MACRO UPDATE: FORECAST CHANGES, POLICY RESPONSE TO THE VIRUS

Berenberg Macro Flash

Forecast changes
For the next few months, our economic and financial forecasts will be shaped much more by the coronavirus epidemic than by economic fundamentals or shifts in monetary and fiscal policy. That the number of active COVID-19 cases outside China would rise significantly through April had been part of the calls we updated a week ago (see chart below). However, the semi-lockdown which Italy has imposed on Lombardy and some nearby regions in the economically strong north of the country goes beyond the disruptions we had anticipated. These measures affect 16 million people, more than one quarter of the Italian population. They are scheduled to last until at least 3 April.

The semi-lockdown with serious travel restrictions exacerbates the near-term damage significantly. It seems to be less draconian than the lockdowns China has enforced on much bigger regions. It may thus not be quite as effective as the recent measures in China where the number of active coronavirus cases continues to decline (down from a peak of 58k on 17 February to 27k on 6 March). With luck, the Italian response can at least help to slow down the advance of the virus, giving the Italian health system and other countries more time to prepare for a further rise in cases. However, beyond the direct impact on activity, the Italian measures – and the possibility that other parts of Europe may move in the same direction in coming weeks – are likely to weigh significantly further on confidence near-term.

In response, we have cut some of our key economic forecasts further (see Forecasts at a Glance). We now expect a Eurozone recession in the first half of 2020 and believe that the recession in Italy and Germany will be deeper than we had anticipated a week ago.

Italy: We now expect GDP to decline by 1.0% instead of 0.3% in Q2. With a downward revision to Q1 GDP from -0.1% to -0.8%, this takes our forecast for the full year 2020 to -1.2% from -0.3%.

Eurozone: We now project that GDP will fall by 0.4% qoq in Q1 and 0.5% qoq in Q2 instead of stagnating in Q1 and falling mildly by 0.2% qoq in Q2. For full-year 2020, we look for a contraction of -0.1% instead of growth of 0.5%.

Germany: We now look for declines in GDP by 0.2% and 0.6% qoq in Q1 and Q2 instead of falls by just 0.1% and 0.2%, respectively. That brings our annual forecast 2020 as a whole to -0.4% instead of 0%.

France: We now expect GDP to rise merely by 0.1% instead of 0.2% qoq in Q1 and contract by 0.3% instead of advancing by 0.1% in Q2. For the full year 2020, we now look for growth of just 0.3% instead of 0.8%.
**UK:** We reduce our 2020 call to 0.9% from 1.3% previously after lowering Q1 to 0.3% qoq from 0.4%, Q2 to 0.0% qoq from 0.3% and Q3 to 0.3% from 0.4%. We expect the UK to announce a sizeable fiscal stimulus in response to the virus-related disruptions on 11 March.

We also reduce our calls for 2020 GDP growth in **Spain, Portugal, Switzerland and Sweden** accordingly.

We maintain our view that economic activity should start to rebound by the end of Q2 as the outlook for the epidemic becomes clearer. However, the risks are rising that the virus-related hit to growth may turn out to be more protracted. Conversely, partial lockdowns in more regions could cause a significantly deeper hit to economic activity in March 2020 and in Q2, followed by a stronger snapback from such depressed levels once such lockdowns are eased.

**The role of monetary and fiscal policy**

The world is facing a medical emergency that monetary and fiscal policy cannot fix. The situation will settle down once we have more clarity about the future course of the disease. Until then, we face serious downside risks. This is very different from the post-Lehman and the euro debt crisis when monetary policy (massive Fed bond buying in early 2009 onwards, Draghi’s “whatever it takes” in July 2012) made the crucial difference.

The monetary and fiscal policy responses matter a lot for the day-to-day moves of markets as the volatile reaction to the Fed's intermeeting cut of 50bp on 3 March has shown. To some extent, monetary and fiscal policy can contain second-round risks such as those of equity sell-offs dealing an additional serious hit to consumer confidence and corporate balance sheets. Policy can also limit the damage to demand and prevent a supply-side shock exacerbating the demand side shock by creating acute cash-flow problems across the economy. However, much of the additional fiscal stimulus and the effect of lower interest rates on credit demand will likely unfold only in the second half of this year, that is at a time when we will already know much more about the course which the Covid-19 disease is taking.

**The potential ECB response**

The ECB will most likely react to the virus epidemic at its meeting this Thursday. Unlike the Fed and the BoE, the ECB has limited room to act as its key rates are already at zero or negative and it is facing a dearth of investible sovereign bonds under its current rules. Cutting the deposit rate from -0.5% to -0.6% or -0.7% and injecting more liquidity into a system already awash in cash would not make much of a difference. We thus see a slightly less than even chance that the ECB response will include a deposit rate cut at this stage. More likely, the ECB will announce some targeted measures such as new generous liquidity injections or re-financing facilities for banks aimed at keeping liquidity flowing to small and medium-sized businesses. The ECB could also raise the amount of monthly bond purchases temporarily and tilt these purchases more towards corporate bonds. If the ECB were to cut the deposit rate, it would make the tiering system more generous for banks at the same time so that the overall package does not hurt banks.
**German fiscal stimulus**

Even pre-corona, Germany was on track to ease fiscal policy by co.4% of GDP this year as part of an ongoing multi-year slow-motion stimulus. This will now likely be scaled up to some 0.6% of GDP. Last night, coalition leaders in Berlin agreed on a combination of targeted help to address cash-flow problems, modest tax relief for businesses and more investment spending. From 2021 through 2024, the federal governments wants to raise its investment spending by €3.1bn per year. In addition, Germany’s most effective automatic stabiliser, the *Kurzarbeitergeld* scheme, will be easier to access and more generous for employers. As in 2008/2009, this scheme could be the biggest single factor to dampen the impact of severe disruptions in parts of the economy to overall household incomes and spending.

**Chart 1: Coronavirus infections: Active cases (in thousand)**

![Chart showing active coronavirus cases](chart.png)

*Daily data. As of 6 March. Active cases are confirmed cases adjusted for recovered cases and deaths, in thousands. Source: Johns Hopkins University, Berenberg.*