

## Focal Point

# The deep economic fallout from global distancing

May 18, 2020



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- Widespread shutdowns amid the Covid-19 epidemic are set to send the global economy into contraction by at least 4% this year, the deepest recession since WWII. The euro area economy will be hit particularly hard (-8%).
- The unprecedented slump in activity in the first half of 2020 may be followed by a rebound from H2 onwards. But it will take until 2022 or beyond for advanced economies to recoup pre-crisis levels of activity.
- Risks remain clearly skewed to the downside. A prolonged lockdown would deepen the 2020 contraction; further waves of infections would result in renewed restrictions, which may delay the recovery even into next year.
- With high uncertainties, rising unemployment and impaired corporate balance sheets dragging on demand for longer, subdued price pressures will prevail this year and next. Soaring public debt levels, ultra-accommodative monetary policies and the threat of deglobalisation may pose upside risks to inflation only in the medium to longer term.

The global spreading of the Corona virus is keeping the world in suspense. Global confirmed infections exceed 4.5m, the death toll has surpassed 300k. Apart from the human tragedy associated with each case, the global economic outlook has deteriorated severely. Most imminently, the economic disruptions from containment measures are a simultaneous hit to supply and demand. These pressures have been complemented by dislocations on financial markets and much tighter financial conditions. The slump in oil prices (following a S. Arabian/Russian price war and collapsing demand) additionally weighs on indebted US shale producers and oil producing EMs more than it benefits consumers in oil importing economies.

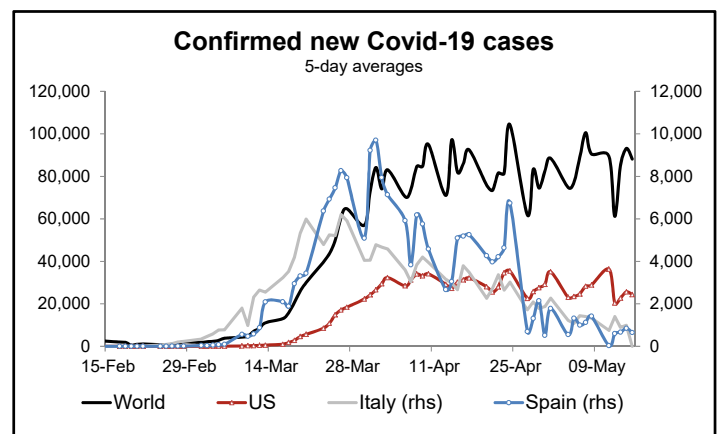
In this note, we summarize implications of the pandemics for our global growth outlook and why the risks to the bleak base scenario are tilted to the downside. In the second part, we detail consequences for the US, euro area (EA) and China.

### The hard way out of the lockdown

Following drastic lockdowns, closures of borders and quarantines, the global spreading of the pandemic flattened over the past weeks (see chart). Many countries have started to ease lockdowns. But surging new cases in countries widely regarded as effective in tackling the crisis (e.g. Singapore, South Korea, but also China) highlight the huge risk of the need for renewed containment measures.

Economic forecasts are thus subject to unusually large uncertainties: regarding the further spreading of the pandemic, the speed of removal of lockdowns and the ensuing hit to business and consumer confidence. In a base scenario, we assume that countermeasures will help to contain the

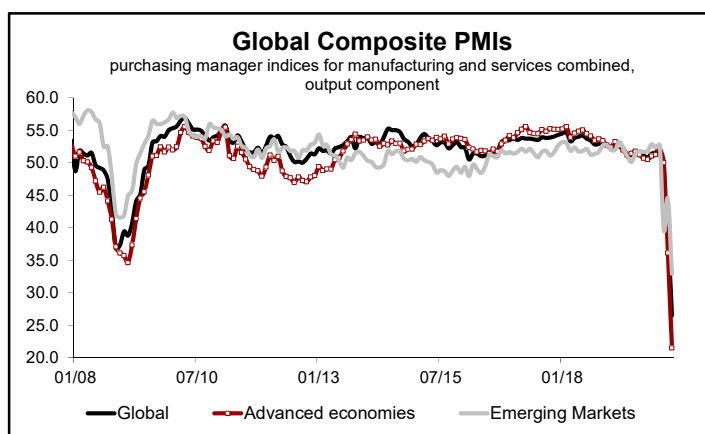
virus (with stable or slightly decreasing infections) – until an effective vaccine can (hopefully) be rolled out in early next year. Yet quarantine measures and restrictions on mobility will be unwound only very gradually. Some segments of the economy, incl. hospitality services, tourism and long-distance traffic, will suffer for longer, as precautionary measures on higher distancing will dent productivity of existing resources more lastingly.



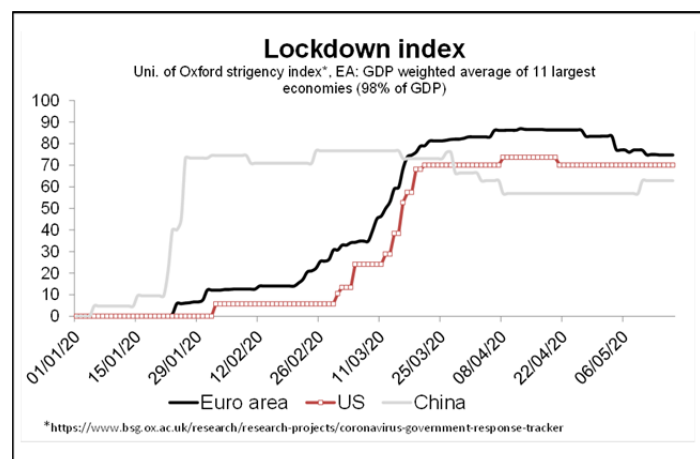
Policy makers have reacted to the crisis promptly and massively, easing the risk of massive defaults and helping to lay the ground for a rebound of activity in H2. Also, corporate balance sheets and bank capitalizations are sounder than at the 2009 Great Financial Crisis (GFC).

That said, with lockdowns now running for two months or even longer and only a gradual re-opening of businesses ahead, the economic fallout will still be very severe. PMIs

are pointing to a deep slump in Q2 (see chart), followed by a drawn-out recovery from summer. Global GDP will contract by at least 4% this year, the deepest slump since World War II and 7 pp below our pre-crisis forecast.



With shutdowns eased, economic growth rates may still rebound in H2. Yet any hopes of a V-shaped recovery will be dashed. It will take years before pre-crisis levels of activity will be recovered in the advanced world. Supply capacities may generally be restored rather quickly. But demand is set to remain hampered for longer. Rising unemployment rates and economic uncertainty will weigh on consumption, with orders of durable goods postponed or cancelled. Similarly, economic uncertainties and weaker corporate balance sheets will restrain capex spending for longer. After a large fiscal splurge this year, governments will need to rein in spending resulting in a negative fiscal impulse in 2021 and beyond, even though fiscal retrenchment will be very cautious given the fragility of the economies. So it will take until 2022 or beyond before advanced economies will have recouped pre-crisis activity.



Soaring public debt levels, ultra-accommodative monetary policies and the threat of de-globalisation may pose upside risks to inflation in the longer term. Disinflationary pressures are likely to prevail this year (with inflation remaining low also in 2021), with a sharply wider output gap compounded by the pass-through of lower energy prices.

### Health risks drive our alternative scenarios

While this outlook may appear bleak, the risks are still tilted to the downside. We are particularly concerned about a prolonged shutdown and much slower resumption of business and (even worse) the risk of repeatedly resurging infections and renewed shutdowns. No economic measure

can have full effect until the health crisis is under control. Our knowledge of COVID-19 remains very limited and it is hard to project whether and when it will weaken. New waves of contagion, resulting from a mutation of the disease or a too hasty lifting of the restrictions, would force a quick return to lockdown. In the worst case, repeated “stop and go” lockdowns may become a new normal until a reliable vaccine and drugs are distributed on a global scale (at least 18 months, according to the more optimistic predictions). Lockdowns are clearly very costly in terms of activity: the OECD for instance estimates that the direct impact (i.e. not counting the effects on global supply chains and confidence) of one month of restriction is around two percentage points of annual GDP.

Annual GDP growth (in %)	Central scenario			Risk scenario		Deeply adverse scenario	
	2019	2020	2021	2020	2021	2020	2021
US	2.3	-7.5	5.0	-9.5	4.0	-11.5	2.0
Euro area	1.2	-8.0	4.5	-12.0	4.0	-14.0	1.0
Italy	0.2	-10.0	5.0	-14.5	3.0	-16.0	-1.5
China	6.1	1.3	8.0	-1.0	5.5	-4.0	1.5
World	2.8	-4.0	5.5	-5.5	4.2	-8.5	1.0

Annual Inflation (% yoy)	Central scenario			Risk scenario		Deeply adverse scenario	
	2019	2020	2021	2020	2021	2020	2021
US	1.8	0.4	1.4	0.1	0.8	-0.1	-0.2
Euro area	1.2	0.3	1.0	0.0	0.5	-0.2	-0.5
Italy	0.8	0.0	1.2	-0.4	-0.6	-1.0	-1.5
China	2.9	2.5	1.7	2.0	0.5	1.6	-1.5
World	2.6	1.8	2.1	1.5	1.7	1.3	1.1

These considerations drove our thinking of two alternative risk scenarios. In the first one, we assume that contagion remains high until the summer, forcing countries to maintain (and partially re-tighten) social distancing measures. Longer lasting restrictions put a bigger strain on public finances, especially in fiscally weaker countries.

In a much more negative scenario, health authorities prove incapable of stopping the contagion and widespread repeated lockdowns are required well into 2021, as no vaccine is available before the second half of that year. This saps confidence, hitting the economy over and above the disruption caused by the shutting down of several activities. The GDP collapse proves too strong for public finances in several states, triggering a wave of rating downgrades and concerns about debt restructuring. The health emergency and financial turmoil greatly depress activity in 2020 and allow for only an anaemic recovery thereafter.

### US: policy response dampened by health risks

In our base case, we expect US GDP to contract by 7.5% this year, before rebounding by 5% in 2021. After a nearly 40% annualized GDP drop in Q2, we see a gradual recovery in H2 underpinned by the unprecedentedly large fiscal stimulus. The US economy will fare only mildly better than the EA, as the lack of a centralized healthcare system and of a tight social security net will increase uncertainty. This will keep consumption growth muted even when the health emergency is over.

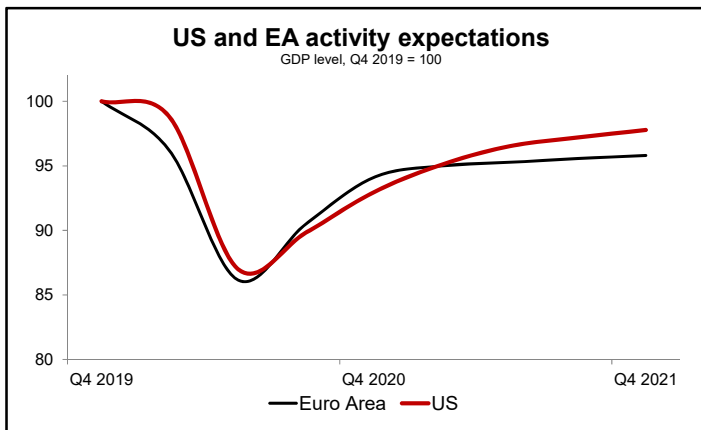
The federal administration is pushing for a quick reopening as new cases have started to stabilize for the country as a whole. However, the decrease is mostly due to the fast drop in New York, New Jersey and Louisiana. Elsewhere new cases are at best stable or still increasing. This raises the risk of a large-scale return to lockdown.

The outlook for the labour market and purchasing powers is the second reason why we expect a gradual recovery only. The unemployment rate rose to 14.7% in April, but this is likely to be underestimated. A considerable number of people temporarily stopped looking for employment in March and April given the scale of disruption. Once they are back into the labour market, the unemployment rate could easily rise to above 20% and may not go back below 10% before the end of the year. The Federal topping up of unemployment benefits is funded until July, but will likely be extended to August. According to estimates based on micro data, it should halve the drop in disposable income to -3% for 2020 as a whole. Yet the impact on consumption may be more severe as precautionary savings may increase given the much higher uncertainty about job prospects originated by the sharp rise and, possibly slow reduction, in unemployment. Congress is debating another fiscal package, including further transfers to households, which should be put into law by the end of June. This should reduce uncertainty, but the size and details are still subject to discussion.

Finally, uncertainty will be detrimental for private investment. Oil producers will have to [curtail capex](#) at least over this year as the shale industry needs to cut capacity and faces a deep restructuring, with several small operations disappearing or being acquired by larger firms. Non-oil companies will not provide much of an offset, as they will remain cautious, given the need to reassess the outlook for demand and for global supply chains.

All this will have a clear disinflationary impact, which adds to the effect of record low oil prices. We expect core inflation to dip to below 1% in the second half of the year and not to return to 1.5% before Q3 2021.

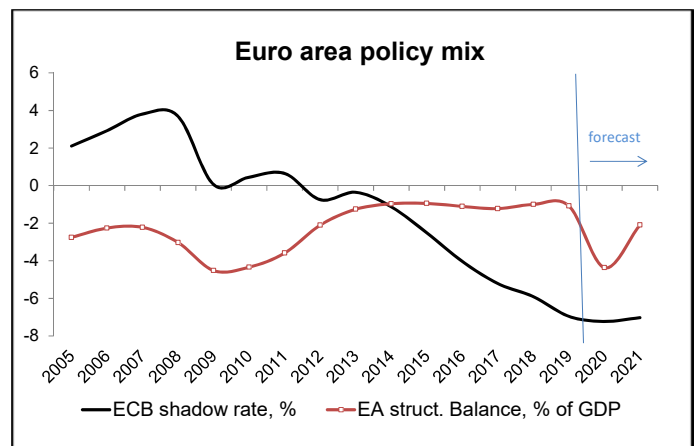
The Fed set up a huge rescue plan, whose most important measures (bond buying and support to banks' liquidity) are open-ended. This should ensure a powerful response also in the most negative scenarios. As recently reiterated by Chair Powell, most of the further support will have to come from the fiscal side. The extension of the lockdown into the summer would drag 2020 contraction down to -9.5% and lead to a slower pick up, as the prolonged halt of activity will also dent the production capacity via corporate failures and higher structural unemployment. These phenomena will be even stronger should the health crisis prolong into 2021. In that case, a deep GDP contraction this year will be followed by near-stagnation.



### Euro area: restricted fiscal policy dents upswing

Uncertainty surrounds the economic implications of the shutdown period that lasted for about two months in the euro area. The European Commission (EC) for instance expects a drop of growth relative to the non-pandemic baseline scenario between 8 pp (six week lockdown base case) and 15.5 pp in a more severe ten-week lockdown scenario. But the contraction of Q1 GDP by 3.8% qoq with only two weeks of full lockdown in March points to a severe fall in any case. Monetary and fiscal policy responded boldly to the recession. The ECB embarked on additional measures like extra [corporate QE](#), the creation of the Pandemic Emergency Purchase Program ([PEPP](#)) with a volume of € 750 bn, [liquidity and credit](#) enhancing measures amid [collateral easing](#). Fiscal policy also reacted quickly. On the European level a € 540 bn pack relying essentially on loans (EC unemployment scheme, EIB, ESM) was launched. Direct support measures from euro area economies sum up to about € 300 bn. However, these measures are concentrated on economies with fiscal leeway, with about 40% of this number coming from Germany. Outright pan-EMU solidarity transfers are lacking so far, but we expect the Recovery Fund (with a likely volume of about € 1 trillion) and the forthcoming, expanded European Budget to provide more direct support, especially to Southern European economies, which suffer due to the pandemic as well as the exposure to battered tourism. That said, we expect [no debt mutualisation](#).

Output will fall to about 14% below pre-crisis levels in Q2 and not recover this loss before 2022. Annual GDP will contract by -8.0% in 2020 and rebound by only +4.5% in 2021. Inflation will remain very low near term and recover to only 1.0% in 2021 amid a persistent economic slack.



In the risk scenario mounting doubts on long-term public debt sustainability trigger financial market nervousness and negative rating actions leading to a downgrade of fiscally weak countries. Some governments may need to ask for ECB help (e.g. via the OMT) pledging a significant fiscal retrenchment (e.g. wealth tax) in 2021. However, the economic and financial stress is ultimately manageable with activity starting to expand towards year-end again, averaging -12% in 2020 and 4.0% in 2021. In the deeply negative scenario an unprecedented depression will bring public finances of some euro area under severe stress, with strong unconventional help required. Output will only start to expand in 2021 while prices will fall this and next year.

### **China: Demand side holding back the recovery**

China, where the virus originated, was hit first and phased out its lockdown in early April. Since then, the local emergence of fresh Covid-19 clusters led to a temporary re-tightening of containment measures. Generally, social distancing and case tracking measures continue to be applied. Economically, the lockdown led to a drop of China's GDP growth by 6.8% yoy in Q1 2020. However, activity indicators started to bounce back to different degrees. While IP growth improved substantially (to +3.3%yoy in April), retail sales remain heavily burdened (-7.5%yoy in April). Generally, the demand side will be the restraining factor in the recovery. Domestically, the need to prevent a renewed outbreak will hit services sectors especially hard. Moreover, the income and confidence loss will dent domestic consumption. Less migrant workers returned to large cities than in 2019 suggesting that unemployment has risen. While reliable data on this topic do not exist, the Politburo has already an issue. Exports have so far held up, but slumping PMI new export orders point to mounting headwinds from the external side.

Amid weak demand and signs of rising inventories, production may need to be cut back. This in turn could lead to a negative feedback loop of higher unemployment, less income and less demand. Against this risk, we expect fiscal policy to be stepped up. So far, China has been rather reluctant in providing fiscal support compared to other countries. But the upcoming (postponed) annual National People's Congress on May 22 will likely provide details on employment, income and infrastructure measures. We see the 2020 fiscal impulse between 3.5% and 4% of GDP. Monetary policy will also continue to help. We expect further cuts of the Loan Prime Rate by 30 bps and in the reserve requirement ratio (RRR) by 100 bps in 2020.

Risks are to the downside. There seems to be an ongoing conflict within the Party about the size of fiscal help. The large packages during the GFC led to unsustainable debt on local levels but also at SOEs, keeping China more cautious this time. Thus less fiscal support, more negative confidence effects, rising unemployment, a larger setback in investments or a prolonged period of suppressed international demand amid disrupted supply chains could keep the recovery much more muted. In this case, we expect GDP to drop by 1.0% in 2020, compared with +1.3% in our base case. If a renewed Covid-19 outbreak would necessitate larger shutdowns again, GDP is likely to be hit even much more strongly.



# Imprint

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**Sources for charts and tables:** Thomson Reuters Datastream, Bloomberg, own calculations  
Version completed on May 18, 2020

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