BUSINESSEUROPE

ECONOMIC OUTLOOK WINTER UPDATE

February 2021

Economic situation

- Our Autumn Economic Outlook, published on November 3, suggested the EU economy would **fall by 7.3% in 2020, followed by 5.0% growth in 2021. As we discuss in detail, the balance of risks to such a forecast have shifted to the downside in recent months.**

- **On the positive side,** GDP data suggests the EU economy including the 3 largest economies did slightly better in the final months of 2020 than had been expected, boosted both by strong manufacturing exports and companies adapting better than previously to lock-down restrictions.

- **On the negative side,** business confidence remains lows, with many companies' financial positions continuing to deteriorate, at the same time as increasing prevalence of the more transmissible UK variant of the virus raises the prospect of lengthier and more severe restrictions than previous envisaged.

- **The outlook for 2021 will continue to be dependent upon the evolution of the virus**, including avoiding more transmissible mutations (requiring stricter lockdowns), and the successful roll-out of effective vaccines, as well as a supportive economic policy environment.

Policy recommendations

- With lockdown restrictions continuing, policy-makers must **avoid any premature unwinding of measures to support businesses and workers**, such as wage subsides and tax holidays, which would risk prolonging the downturn and increasing economic scarring.

- At the same time, dependent upon adequate supplies, governments must **prioritise widespread and rapid roll-out of vaccinations** which are key to reducing hospitalizations and to allowing economies to reopen more fully.

- The EU's Next Generation EU Recovery instrument must be implemented without delays. Member States' **Recovery and Resilience plans must support investment and reforms** that can help transform EU growth, productivity and competitiveness.

- With bank lending to companies already under pressure, any changes regarding the regulatory requirements for bank capital in the context of the transposition of the final Basel III agreement must be carefully calibrated to ensure they do not lead to a sudden reduction in lending and investment.

- In the medium term, Members States will need to find pathways back to sustainable fiscal positions, and the ongoing EU economic governance review needs to be concluded in a timely manner that supports these efforts. New EU tax legislation must not damage our competitiveness, with corporate tax reform best agreed through the OECD, rather than unilateral EU measures.

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1. Overview of the economic situation

BusinessEurope's Autumn Economic Outlook, published on November 3, suggested the EU economy would **fall by 7.3% in 2020, followed by 5.0% growth in 2021**

Looking back, the EU economy seems to have performed better in the final months of 2020 than we expected, with the three largest economies, Germany, France and Italy, experiencing slightly lower GDP drops than we forecasted. In particular, manufacturing has performed relatively strongly in recent months in the EU, boosted by strong export demand, including from the United States and China. Having increased productions in order to stockpile ahead of the end of the UK/EU transition period, the outlook has also been boosted by the agreement for a UK/EU trade deal.

Looking ahead, the news since November has been dominated by the 2nd wave of Covid-19 infections in the EU, and subsequent lockdowns. The present wave of lockdown is causing difficulties for many businesses, in particular in the hospitality and tourism sectors, but it is also the case many businesses have become more adapt at continuing activity despite lockdown restrictions than in the spring, limiting the short-term impact of the present wave of lockdowns.

On the negative side, business confidence remains lows, with many companies' financial positions continuing to deteriorate as increasing prevalence of the more transmissible UK variant of the virus raises the prospect of lengthier and more severe restrictions than previous envisaged.

The outlook for 2021 will continue to be dependent upon the evolution of the virus, including avoiding more transmissible mutations (requiring stricter lockdowns), and the successful roll-out of vaccines that prove able to provide protection against any widespread COVID variants. In particular, if the vaccination roll-out can be speeded up, allowing a relatively rapid reduction in restrictions.

In aggregate, whilst there remains scope for a strong bounce-back in the economy in the second half of the year if the evolution of the virus is favourable and policy is strongly supportive, on balance, the risks to our autumn forecast are now on the negative side, particularly for those Member States which are continuing to experience strong transmission levels.

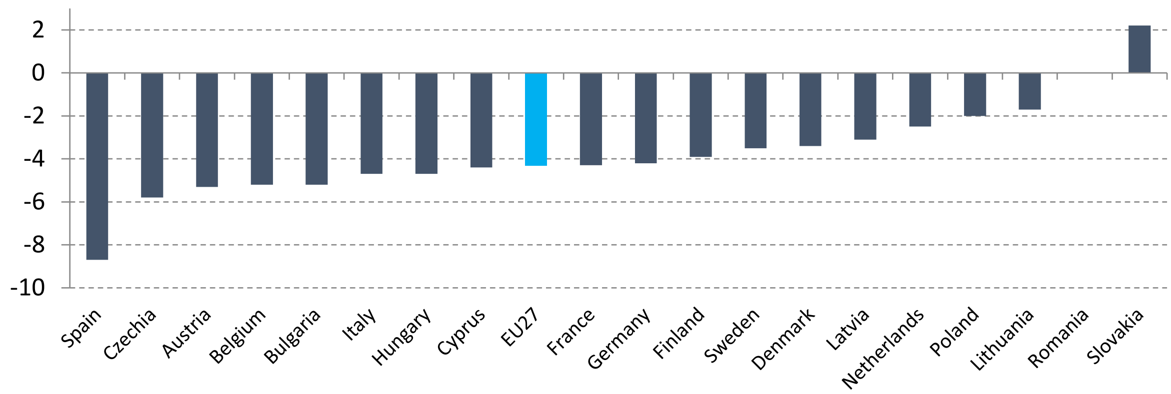
The EU economy fared a little better in the final months of 2020 than we had expected

Recent data releases show that the German economy contracted by 5.0% in 2020. This is somewhat more positive than our autumn forecast, where we expected a 5.4% drop. France also did better with a 8.3% drop as contrasted to an expected 9.0% drop, and Spain lost 9.1% of its GDP in 2020, faring better than the 11.5% drop our autumn outlook forecasted. Reflecting this EU27 saw a 6.4% GDP drop in 2020, beating out 7.3% forecast.

In particular, as we explore in further detail below, export data shows that EU exports had managed to recover well from the collapse in the spring. At the same time, many businesses have been better able to carry on trading through the most recent restrictions than had been the case in the spring. Overall, there is the possibility that economic growth in 2020 may have been a little less negative than our autumn forecast of -7.3% suggested.

Nevertheless, GDP data now available up to Q3 reminds of the different impacts the covid crisis has had on EU Member States (see graph below).

Graph 1: EU Member States: Real GDP in 2020Q3, relative to 2019Q3



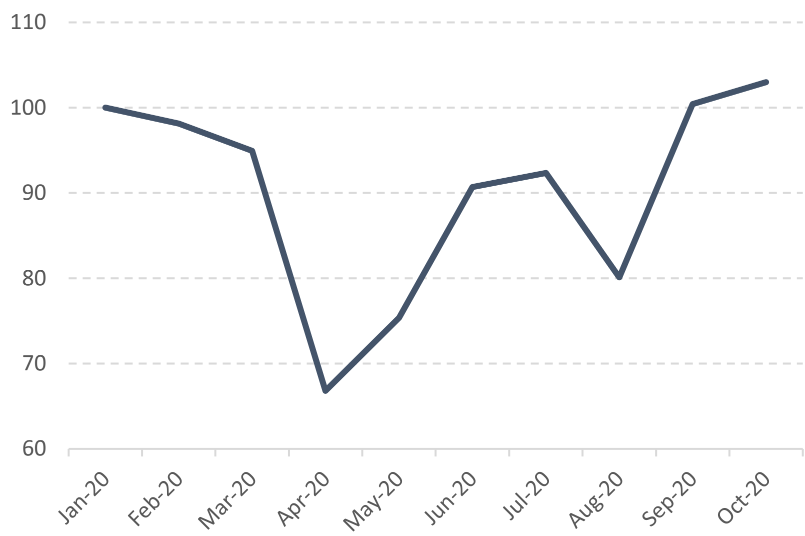
Eurostat

Exports have recovered relatively quickly

Exports have recovered fast from their record-breaking drops in the spring. Whilst we do not explicitly show seasonally-adjusted data, because the magnitude of the drop speaks for itself, the export numbers show that total EU goods exports were at only to thirds of the January level by April, but subsequently recovered back to the January level towards the end of the year.

This recovery in exports has supported the European economy at a time when domestic consumption has been heavily suppressed. With vaccinations underway in all major economies exports are likely to pick up further as our main trading partners also see a return to normal economic conditions and growth.

Graph 2: Total EU goods exports, index January 2020=100, not seasonally adjusted

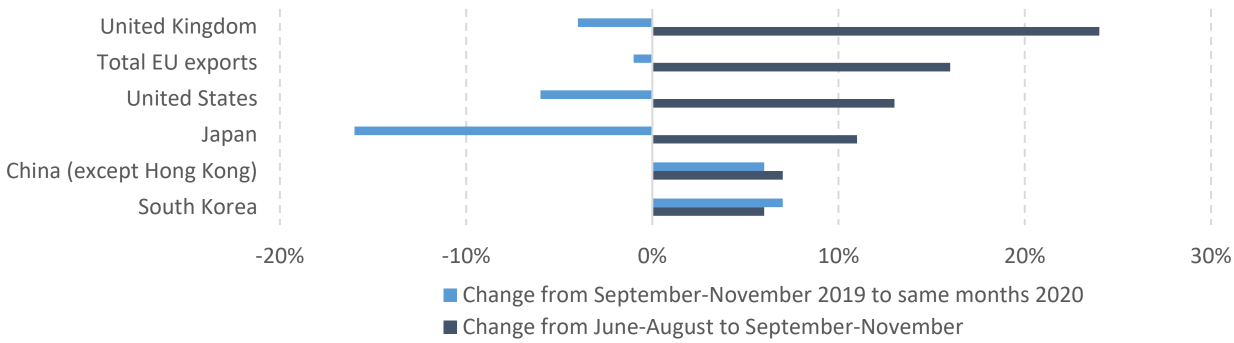


Own calculations based on Eurostat

But as the graph below shows, the export picture varies considerably geographically. Whilst EU exports to the US and Japan have rebounded considerably in recent months, they remain significantly below pre-crisis levels. In contrast, whilst export growth to China and Korea appears a little more muted in recent months, stronger performance in the first half of the years, means there was an increase in overall exports to these regions in 2020. Finally, we saw a very strong increase in exports to the UK in recent months, in part reflecting companies stock piling ahead of the UK leaving the EU single market.

These geographical difference in export demand will clearly be important in determining member states own performance given different geographical trading specialisms.

Graph 3: EU export growth, selected major trading partners

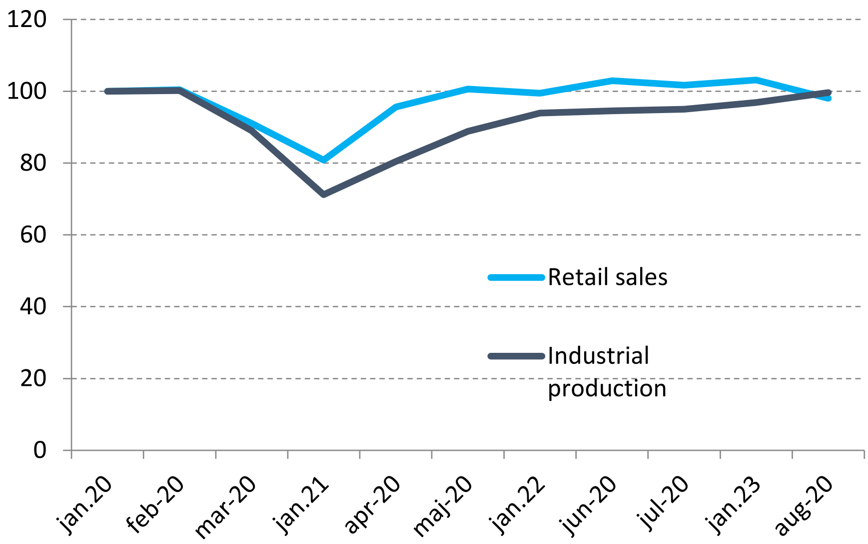


Own calculations based on Eurostat

Very quick bounce-back after the spring lockdowns

Consumer spending bounced back very strongly as soon as lockdowns were lifted in the spring. Industrial production also saw a relatively fast recovery bolstered by export sales.

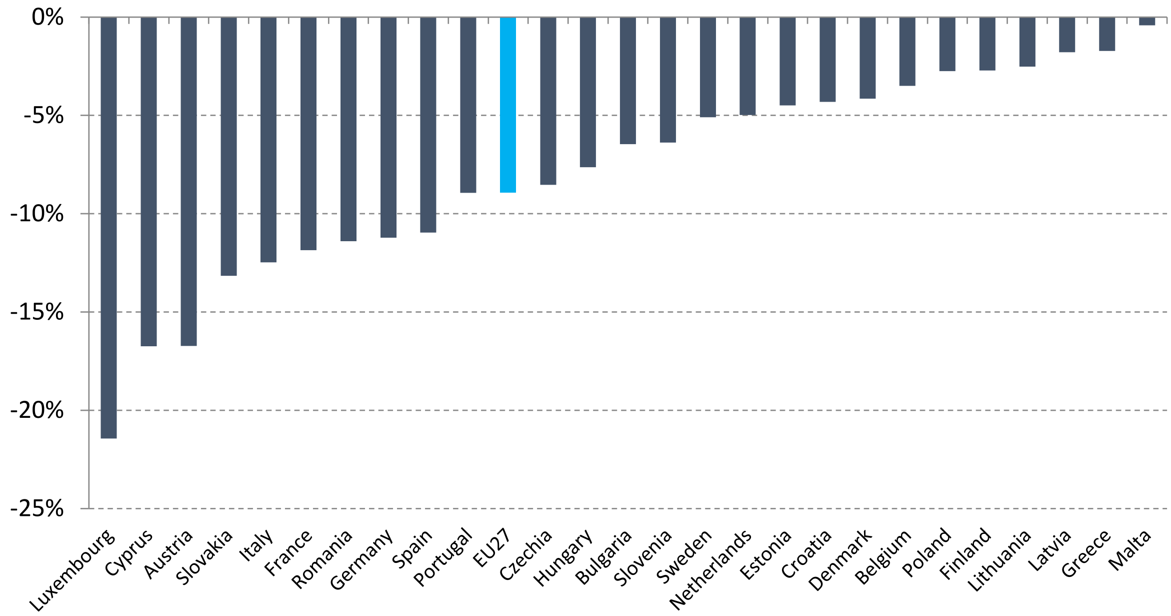
Graph 4: Industrial production and Retail sales, index 100=Jan 2020. Seasonally and calendar days adjusted



Own calculations based on Eurostat

Developments vary across member states, however, both in terms of their GDP growth and sectoral drops in economic activity, with the industrial production output for example having fallen by more than 10% in France, Italy, Spain and Germany, but less than 5% in Poland, Denmark and Belgium, as shown below.

Graph 5: Industrial production, seasonally and calendar days adjusted, change from 2019* to 2020*



*Own calculations based on Eurostat   *Jan-Nov*

2. New wave of lockdowns

The second wave of lockdowns has seen a quite significant drop in activity, albeit less pronounced than during the first wave of lockdowns in the spring, judging from fast Google-mobility data (as a useful first indication with very up-to-date information).

In keeping with this the economic impact of the lockdowns in the winter will be severe, but likely less so than the spring lockdowns. It also seems likely that many companies and households have found ways of coping e.g. by becoming more effective at employing remote work, online e-commerce instead of in-store trading etc. to reduce the loss of production, productivity and spending.

Graph 6: Change in mobility from January 2020 to the spring and the winter lockdowns in Retail and Recreation, and in Groceries and Pharmacies

	Retail and Recreation		Groceries and Pharmacies	
	Spring lockdown	**Winter lockdown**	**Spring lockdown**	**Winter lockdown**
Germany	-52%	-60%	-15%	-12%
France	-80%	-39%	-44%	-4%
Italy	-81%	-27%	-55%	2%

Google Mobility data, cutoff points May 1 and January 10

A significant concern at this stage is that many companies already have taken on loans and spent their free capital to survive through the first period of lockdowns. With the end now in sight due to the vaccine roll-out we expect businesses to generally be able to weather another lockdown, provided the necessary government support schemes remain in place. Regardless, we will see more insolvencies, which will pose a downside risk to the forecast in the coming months.

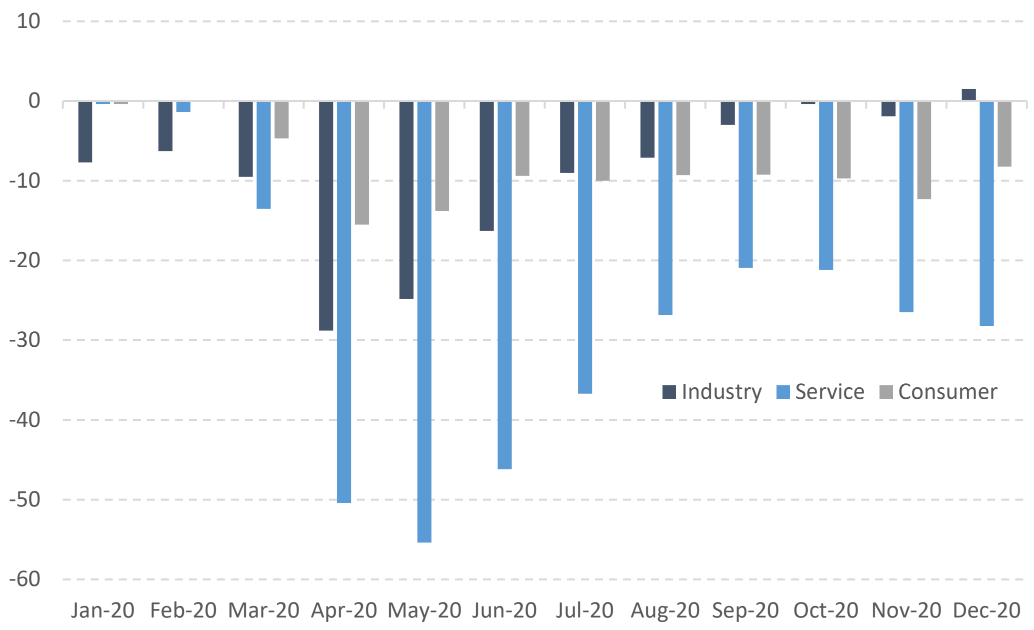
Business confidence remains low, albeit above the spring levels

Business confidence, especially in the services sector, remains very low. Business confidence levels were partially restored after the lockdowns ended in the summer of 2020 but have since dropped with the reimposition of lockdowns. Recent PMI data has also proven more negative than we had hoped for, reinforcing the view that in the short run the economic outlook has soured since our autumn forecast.

As long as business confidence remains at low levels we are unlikely to see a significant pick-up in business investments, which is necessary to drive growth and help our economy fully recuperate from the crisis. Widespread vaccinations should in time, however, allow companies to prepare for a return to normalcy, paving the way for a pick-up of business investments necessary to get a strong economic recovery going.

Consumer confidence improved after the lockdowns ended in the summer, but has similarly remained negative. We saw last year that spending nevertheless increased very markedly once lockdowns ended even with the consumer mood still in negative territory. A similar development is likely this year, bolstered by the fact that widespread vaccination finally gives us hope that the end of the pandemic is now in sight.

Graph 7: Consumer confidence index and business confidence indices for Industry and Service. Percentage points change from same month previous year



Own exposition based on European Commission

3. A rapid and successful vaccine roll-out is essential for economic recovery in 2021

With lockdowns likely to stay in place until vaccinations have become sufficiently widely disseminated, the speed and success of the roll-out will be the most important determinant of how our economies will fare in 2020.

The EU started vaccinations on December 27, with many member states clearly taking time to build up capacity. Our capacity to disseminate vaccines will likely become more effective with lessons-learned, but the amount produced and made available to EU member states will remain a key constraining factor the following months.

A positive but realistic scenario is that vaccinations allow restrictions to be gradually lifted through the spring with consumer confidence and spending, bolstered by the onset of the tourism season, also gradually returning, setting the stage for a strong recovery in the second half of the year.

Similarly, the key downside risk is that new strains of the virus rapidly spread within the EU, creating the possibility that current vaccine are less effective in dealing with them, prompting government placing new restrictions on business activity.

Thus whilst the economic situation has evolved slightly more positively than we might have feared in recent months, the situation remains precarious. Ensuring a speedy recovery and avoid long-term scarring of the economy remains crucial, and requires policy-makers to, in particular:

- Avoid any premature unwinding of measures to support businesses and workers, such as wage subsidies and tax holidays, which would risk prolonging the downturn and increasing economic scarring.

- Implement the EU's Next Generation EU Recovery instrument without delays. Member States' Recovery and Resilience plans must support investment and reforms that can help transform EU growth, productivity and competitiveness.

- With bank lending to companies already under pressure, any changes regarding the regulatory requirements for bank capital in the context of the transposition of the final Basel III agreement must be carefully calibrated to ensure they do not lead to a sudden reduction in lending and investment.

- In the medium term, Members States will need to find pathways back to sustainable fiscal positions, and the ongoing EU economic governance review needs to be concluded in a timely manner that supports these efforts. It will also be important that new EU tax legislation does not damage our competitiveness, with corporate tax reform best agreed through the OECD, rather than unilateral EU measures.