SUERF THE EUROPEAN MONEY AND FINANCE FORUM

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How deep will it fall?[1]
Comparing the euro area recessions of 2020 and 2009


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IMF Managing Director Georgieva predicts "a ***global recession in 2020 at least as bad as the Global Financial Crisis or worse****" – but expects a recovery in 2021.*[2] *Recently published* ***expert and market forecasts*** *for* ***euro area growth*** *in 2020 range* ***from -1.6%*** *(ifo)*[3] ***to -9.9%*** *(Morgan Stanley)*[4] *while forecasts published earlier by* ***international organizations*** *are no longer valid. In G7 countries,* ***output*** *initially* ***fell by roughly one quarter*** *as a direct impact of the shutdown according to OECD calculation, which translates into* ***up to 2% for each month that the crisis continues****, and around 5% of GDP for each quarter. The IMF's estimates even show a monthly loss of 3% of annual GDP.*

In the 2009 recession, official forecasters were slow to adjust, with their projections failing to converge toward the ***final outcome (-4.5%)*** *before mid-year. This time, adjustment is much faster. Although difficult to compare, the two crises share* ***some similarities****: strong impact on* ***manufacturing*** *and* ***finance****, high relevance of* ***trade, all euro area countries affected*** *(yet not equally vulnerable), strong* ***government***

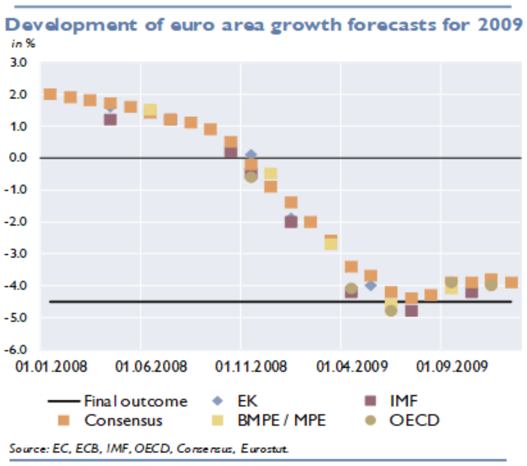
[1] Opinions expressed by the authors do not necessarily reflect the official viewpoint of the Oesterreichische Nationalbank or of the Eurosystem. We acknowledge the contribution of Anna Raggl (OeNB) to a previous version of this note.

[2] IMF Press Release No. 20/98

[3] EconPol Policy Brief 21 2020, March, Vol. 3, ifo

[4] Morgan Stanley Research, Global Weekly COVID-19 Impact Update: March 20, 2020.

reaction**. Nonetheless, there are **<u>significant differences</u>**: this time the crisis unfolds much **faster**; **services** play a central part alongside manufacturing; **finance** is only an amplifier, not a trigger, with the focus being on **shadow banking** and corporate debt; banks may, however, play a role as shock absorbers, as they are better capitalized now; **China** may not drive the post-crisis recovery of the world economy this time; emerging and **developing economies** are probably more vulnerable; on a positive note, EMU may benefit from a **crisis framework with safety nets.



*The **Spanish flue of 1918/19** triggered a **recession similar in magnitude** to the 2009 recession yet is **hardly comparable** to the current pandemic, given the economic stimulus created by continued war production then and progress made in public health since.*

1. Current market and expert forecasts point to a deeper recession than in 2009

Published forecasts of official institutions are unavoidably **behind the curve** due to their longer publication intervals and their rather cautious approach given the responsibility that comes with their authority. So far, only two **official institutes** (OECD and ECB) have provided forecasts for the euro area economy after the COVID-19 outbreak in Europe. The *OECD* estimated (on March 2) a weak GDP growth of +0.8% in 2020 but highlighted the possibility of a recession in its broader contagion scenario (no figures displayed). Yet, OECD Secretary General Angel Gurria also called the pandemic the "greatest economic, financial and social shock of the 21st century." The *ECB* too officially forecast +0.8% (on March 5), implying a rather modest downward revision partly due to early cut-off dates.

Economic actors seeking guidance in rapidly changing crisis times, however, must resort to predictions available from local **think tanks or market institutes**. Among the German economic expert institutes, the ifw was first to release an update (on March 11), expecting negative growth of -1.0% for the euro area in 2020. The ifo (on March 19) already projected as much as -1.6%, and the Austrian IHS followed with -2.0% (on March 26). The ifo published a scenario forecast for Germany (on March 22), according to which economic output could shrink by a range of -7.2 to -11.2; or by a range of -10.0 to -20.6 percentage points compared to the baseline, depending on whether the partial standstill of the economy lasts two or three months, respectively.[5]

[5] Ifo-Pressemitteilung 23.03.2020

Recent **market-produced forecasts point toward an even deeper fall into negative territory**. Market forecasters typically provide **two or three scenarios** with deviating assumptions reflecting the high degree of prevailing uncertainty. Most importantly, those scenarios differ in the assumption on **how long** the shutdown will last, determining the shape of the curve (V, U or L). At present, even the baseline forecasts are rather pessimistic. For 2020, *Raiffeisen Bank International* (March 18) projects a decline of -4%. *Oxford Economics* (March 20) anticipates -2.2% in its baseline and -3.2% in its downside scenario. *Morgan Stanly Research* goes even further, seeing annual GDP declining by -1.5% in its 'bull case', by -5.0% in its base case, and by **-9.9%** in its 'bear case'. The three cases are distinguished by the length of the recession (one, two or three quarters).

Multiple channels of crisis transmission

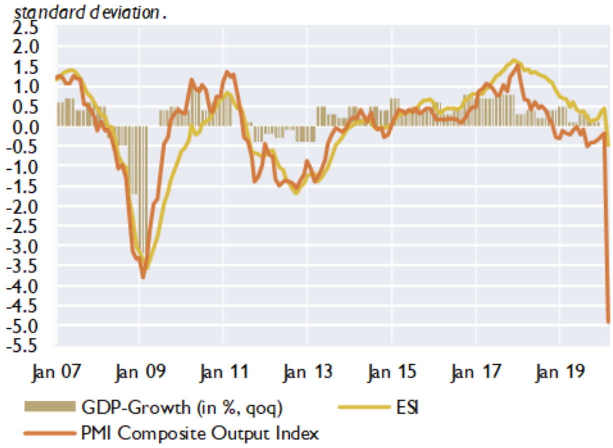
Earlier forecasts (OECD) saw the crisis rather as a **supply-side** phenomenon, pointing to the special role of China regarding global supply chains, travel and commodity markets. More recent forecasts built on the even larger effects of **shutdowns** of up to two-thirds of **services and industries** all over the world, implying a huge **demand-and-supply impact**; whose combined nature is yet to be better understood (Fornaro and Wolf, 2020).[6] Additionally, the most unpleasant cases also price in the **financial disruption, above all**, due to pervasive **uncertainty** putting almost all investment decisions on hold. In contrast, **government and central bank action** is acknowledged to slow down the decline and to preserve a minimum level of trust and liquidity in the economy. However, the demand-supporting component of the measures will not be fully effective in boosting the recovery until the health crisis is over. This highlights the unprecedented degree of **uncertainty** of the current crisis. In 2009 there was a lot of uncertainty about the magnitude of legacy assets buried in the balance sheets of key financial institutions, which at least left room for expert intuition. This time, however, economic policymakers are caught off guard, given the non-economic sources of the crisis.

First indicators

The **Composite PMI** for the euro area for March shows an extraordinary drop (flash release from March 24). Also, the **Economic Sentiment Indicator** (ESI) fell dramatically in the euro area (-8.9 points down to 94.5). Due to the outbreak of COVID-19, the data collection period stopped earlier than usual, and only approximately 15% of the consumer responses were collected after the strict confinement measures taken by the countries. Still, consumer confidence went below its long-term average for the first time in over five years.

Euro area: Sentiment indicators

Indices, Deviation from the mean value of the indicator relative to the standard deviation.



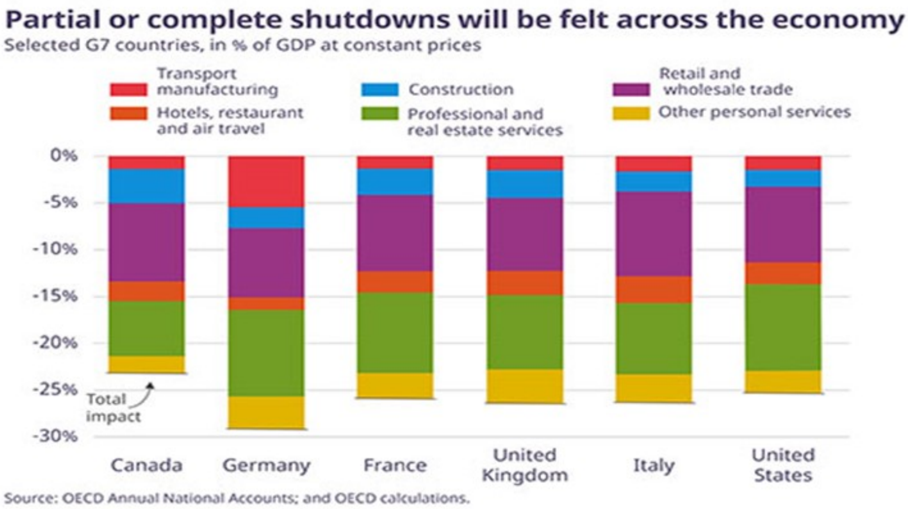
Source: Eurostat, EC, Markit, own calculations.

An *OECD* analysis indicates that the magnitude of the **initial direct impact** of the measures to contain the epidemic is more severe than the contraction during the Global Financial Crisis (GFC).[7] Their **sectoral analysis** suggests a **decline in the level of output of between one-fifth to one-quarter** in many economies, with consumers' expenditure potentially dropping by around one-third. This estimate reflects neither any additional indirect impacts nor offsetting factors. The forecast developments correspond to a decline in annual GDP growth

[6] https://voxeu.org/article/coronavirus-and-macroeconomic-policy

[7] http://www.oecd.org/coronavirus/en/

of up to **2 percentage points for each month** of continued strict containment, and between 4 and 6 percentage points for each quarter of shutdown. *IMF* Director Thomsen expects the closure of nonessential services to account for about one-third of output.[8] Hence, **each month translates into a 3%** drop in annual GDP, not considering other disruptions and spillovers to the rest of the economy. *Bruegel*, however, estimates that governments aim at absorbing up to 80% of the shock.[9]



2. What to learn from a comparison with earlier crises?

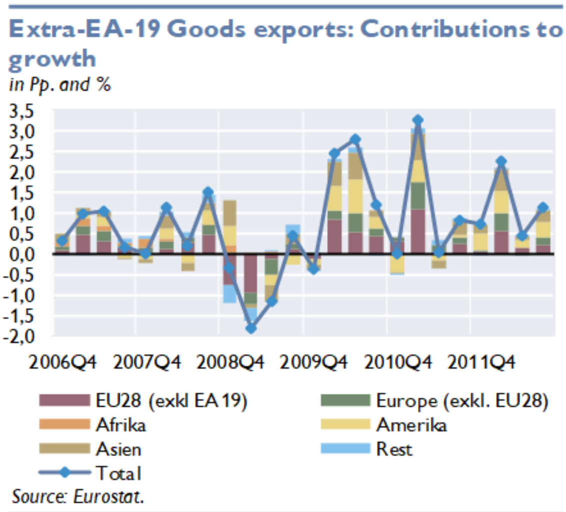
Even if the COVID-19 crisis is hard to compare with the Global Financial Crisis (GFC), some lessons can be learned from such a comparison.

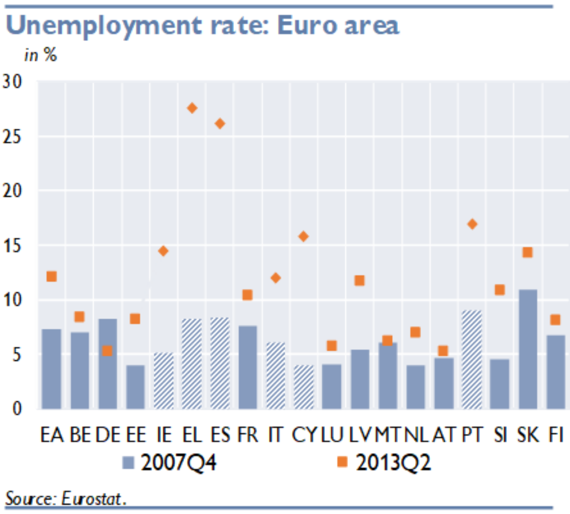
In the GFC case, a **seemingly negligible turmoil** in what was considered to be a rather remote segment of the U.S. mortgage market turned into a global financial and economic crisis from 2007 to 2008. After the **fall of Lehman Brothers** – a major U.S. investment bank – in September 2008 the 'turmoil' quickly turned into a run on international money markets.

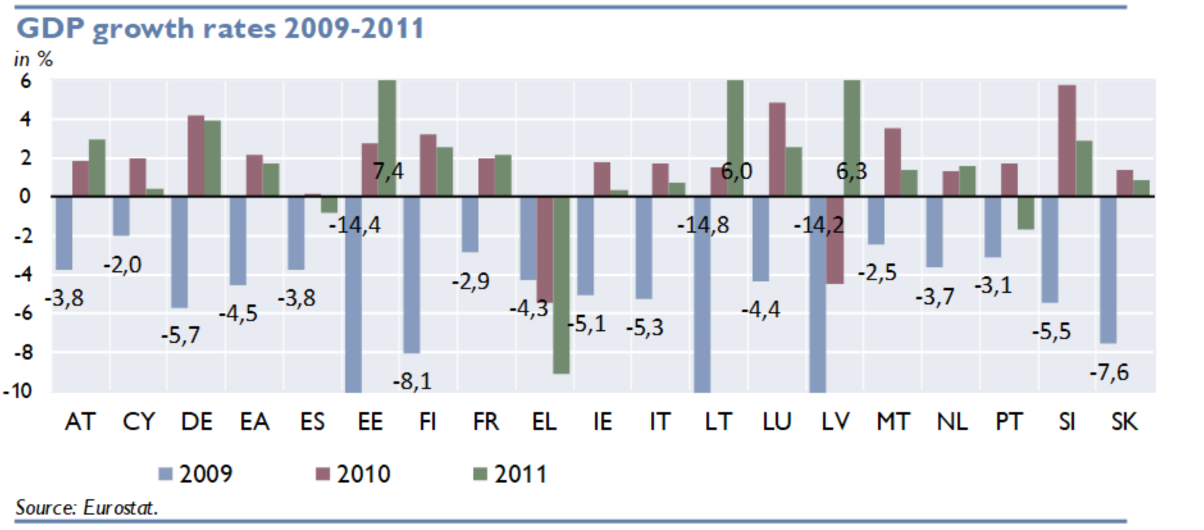
A slump in global **confidence** and a compression of international **trade** flows followed. The **financial sector and industrial sector** were hit particularly hard. Industrial production as well as capacity utilization shrank throughout the currency area. **All countries** experienced a shrinkage of GDP in 2009. The unemployment rate rose; led by lay-offs in the industrial sector.

[8] https://blogs.imf.org/2020/03/30/europes-covid-19-crisis-and-the-funds-response/

[9] https://www.bruegel.org/2020/04/will-the-economic-strategy-work/







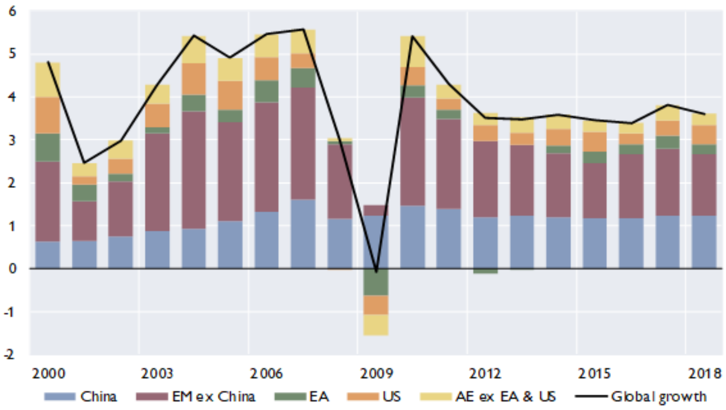
The crisis of 2009 was characterized by three key aspects:

- <u>Financial imbalances</u>: The crisis followed years of **misallocation**, causing the value of many asset classes to evaporate in a flash. The result was a mismatch between debts and assets on the **balance sheets** of many firms and banks that hampered the recovery process.

- <u>Euro area imbalances</u>: While the initial negative shock hit the euro area in a largely symmetric way, it subsequently revealed deeper-seated **imbalances** between member states of the **euro area**. Several countries were dragged deeper into recession by a **finance-fiscal doom loop**. As a result, the impact – particularly on labor markets – differed markedly between euro area members.

- <u>Not all economies went into crisis mode at the same time</u>: In 2009, **emerging economies, most notably China**, contributed approximately as much to global GDP growth as advanced economies lost. After the onset of the global financial crisis in 2008/09, China and other **emerging economies** drove the upswing by accounting for approx. **three quarters of global growth** between 2010 and 2018.

Contributions to global real GDP growth
Percentage points



Source: Own calculations based on IMF WEO (October 2019).
Note: Growth contributions are calculated based on the series "gross domestic product based on purchasing-power-parity (PPP) share of world total (percent)" and real GDP growth, both on the country level.

It took long before forecasters captured the extent of the slowdown. U.S. house prices had started to decline in late 2006 but the trigger-event for the crisis becoming global (the collapse of Lehman Brothers) did not come until September 2009.

The 2008 **winter forecast** round was the first forecast round to see the euro area growth entering **negative territory**. Thereafter, forecasts did not converge toward the final figure (-4.5%) **until summer** 2009, shortly before half-year data were becoming available.

The **Spanish flue** is another often quoted benchmark for a COVID-19 recession. This **pandemic** of 2018/19 claimed a death toll of roughly 2% of the global population. Barro et al. (2020)[10] estimate that the Spanish flu death rate corresponds to 6% decline of GDP. Interestingly, the results are **correlated** with a country's **real per capita GDP**, implying a stronger impact on developing countries. However, comparison of the two pandemics has its limits since **public health** is in a much better shape today and since **medical innovation** allows for more effective treatment today than in the poor times after WW I, when many economies were sustained by **war production** (Reinhart, 2020).[11]

3. Major differences between 2020 and 2009 (as well as 1918)

1. Available indicators point to a **much faster** unfolding of the current crisis.

2. **Services** were initially hit more strongly than production by the current (partial) shutdown, but the **production** sector followed sequentially.

3. **Unlike in** 2008, finance is just a transmitter and amplifier but not a trigger. While banking is smaller and better prepared now, the **shadow banking** sector is bigger than it was during the GFC.

4. **Corporate credits** have peaked recently and could pose significant vulnerabilities, particularly in the **energy sector** hit by an additional oil price shock.

[10] Barro, R., J. Ursua and J. Weng. 2020. The Coronavirus and the Great Influenza Epidemic - Lessons from the "Spanish Flu" for the Coronavirus's Potential Effects on Mortality and Economic Activity. CESifo Working Paper No. 8166.

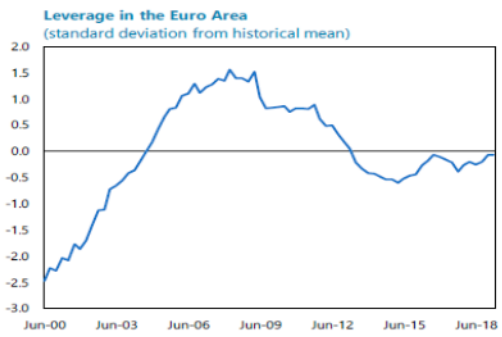
[11] Reinhart, C. 2020. This time truly is different. Project Syndicate, 23 March.

5. **China** is much harder hit today, making a recession this year extremely likely. China played an important role fostering the global recovery during the GFC. In principle, today, China could be a "**demander of last resort**." The Chinese economy accounts for at least 16% of world output (World Bank figure of 2018) – more than twice its share in 2008 (around 7%) and one-third of global growth. On the other hand, the policy space of China may be smaller than in 2009, given its own domestic imbalances (public and private debt). Further, is it unclear whether China can kick-start its economy without triggering a second wave of COVID-19 cases. If it can and if trade tensions get resolved, it may use its levers to foster its global economic and political position.

6. Other **emerging and developing economies** may be more **negatively affected** than in 2009. Their societies and health systems are less prepared for the pandemic, and their economies and financial systems suffer from typical risk-off phenomena, such as capital outflows, commodity price declines and currency devaluation as well as dollar shortage. Developing countries are particularly vulnerable as their total debt reached 191% of their GDP in 2018 – the highest level ever (UNCTAD), three-quarters of it private (corporate bonds), one-third held by external creditors in foreign currency – and most of it due soon.[12]

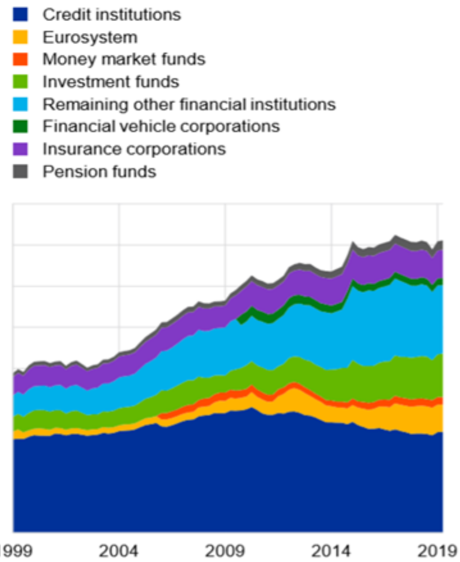
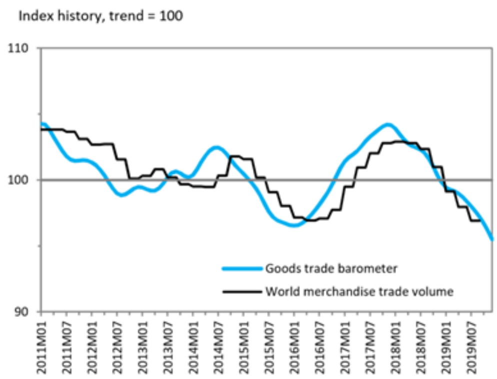
7. On a positive note, **governments** are generally **more proactive today** – on liquidity rather than solvency issues, for the time being. At the same time, EMU now benefits from having put **crisis management framework** in place, with the caveat that the effectiveness of this framework remains questionable in the presence of sovereign-banks doom loops.

Key differences between 2008 and 2020 at a glance

Sector	2008	2020	Illustration
Banking	• **Highly leveraged** • **High profitability** before the crisis • **Sovereign-bank loop prolonged crisis in the EA**	• **Smaller leverage** in the EA • Existing **resolution plans** • **Low profitability** before the crisis • **Sovereign-bank loop?**	Source: IMF staff estimates, based on Growth-at-Risk Tool. Note: The chart shows an aggregate indicator based on growth in nominal credit and credit/GDP, market capitalization/GDP, house price-to-rent and house price-to-income ratios. 13

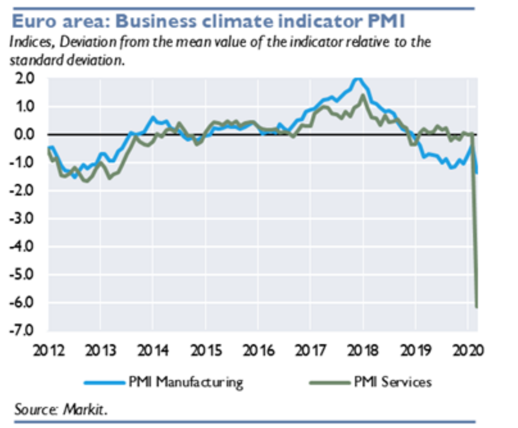
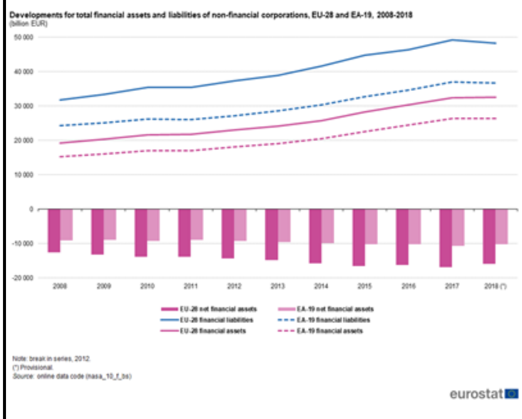
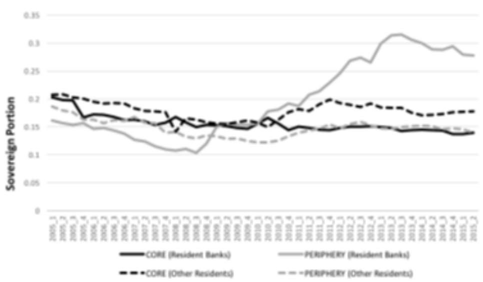
[12] https://unctad.org/en/PublicationsLibrary/gds_tdr2019_update_coronavirus.pdf?user=1653

[13] Source: www.IMF.org/~/media/Files/Publications/CR/2019/1EUREA2019001.ashx

Shadow banking	• **Fueled** the **housing bubble** in the U.S. • **Run** on shadow banking **triggered crisis** • **Transmitted** to the EA **via money markets** • Low degree of interconnectedness in the EA (5.6% in 2006)	• Considerably **larger in the EA** • Interconnectedness appears to be somewhat larger (8% in 2017)	**Total assets of the euro area financial sector** (ratio to nominal GDP; March 1999-June 2019)[14] 
Inter-national trade	• **Considerable slump** in world and extra-EU trade • First **trade credit** cut-off • Then driven by a **slump in demand**	• **Considerably larger slump** to be expected • Driven by more factors: • (Larger initial) **Fall in demand** • **More non-tariff measures** • **Revolving** and unpredictable **interruptions of value chains**	**WTO: World trade barometer**[15] 
Manu-facturing	• **Hit first and hardest,** most of all by the decline in international **trade**	• Affected by the **decline in trade** and the interruption of value chains • Later by workers caring for schoolchildren, being affected or locked out • Ultimately affected by drop in consumer demand due to lost income and forgone consumption opportunities	

[14] Source: www.ECB.europa.eu/pub/fie/html/ecb.fie202003~197074785e.en.html#toc14

[15] Source: https://www.WTO.org/english/news_e/news20_e/wtoi_17feb20_e.pdf

Services	• Hit **only in second round** • Public sector of crisis economies hit hard-est	• Immediately and **excessively hit by lockdowns** (PMI dropping more than manufacturing) • **Some sectors** (e.g. tourism) **typically highly leveraged** • No catch-up consumption to be expected	
Corporate sector	• Relatively mildly leveraged	• Historically **high leverage** • **Shale oil** producers already overly indebted → oil price slump, chain reaction?	 [16]
Emerging markets	• Broadly stable thought crisis • **U.S. dollar shortage** at beginning of crisis • China boosted global recovery in 2009/2010	• EM even more **effected** by health crisis? • **Dollar** shortage • Total **debt of devel-oping countries** highest ever	 [17]
Sovereigns	• Caused double-dip recession • Initially **no** collective **crisis management** framework	• **Italy**: home bias even stronger • **ESM** & OMT exist • **Rising yields** on safe assets – troubling sign?	 [18]

[16] Source: Eurostat

[17] Source: MSCI Emerging Markets Index

[18] Source: Domestic Banks as Lightning Rods? Home Bias and Information during the Eurozone Crisis, cesifo Working Papers 7939, 2019, November 2019

4. There are many open and unresolved issues at this point

The length and the shape of the current recession (**V** or **U**, or even **L**) depends on the answers to following questions:

1. **How long will the shutdown last according to existing research?** A recent report by the Imperial College COVID-19 response team[19] indicates that without any intervention the peak (!) of mortality is expected to occur three months after the initial outbreak. However, by that point, the health care system will be completely overwhelmed, and mortality will be much higher than under alternative scenarios. The most successful alternative, i.e. the suppression strategy (followed by and large across continental Europe), however, will hardly be able to completely prevent human-to-human transmission in densely populated countries; at least absent any coordinated trans-European strategy. As a result, this approach can probably just buy time; either until efficient tests are available that facilitate (regular) cross-tests of the entire population, or until a vaccine is available (estimated by the researchers to take 12-18 months).

2. **Will the shutdown be short enough to avoid a balance sheet recession?** The measures to counter COVID-19 exacerbate existing domestic and global imbalances (private and public indebtedness, etc.).

3. **Will the offsetting monetary and fiscal interventions be enough?** At a first glance, they are at least more aggressive than those taken during the GFC: 2/3% of GDP purchases by the ECB, 2% of GDP discretionary fiscal stimulus and 13% of GDP in terms of guarantees. Arguably, governments must fulfil a role as "**payer of last resort**" (Saez and Zucman, 2020)[20] in the face of this emergency unprecedented in the post-war period. Thus, the knock-on question is: can businesses keep paying their workers (instead of laying them off) and their necessary bills such as rent, utilities, interest, etc. (instead of going bankrupt)?

4. **Can we revive the economy as quickly as it lapsed into coma?** Moreover, to what extent will that economy be the same as it was before the crisis, given prolonged hesitance to revive social contacts? Since the current crisis has a vast impact on individual behavior it might trigger structural change. Sectors such as tourism or passenger aviation might experience a permanent shock. In contrast, online services might have got a level boost. More generally, the temporary freeze of economies and value chains could alter the nature and character of international trade. A trend to local production and value chains would add to the populist pressure on globalization in recent years. Despite their costs in terms of short-term economic growth, these developments would, after all, help achieve committed decarbonization targets. A 'green recovery' fostered by climate-friendly investment programs could add to that, although this term remained just a catchword during the GFC.

5. **Will China again play a positive part in fostering the global recovery?** Even before the outbreak of COVID-19, growth projections for China were subdued. Thus, it is almost certain that GDP will significantly contract in Q1/20 year on year for the first time since the publication of comparable data in 1989. It is not clear if the gradual reduction of the draconian measures taken in Wuhan and beyond will allow a quick rebound of growth. So far, however, there is little evidence that China will have the role it did during the GFC: the central bank has only taken moderate action by slightly lowering lending rates and reducing minimum reserve requirements to free additional funding for bank loans of USD 79 billion. The fiscal

[19] https://www.imperial.ac.uk/media/imperial-college/medicine/sph/ide/gida-fellowships/Imperial-College-COVID19-NPI-modelling-16-03-2020.pdf

[20] https://gabriel-zucman.eu/files/coronavirus.pdf

intervention is even less clear. Given its increasing domestic orientation and its worrying level of indebtedness, China will likely focus on its own interests, domestic and elsewhere. But however unlikely it might be, a massive, construction-heavy stimulus program to revive its domestic economy as launched in 2008/9 could benefit export industries elsewhere, particularly in Europe.

6. **How will the huge government interventions be financed?** Not only is the scale of the current fiscal injections unprecedent. While in 2009 many governments acquired assets that partly helped to reduce incurred debts (e.g. the US through TARP) now governments increasingly embark on tools such as direct cash handouts. It will be crucial for the post-crisis economy to find growth-friendly ways to finance these debts and to make sure that its distributional impact will be conducive to overall societal stability.

7. **Will the EMU crisis management framework suffice** in the case of another sovereign debt financing crisis triggered by vulnerabilities in peripheral euro countries? Has the framework been sufficiently adapted in order to prevent a resurgence of the centrifugal forces in the Euro area? Given that Europe suddenly became the epicenter of the crisis of late, collective measures taken by the EU (Council) thus far – including a relaxation of fiscal rules and a joint bid for protective equipment – appear inadequate, even if the response of individual EU member states and the ECB partly fill this gap (with the latter refueling debates about the overburdening of the ECB).

About the authors

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