EUROPEAN ECONOMICS UPDATE

Some thoughts on the lasting damage from the crisis

• The euro-zone is not suffering from excessive leverage among banks and households, or slow and counter-productive responses from policymakers, which held back its recovery from the last two crises. But the current downturn still throws up some of the same problems, as well as some new ones, which suggest that the economy will not return to its previous trend for the foreseeable future.

• With lockdown measures being lifted across the euro-zone and activity starting to increase, attention is turning to the longer-lasting damage – or “scarring” – that this crisis will do to the economy. That could mean permanent damage to the economy’s supply potential, or a lasting hit to aggregate demand, or both.

• Looking at past recessions and recoveries suggests that a permanent hit to GDP is very likely. As Chart 1 shows, euro-zone GDP failed to return to its pre-crisis trend after either the global financial crisis (GFC) or the euro-zone debt crisis. European economies have also failed to recover lost ground after more mild downturns. Of the countries that later adopted the euro, seven experienced recessions in the early 1990s and have a long enough back run of data to establish a pre-recession trend. Chart 2 shows how their economies were affected over the next four years. Although there was a wide range of outcomes, all seven failed to return to their previous trend.

• However, there are several reasons why the euro-zone should experience a bigger rebound than after previous crises. The first is that the current downturn is not the result of a boom-and-bust cycle. Experience suggests that recoveries following financial crises are particularly weak, as households and firms deleverage by reducing their consumption and investment, and banks deleverage by reducing their lending. Since debt in the private sector is not as high now as it was in 2007, and the banks are in better shape, that might be less of a problem this time round.

• The second reason why the recovery might be stronger than after other recent crises is the reaction of policymakers. Loan guarantees, which were not available on the same scale following past recessions, will provide extra support to banks and encourage them to keep lending. What’s more, governments have made furlough schemes more generous to limit the hit to employment and incomes. And tax cuts or deferrals should ease the pressure on businesses. Admittedly, governments also loosened fiscal policy in 2008 and 2009, but fiscal support this time round has been on a much larger scale.

• Meanwhile, the ECB has acted more quickly to stabilise financial markets and support lending to the real economy, with increased asset purchases and more generous loans to banks. And the Governing Council is unlikely to repeat the mistake it made in 2011 when policy was tightened prematurely.

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Chart 1: Quarterly Euro-zone GDP (€trn)

![Chart 1: Quarterly Euro-zone GDP (€trn)](image1)

Sources: Refinitiv, Capital Economics

Chart 2: Range of GDP Relative to Pre-Recession Trend in Seven Euro-zone Countries* (%)

![Chart 2: Range of GDP Relative to Pre-Recession Trend in Seven Euro-zone Countries* (%)](image2)

Sources: Refinitiv, Capital Economics

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• However, while the economy won’t suffer from all of the same problems that have held back recoveries in the past, some of them will resurface. One is the risk of previously viable firms going bankrupt. Some firms that were healthy before governments imposed shutdowns will go bankrupt, and it could take a long time for them to be replaced by new businesses. So some of the failed businesses’ capital will become obsolete and other firms will delay or cancel investment, further reducing the economy’s productive potential. What’s more, people who have lost their jobs will need to find work elsewhere, perhaps in sectors where they are less productive. Or they might not find jobs at all. After the global financial crisis, it took until Q4 2016 for employment in the euro-zone to return to its level in Q1 2008. (See Chart 3.)

• Meanwhile, although policymakers have acted quickly and on a large scale, monetary stimulus might be less effective than in the past. With little room to cut interest rates, the ECB has more quickly had to resort to “unconventional” tools. And while extra asset purchases should help to prevent a re-run of the debt crisis for the next couple of years, with bond yields already so low it seems unlikely to have a big impact on economic activity by pushing long-term interest rates down.

• When it comes to fiscal policy, we are unlikely to see the return of austerity in the next year or two. But it is a possibility further down the line. The EU’s fiscal rules could mean governments have to run tighter fiscal policy than they would otherwise in order to achieve mandated debt reductions. They might also raise taxes to pay for extra spending on healthcare, for example, which could deter investment.

• The global backdrop also bodes ill. The crisis has hit all major economies and regions, albeit at slightly different times and in different intensities. This means that the euro-zone can’t rely on strong demand for its exports from other countries. And looking further ahead, it’s also possible that this crisis will accelerate the process of de-globalisation, perhaps as companies attempt to reduce their vulnerability to global pandemics and border closures by making their supply chains more local and reducing the amount of “just-in-time” production. This could make businesses more resilient to a similar shock in the future, but it would also make them less efficient in “normal” times. And the process of relocating production from lower cost to higher cost regions could also act as a drag on global growth.

• As well as suffering from these familiar problems, businesses will also face new challenges posed by social distancing. We can’t predict with any certainty to what extent and for how long consumer behaviour will change. But even after social distancing rules are lifted, demand is likely to be weaker as consumers are cautious about returning to shops, restaurants and going on holidays, and don’t fully offset that by spending more online. And supply will take a hit too, as factories may have to work at below full capacity for a prolonged period, while shops, restaurants and theatres (among many other businesses) will not be allowed to admit as many customers. There might also be extra red tape from new health and safety regulations. All of this could cause additional bankruptcies over and above the effect from the immediate fall in demand.

• As things stand, we have pencilled in a recovery that would take euro-zone GDP to about 6% below its trend from 2013 to 2019. (See Chart 4.) That would be a much smaller shortfall than after the global financial crisis, but similar to that after the euro-zone debt crisis. Compared to our pre-crisis forecasts for the next couple of years, the shortfall is even smaller. At the national level, scarring is likely to be greatest in economies that are more dependent on tourism and hospitality, and are more likely to turn to austerity to reduce their debt burdens. That group includes Italy, Spain and Greece, and perhaps France too.

![Chart 3: Employment (mn)](chart3.png)
![Chart 4: Quarterly Euro-zone GDP (€bn)](chart4.png)
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