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Research Briefing | Europe

Who's best – and worst – placed to recover in H2?

Economist

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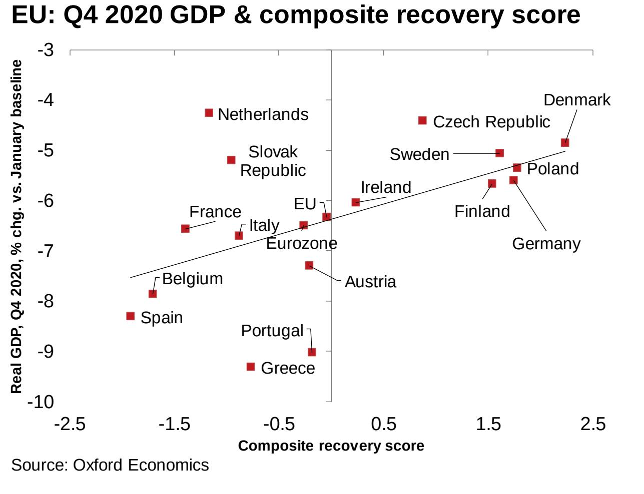
- **The EU has entered the initial stages of an economic recovery as the spread of the pandemic has slowed materially, allowing governments in most countries to begin easing lockdowns. Yet, we expect the recovery in H2 to be gradual, incomplete, and divergent across countries, with the speed and extent of economic rebounds depending on three key factors.**
- **The length and severity of lockdowns are a proxy for the damage dealt to the economy. Larger income losses are bound to constrain the boost from pent-up demand. Spain, Ireland, France, and Italy look particularly at risk on this metric.**
- **A previous analysis of countries' structural pandemic vulnerability shows that Northern European as well as the German and French economies look better positioned to weather the shock than countries in the eurozone periphery.**
- **Lastly, governments' discretionary fiscal easing indicates how much of the initial economic damage and structural vulnerability policymakers will be able to offset. Poland, Ireland, and Denmark are ahead of the pack on that metric.**
- **Combining the three metrics, Denmark, Poland, and Germany look best placed to rebound, with Spain, Belgium, and France likely to suffer a subpar recovery.**

Bad news is still dominating in Europe as successive data releases clarify just how deep the pandemic and lockdowns will push the economy into recession. We expect EU GDP to plummet by 13% in H1. But a gradual recovery is already under way as governments in most countries have started to ease lockdowns (**Figure 2**). This will allow more and more people to return to work (**Figure 3**), consumers to spend some of any excess savings, and fiscal stimulus measures to feed through to activity. However, the recovery is likely to vary significantly (**Figure 1**) between countries and will crucially depend on a few factors.

Figure 1: Countries' recovery prospects across Europe show a worrying variation



We expect the EU economies' recovery from the pandemic shock to be very uneven. Our new composite recovery score highlights three factors that will help determine the pace and extent of countries' rebound in H2 this year. It combines the lockdown severity and length, countries' structural pandemic vulnerability, and the size of their fiscal responses. All told, it suggests that Denmark, Poland, and Germany are well placed to recover.

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We think the following three factors will help determine the speed and extent of economic rebounds in H2 2020:

- The **damage being dealt to the economy** during the lockdown via income losses and bankruptcies
- Countries' **structural vulnerability to the pandemic** and governments' containment steps
- The size of **governments' discretionary fiscal easing** to jump-start the recovery and partially offset the economic damage from the lockdown.

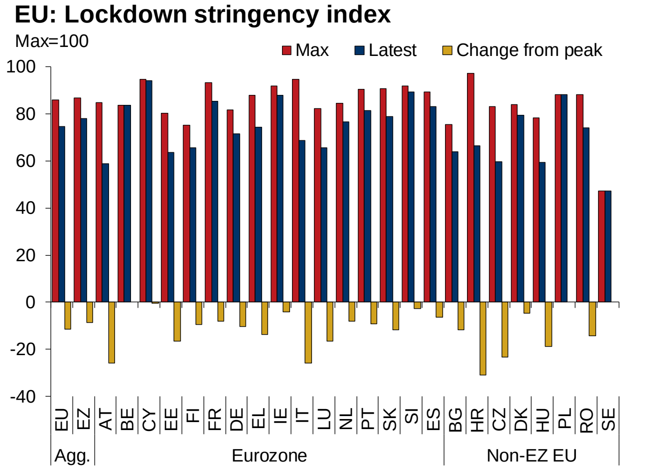
Hard economic data will ultimately tell us how large the economic damage from the pandemic and the lockdown was in H1. In the meantime, we rely on our GDP forecasts. But given the unprecedented nature of the current crisis, we complement our analyses with various proxy measures to get a better sense of real-time growth dynamics.

The length and severity of the lockdown should be a useful proxy for the damage the pandemic dealt to the economy. The lockdown stringency index from Oxford University has shown a high correlation with Q1 GDP growth figures in the eurozone (**Figure 4**). We expect that this will broadly hold in Q2 as well. A longer lockdown is likely to exhaust more firms' liquidity and capital reserves and trigger a larger loss of wage incomes, even with many countries having put in place short-term work schemes. This will restrain pent-up demand. A more severe lockdown will likely affect a larger share of the economy.

Despite their close geographic proximity, **countries have shown a large variation in the lockdown length and severity** (**Figure 5**). Lockdowns in Finland, Denmark, and Germany were among the shortest and least severe because they were far from the hotspots and benefitted from an early warning and timely introduction of containment measures. We removed Sweden from the chart because it's an outlier and data on its lockdown likely grossly understates the hit to the economy as people voluntarily reduced contact.

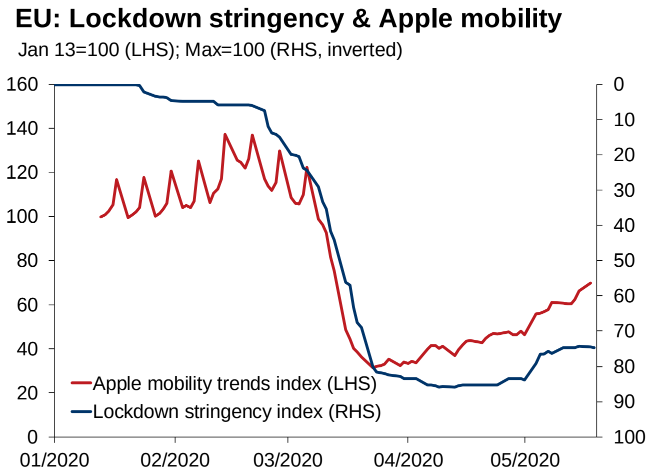
On the other end of the scale, **Spain, Ireland, Romania, France, Italy, and Portugal had to endure particularly long and harsh lockdowns.** This was broadly reflected in their Q1 growth figures, with GDP falling by 5.8% in France, 5.2% in Spain, and 4.7% in Italy compared to Germany's -2.2%. Some particularities may help explain France's underperformance, but we expect these countries to also be among the worst performers in Q2. This will put them at a large disadvantage in the race to recoup these losses in H2.

Figure 2: Most governments have begun to ease their lockdown



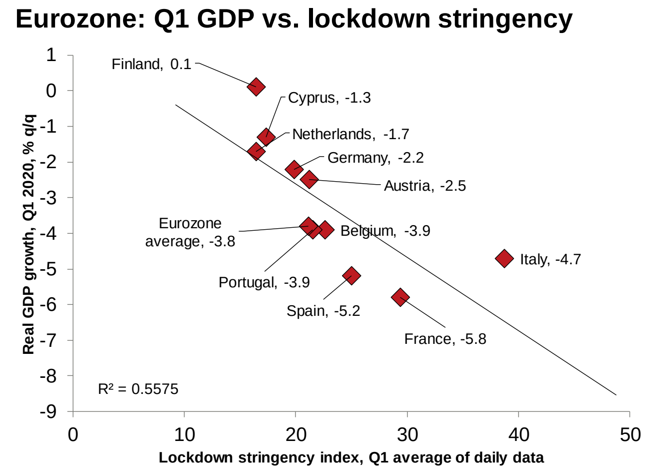
Source: Oxford Economics/Haver Analytics/Blavatnik School of Government

Figure 3: Real-time mobility data suggests that a gradual economic recovery has begun



Source: Oxford Economics/Haver Analytics

Figure 4: Lockdown stringency explains much of the variation in Q1 GDP across the eurozone



Source: Oxford Economics/Haver Analytics/Blavatnik School of Government

Who's best – and worst – placed to recover in H2?

We also recently built a Structural Pandemic Vulnerability Score to gauge how well EU countries are placed to deal with the pandemic (see also here). We split the score into the components relating to external and internal vulnerabilities (**Figure 6**). **Italy, Portugal, and Ireland — three countries that experienced among the harshest lockdowns — are also among the more vulnerable.** Italy and Portugal are likely to suffer under their weak economic structures and reliance on tourism. The same is true for Greece. Ireland is mostly exposed via its very large manufacturing sector that relies on exports, which is also a drag for Slovenia and the Czech Republic. The latter are additionally at risk from their reliance on and integration into industrial supply chains, which may stutter given uncoordinated easing of lockdowns.

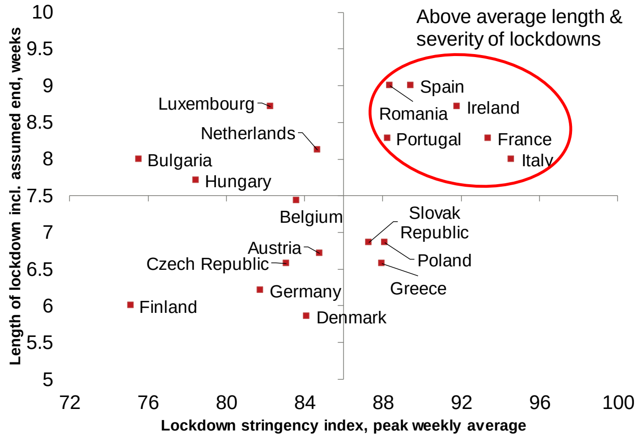
On the positive side, **France, Denmark, Sweden, and Germany may be somewhat sheltered**, although we do worry that this indicator understates the reliance on exports and manufacturing in the latter three countries, especially Germany with its focus on investment goods and cars, which are likely to face a period of subdued demand.

The last aspect we want to highlight is countries' fiscal response. A strong fiscal response can offset some of the income losses stemming from the recession, and it can help jump-start the recovery. We have looked at the size of the fiscal responses in detail (here and here). What stands out from that analysis is that **countries with deeper recessions this year and generally weaker public finances look on track to also suffer from a weaker discretionary fiscal response** (red columns in **Figure 7**). In contrast, some of the countries that coped comparatively well, such as Poland, Ireland, Denmark, the Czech Republic, and Germany, also benefit from solid fiscal support. Although in the case of the Czech Republic, we think implementation and composition of the fiscal response undermines effects.

We have combined the three factors into a single number, the Composite Recovery Score (**Figure 8**). **The main takeaway is that most countries facing a harsher lockdown and higher structural vulnerabilities are also at risk from a subpar fiscal response**, while the opposite is true of countries on the other end of the spectrum. Given the prevailing high uncertainty, the score offers a valuable framework that informs our GDP forecasts for H2 2020. **Countries with a higher (lower) Composite Recovery score are likely to see their economies converge faster (slower) towards their previous growth path (Figure 1).**

Figure 5: Spain, France, and Italy suffered among the longest and harshest lockdowns

EU: Lockdown length & severity

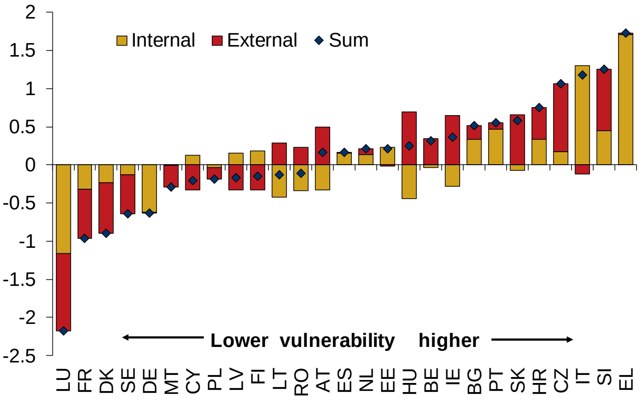


Source: Oxford Economics/Haver Analytics/Blavatnik School of Government

Figure 6: Italy and Greece show an elevated domestic vulnerability to the pandemic

EU: OE structural pandemic vulnerability score

Normalized

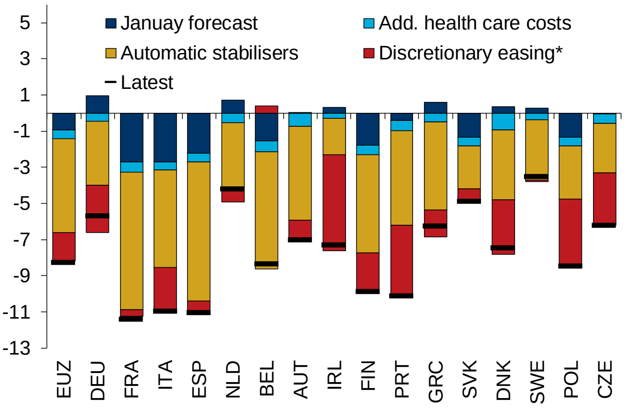


Source: Oxford Economics/Haver Analytics

Figure 7: Discretionary fiscal responses vary greatly

EU: Fiscal balance

2020, components relative to January forecasts, % GDP



Source: Oxford Economics/Haver Analytics (*easing (-) / tigthening (+))

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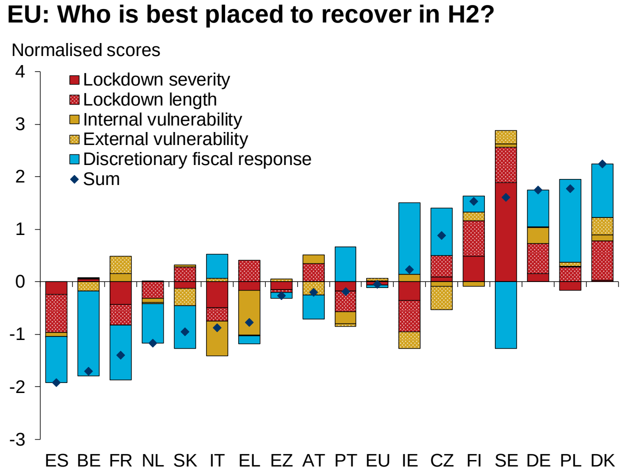
Admittedly, this is a somewhat simplified approach focusing only on a few key aspects, and it glosses over some country-specific factors. Hence, there are some outliers in the chart, such as Portugal, Greece and Netherlands. For the two southern countries, our score understates their exposure to the tourism sector, while in the Netherlands revisions of historic fiscal data wrought havoc with our data. However, this doesn't undermine the validity of the results.

The bottom line from our analysis is this: **The pandemic and the ensuing lockdowns are far from having a symmetric impact across EU countries.** What's more, the countries hit hardest also look set to suffer from a subpar discretionary fiscal response. **What Europe will need is a stronger fiscal response,** preferably at the EU level. This has become more likely after the French-German proposal on a [€500bn EU recovery fund](). But if that proves politically challenging, individual [countries should not shy away from spending]() more on their own.

Figure 8: Denmark, Poland, and Germany look relatively better placed to recover in H2 2020



Source: Oxford Economics/Haver Analytics