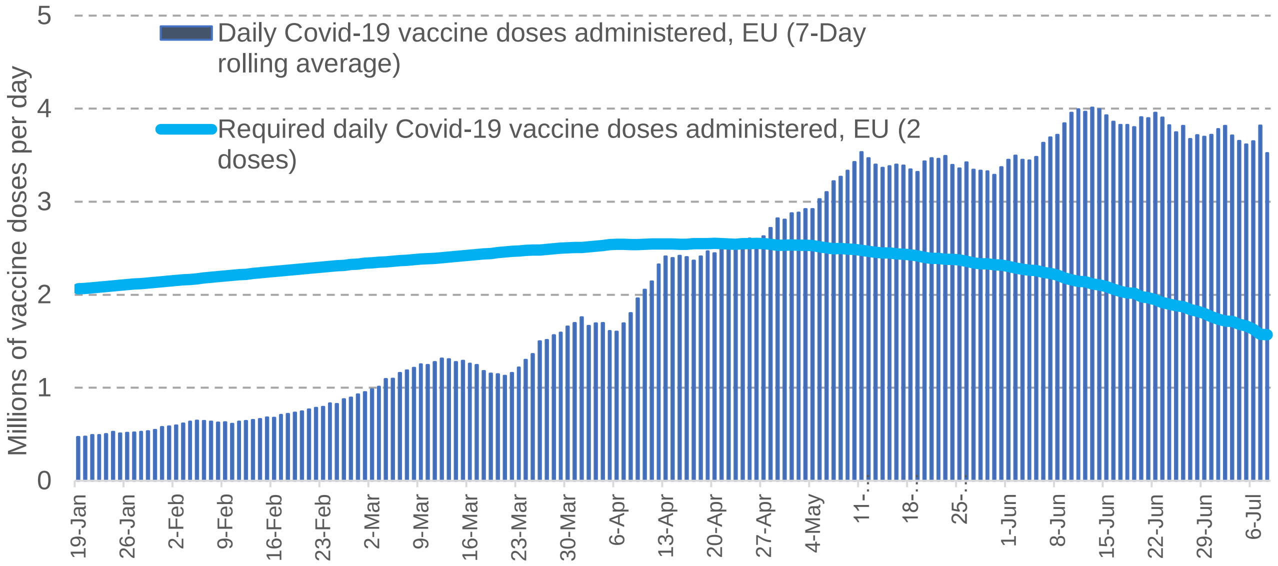


ECB – survey of professional forecasters[16]

Risk of more transmissible virus mutations

After a slow start, the EU's vaccination campaign picked up pace through the spring, with daily vaccinations exceeding the rate needed to meeting the EU's target of fully vaccinating 70% of the adult EU population by the end of summer[17] (shown by the light blue line). Whilst increased vaccination levels are playing an essential role in reducing transmission of the virus, we believe there is a clear downside risk to our forecast from the possibility of new variants increasing transmission and leading to further hospitalisations, and a return of some restrictions on economic activity.

Chart 14: Vaccinations in EU27



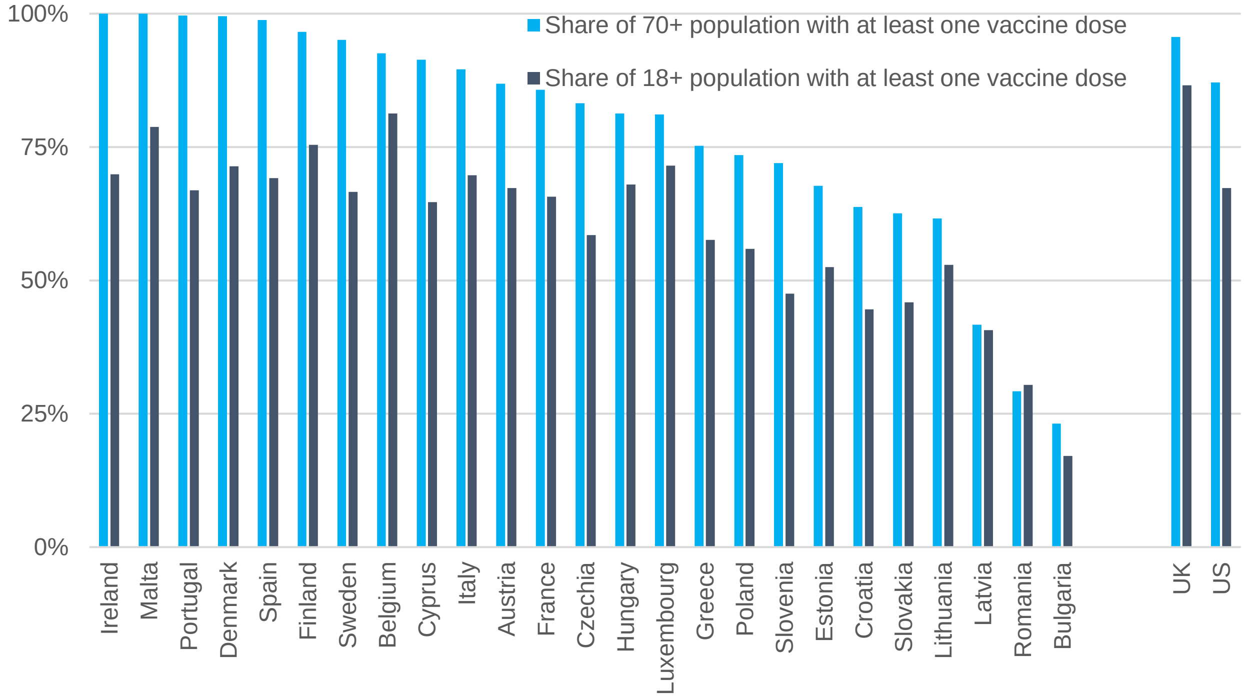
ECDC

[16] https://www.ecb.europa.eu/stats/ecb_surveys/survey_of_professional_forecasters/html/table_hist_hicp.en.html

[17] On 19 January, the European Commission presented a Communication "A United Front to Beat Covid-19" in which they set the goal to fully vaccinate the adult EU population by the end of summer (21 September, 2021): https://ec.europa.eu/info/sites/default/files/communication-united-front-beat-covid-19_en.pdf

In particular, the European Centre for Disease Prevention and Control (ECDC) have noted[18], that the Delta variant is “40-60% more transmissible than the existing variant and may be associated with a higher risk of hospitalisation, with 70% of new infections projected to be due to this variant in the EU by early August and 90% of infections by the end of August”.

Chart 15: State of vaccinations in Europe, the UK and the US



ECDC. No data available for Germany or the Netherlands

Their modelling suggests that a relaxation of measure of the summer could lead to an increase in daily cases in all age groups, with an associated increase in hospitalisations, and deaths, “potentially reaching the same levels of the autumn of 2020”. With the ECDC pointing to evidence that “those who have only received the first dose of a two-dose vaccination course are less well protected against infection with the Delta variant than against other variants”, it is essential that the EU quickly achieves high levels of vaccine coverage.

One concern in this regard is that rapid vaccination rates in some member states hide relatively low levels of coverage for any given age group, and that the number of new vaccination, slightly slowing, may fall further during the summer as member states run out people to extend vaccine eligibility to. In particular, the graph above shows that vaccination rates for older people vary considerably between Member States, with almost all older people having had at least one vaccine dose in Ireland, Malta and Denmark but less than 80% of older people with such protection in around half of Member States. Given Member States generally targeted such people for early vaccination, we must assume that these incomplete coverage rates are due to vaccine hesitancy. Moreover, vaccine hesitancy is generally higher for younger people, underlining that it will be increasingly essential for Member States to invest in boosting coverage rates, for example through mobile vaccination centres if high coverage levels are to be achieved.

[18] ECDC Statement Threat Assessment Brief, 23/06/21 https://www.ecdc.europa.eu/en/publications-data/threat-assessment-emergence-and-impact-sars-cov-2-delta-variant

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