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AFTER THE VIRUS: THE TWO-YEAR RECOVERY

Berenberg Macro Flash

Pandemic update: The number of confirmed infections is rising more slowly. In Europe, the number has gone up by 16% in the last three days to 524k after a 21% three-day increase yesterday and 29% last Tuesday. In the US, the number is up by 32% to 368k in the last three days after +38% yesterday and +57% in the three days to 31 March according Johns Hopkins University as of the morning of 7 April. While the numbers have to be interpreted with caution as they may reflect different testing patterns, they do raise the hope that the first of the economically crippling lockdowns can be eased at some time in May (see our macro essentials).

AFTER THE VIRUS: TWO YEARS TO GET BACK TO PRE-CORONA GDP

The advanced world is grappling with the worst plunge in output in living memory. How long will it take to return to the pre-corona GDP peak once the economy has hit bottom, presumably in Q2 2020? We expect that the losses incurred in the first two quarters of 2020 will be recovered within two years thereafter. We look for a tick-shape recovery. Some observers view this as optimistic. It may well be. The risks to our calls are clearly tilted to the downside, especially for the near-term. However, it is achievable as long as policy makers meet three conditions:

1) They prevent the pandemic from recurring in a new disruptive wave in late 2020 or early 2021. To achieve this, they may need to maintain heavy restrictions on travel with high-risk countries where the pandemic may not yet be under firm control in 2021. Eventually, a vaccine will help.

2) They do not allow the massive shock to the real economy to trigger a serious follow-up financial crisis that would exacerbate and prolong the recession. The current "whatever it takes" policy response, including a readiness to beef it up fast wherever problems occur, supports this hope.

3) Well beyond the initial measures to contain the economic fallout from the pandemic and the lockdowns, they support the subsequent upturn more strongly than they did in the past. If so, the initial reluctance of households to spend and of businesses to invest will be offset over the course of 2021 by more public spending on healthcare, welfare systems as well as on infrastructure, technology and green investment.

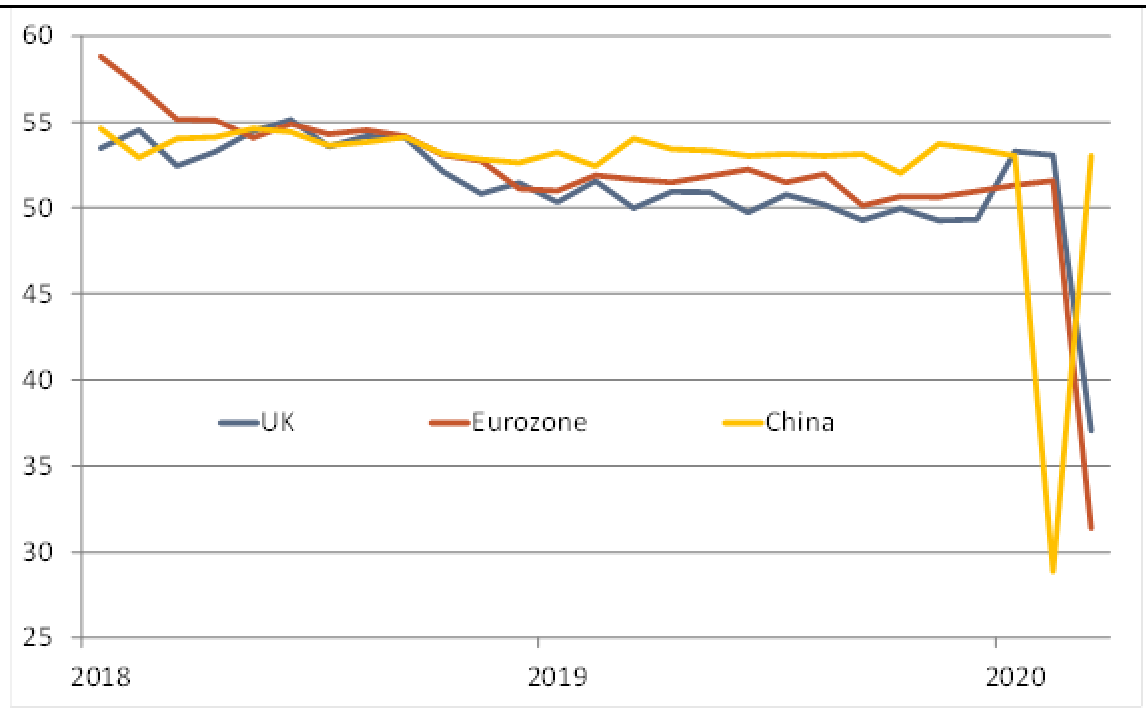
Countries can get back to the pre-crisis level of GDP two years after the trough of a deep recession. As our chart shows, the US, Germany and France began to surpass their Q2 2008 GDP two years after the trough of the post-Lehman mega recession. However, some other countries failed to do so because they tightened fiscal policy too early (the UK), had to digest the inevitable collapse of a vastly overblown and heavily labour-intensive residential construction sector (Spain), fell victim to the euro confidence crisis (Spain and Italy), and/or suffered from serious structural problems (Italy).

This time, the risk of premature fiscal tightening seems remote. We find no major pre-crisis excesses in the real economy that would warrant a lasting plunge in activity akin to that of Spanish residential construction after 2007. That leaves the Italian risk. Because Rome failed to follow up on the Monti/Renzi/Gentiloni reforms of 2012-2018 but reversed some of them instead, Italy will likely suffer a sub-par recovery after the trough of the current recession. Other countries look set to fare better, though.

Of course, the aftermath of the current recession will differ from the situation after the 2008/2009 financial crisis. On the negative side, the current fall in GDP will likely be significantly worse. On the other hand, the world is experiencing an unusual parallel drop in supply and demand. What has to be switched off now can mostly be switched on again with only modest problems once the lockdowns are eased again. Today, the unusually aggressive response of monetary, fiscal and regulatory policy limits the damage to post-crisis demand and supply. Whereas lingering financial stress and an ongoing cleansing of prior excesses typically weigh heavily on the rebound of demand after a financial crisis, we expect this to be less of a factor after the Covid-19 pandemic. We foresee some financial stress but no grave financial crisis. Also, memories of 2008/2009 and the 2011/2012 euro crisis are still fresh. Policy makers will react quickly to any signs of relevant stress before it could seriously hold back the recovery of demand.

Of course, our call that GDP across most of the advanced world can return to its pre-corona level two years after the trough and continue to expand at an above-trend pace for a few years thereafter is more than just a forecast based on an economic analysis. Even more so, it is a bet that policy makers will get it mostly right. That highlights a key risk to the call. A major policy error could do serious damage. Fortunately, monetary and fiscal policy have made a pretty good start in the last four weeks. Let us hope that, at their Eurogroup meeting this afternoon, Eurozone finance ministers send a clear signal of solidarity within Europe that would help to contain some of the financial and – even more so – some of the political risks – see also the overview of EU/Eurozone policy responses.

Chart 1: Real GDP before and after Lehman



2Q 2008 = 100. Sources: Eurostat, BEA

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