European Economic Outlook 2021

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Foreword

The new year starts with better prospects than what we could foresee only a few months ago. This as the introduction of vaccines raises hope that the COVID-19 pandemic can come to an end in the second half of this year. Further, there's clarity about the US presidency and Brexit, although it remains to be seen how these events will play out in the coming months and even years. With this, obstructions to economic growth of the previous year are set to be removed, or at least alleviated in 2021.

GDP growth will be solid in 2021 compared to longer term averages, but these bright figures shroud the underlying recovery from substantial lower levels of economic activity. Private consumption, government expenditure and improved trade dynamics will be the main growth drivers in the coming quarters. Investment is expected to remain subdued in general, as several uncertainties remain in at least the first half of the year, and corporate balance sheets need to be strengthened. Despite this strong growth in particularly the second part of the year, we expect the economy to reach pre-pandemic levels only in the beginning of 2022 at the earliest.

Although the economic recovery is expected to be comparatively strong this year, it remains to be seen to what extent the hibernation has indeed left the economic structure intact. Thanks to fiscal and monetary policy support, the rise in unemployment and bankruptcies for instance have remained limited in Europe, but weakness could reveal itself once this support is lifted, and the effects of prolonged restrictions in activity and movement become clearer.

All in all, 2021 is likely to become a year of recovery, reconfiguring and structuring of foundations for a new period of economic growth. Progress in the suppression of the COVID-19 virus will be essential in determining the course of this recovery.

Economic growth: on a recovery trajectory

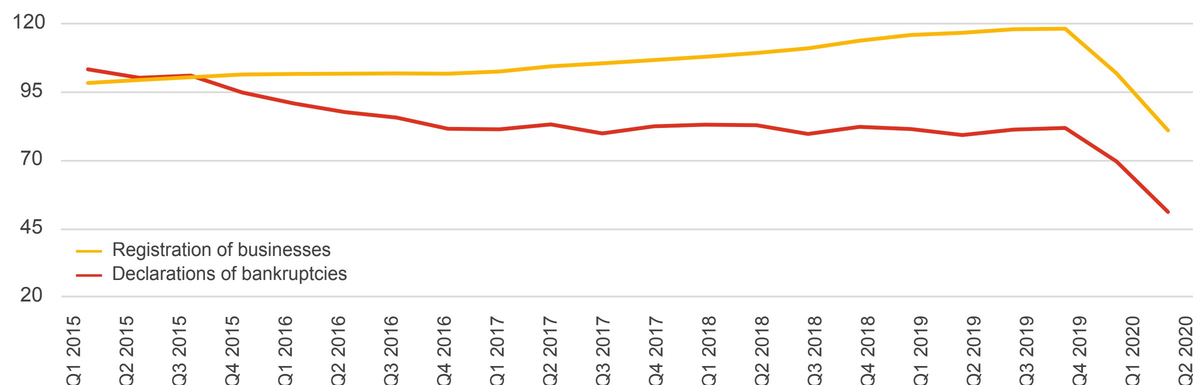
The economic growth rate moved liked a roller coaster in 2020 in many countries. After an accelerated descent in this rate during the first two quarters of last year, as a result of the first lockdowns, growth was strong in the third quarter as restrictions were lifted. In this third quarter, economic growth reached an extraordinary 12.5% in the eurozone compared to the same period last year. Nonetheless, the economy of the eurozone was still 4.3% below the level of 2019 at that time.

This year we will see a similar pattern, albeit with a gentler amplitude. Due to the latest phase of lockdowns, the first quarter of 2021 will show a decline in growth, followed by a strong recovery in either the second or third quarter, depending on the duration of COVID-19 related restrictions. On a whole, the economic growth rate for 2021 will be exceptional from a historic perspective. However, by the end of the year the level of economic activity is very likely still behind that of 2019, before the pandemic started. Only in 2022, the 2019 size of the economy is forecasted to be attained.

The strong acceleration of economic growth will for a significant part be driven by a release of pent-up consumer demand. Because of the lockdown restrictions, people have been forced to postpone purchases, leisure activities, travel plans etc. until the moment these actions are possible again. At such a point spending increases strongly, leading to a rebound in economic activity. Like the third quarter of 2020, people will be keen to go out to spend money on leisure activities after a period of abstention, and to buy 'non-essential' goods in shops again, such as clothes. In turn this leads to a pick-up in trade between countries. What remains to be seen is to what extent consumption will recover this year and how much of accumulated savings will be used for this purpose. For example, many people may still be reluctant to travel, and some may feel the need to keep part of their savings at hand, because of uncertainty about the future income they will receive.

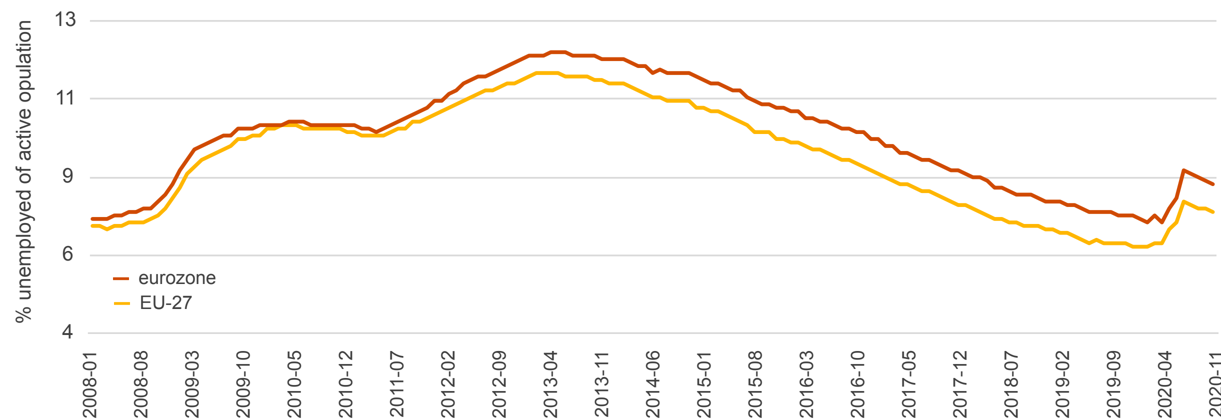
Thanks to government support and furlough programmes, a large proportion of businesses can continue to cover at least some costs and employees can feel more secure in spending money. Without this support, a negative spiral of continuous cutbacks could take place, with dire consequences for economic activity and the structure of the economy at large. Once the threat of the pandemic resides, government support is expected to end, and at that moment any developed weakness will reveal itself. Some businesses may not be able to recover fast enough without government aid and can be forced to lay off workers who were previously protected by furlough schemes. As a result, we will likely see an increase in bankruptcies and unemployment after the restrictions are lifted. So far, the number of bankruptcies even declined during the first two quarters of 2020, which must have been mainly due to government support (*figure 1*). Initially, the rise in unemployment was steep during spring last year, as especially flex workers and those with temporary contracts were made redundant in the first phase of lockdowns, but since July 2020, when many activities were possible again, unemployment started to decline (*figure 2*). All in all, fiscal policy will also this year be an important stabilising factor for the economy, but it cannot prevent adjustments once a normalisation takes place and aid is withdrawn.

Figure 1 The world upside down? Bankruptcies decline noticeably in times of crisis



Source: Eurostat. Note: seasonally adjusted data.

Figure 2 Government support and furlough programmes prevented a further rise in unemployment, for now…



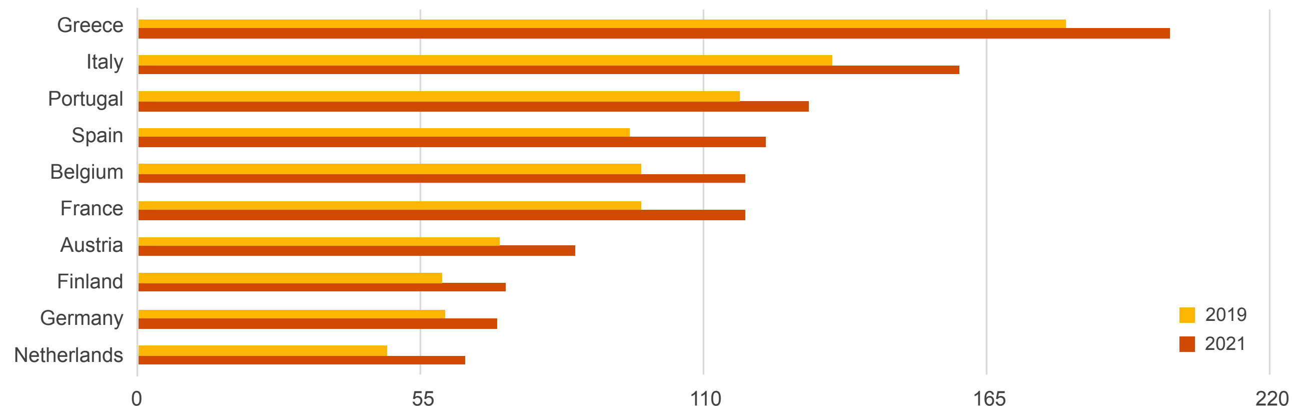
Source: Eurostat. Note: harmonised and seasonally adjusted unemployment rates on a monthly basis.

Such developments could force governments to cut back spending and/or to raise taxes, which are likely to hamper future growth.

Investment is expected to remain weak for the coming quarters, and this will weigh on economic growth. Companies are less inclined to invest due a lack of certainty about how the pandemic will progress, government measures and the moment economies will return to more stable trajectories. Excess capacity given reduced demand, and the need to strengthen balance sheets after a period of lower income and potential impairments are also factors that will influence investment decisions.

Government support has led to a significant increase in debt levels. Most eurozone member states are expected to see their debt levels exceed 60% of their GDP levels in 2021 (*figure 3*). The European Commission suspended the budgetary restrictions of the Stability and Growth Pact in March 2020, in order to allow member states to provide as much support as needed[1]. The loose monetary policy of the European Central Bank (ECB) and demand for sovereign bonds further allow governments to borrow at comparatively low rates. How can governments reduce debt levels again in the future? If the funds are spent wisely, it can lead to higher economic growth, which means higher tax revenues and lower expenditure on e.g. unemployment benefits. However, there are also risks in the ability to increase productivity for example, because of a greying population, or rising interest rates that make servicing debt more challenging.

Figure 3 Gross government debt as percentage of GDP will rise in 2021



Source: European Commission, “European Economic Forecast Autumn 2020; Annex”, November 2020.

1 European Commission, “Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact”, March 2020.

Some support for investment this year will likely come in the form of the Next Generation EU (NGEU) or Recovery and Resilience Facility (RRF) from mid-2021, for the total sum of €750 billion or 5.4% of the EU economy in 2019[2]. The greatest part of these funds will be for green as well as digital investments or reforms in the EU and the period 2021 to 2027. It will however take some time before the direct and multiplier effects of investments funded by NGEU/RRF will benefit economic activity. As such, the overall effect of these funds will be limited in 2021, but it may prevent a strong decline in investment and support sentiment in the shorter term.

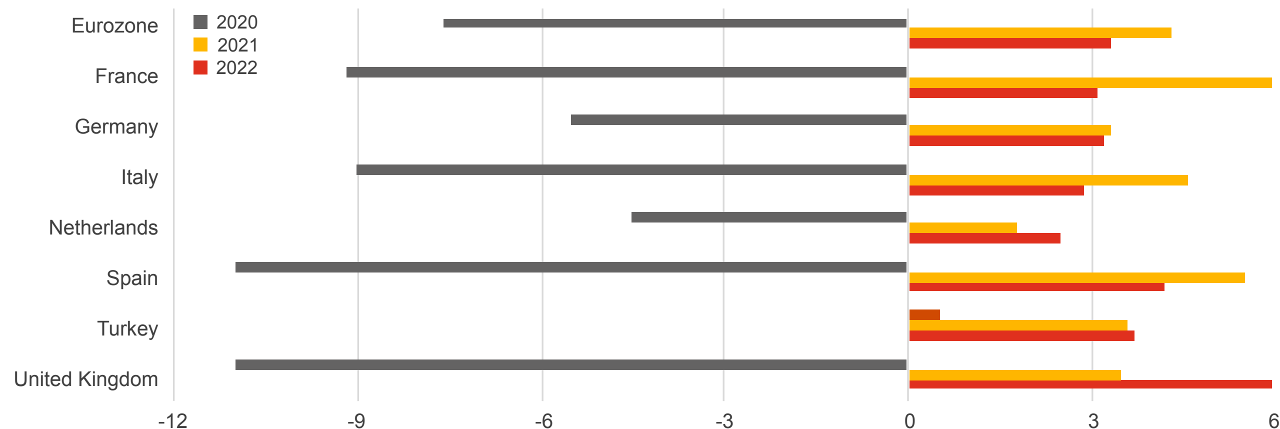
The eurozone economy is expected to grow with 4.3% in 2021, after a decline of more than 7% in the previous year (see underneath). Year-on-year GDP growth for the UK is forecasted to be 3.5% this year, after a significant decline of more than 11% in 2020. Turkey is expected to reach a similar growth level of 3.6% in 2021, but after a less severe hit on GDP growth in 2020, which is estimated to be 0.5%.

Table 1 Consensus real GDP year-on-year growth forecasts

	2020	2021	2022
Eurozone	-7.6	4.3	3.3
France	-9.2	6.0	3.1
Germany	-5.5	3.3	3.2
Italy	-9.0	4.6	2.9
Netherlands	-4.5	1.8	2.5
Spain	-11.7	5.5	4.2
Turkey	0.5	3.6	3.7
United Kingdom	-11.0	3.5	6.0

Note: figures for 2020 are estimates, those for 2021 and 2022 forecasts.

Figure 4 Consensus real GDP: what a difference a year makes

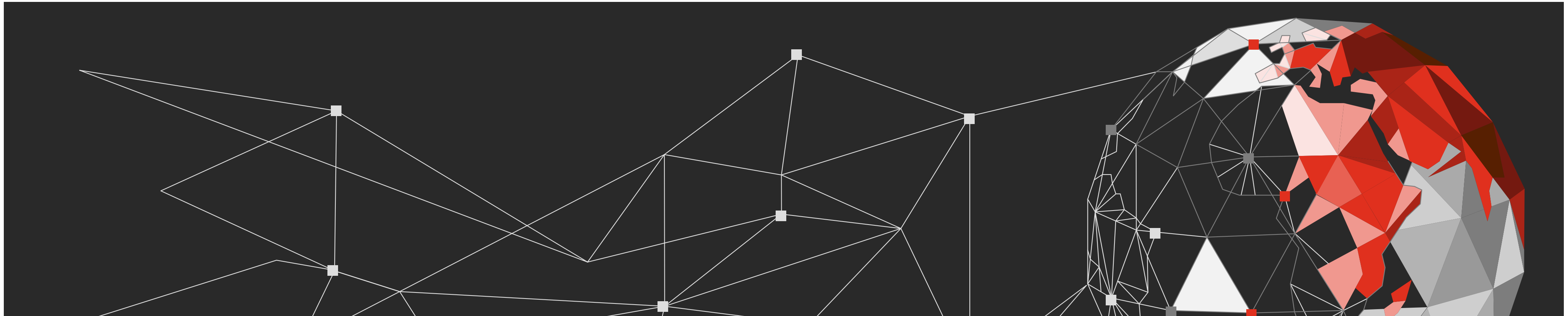


Source for Table 1 and Figure 4: PwC UK and global analysis, national statistical authorities, Refinitiv Eikon, IMF, Consensus Economics and the OECD. Note: figures for 2020 are estimates, those for 2021 and 2022 forecasts.

High level growth figures obscure underlying differences, and do not show how the COVID-19 pandemic impacted sectors differently. In general, services have been hit much harder by the crisis than manufacturing. An important reason is that many services involve personal contact and are connected to mobility, for example travel, hospitality, entertainment etc. These activities suffered most from physical distancing measures and other restrictions. Manufacturing activities experienced a set-back in especially the first phase of lockdowns, but fared better afterwards due to adjustments. In some cases, manufacturing benefited from relative strength in Asia, where many countries were less affected by the pandemic in the second half of 2020, supporting export to this region.

As a result of these differences, the recovery that will take shape this year, is likely to be uneven, because some activities can recover faster. Businesses that benefited from the restrictions, such as online providers of products and services, may have gained an upper hand. Activities such as business travel, potentially changed on a permanent basis, because companies got used to virtual meetings at a distance. These kinds of activities will likely take more than a year to recover to pre-pandemic levels, as demand has changed.

2 European Commission, European Economic Forecast Autumn 2020, p. 65.



Pandemic: a loosening and lasting grip

The economic growth trajectory is strongly dependent on developments in the COVID-19 pandemic and measures taken to suppress the spread of the virus. We will later show in this monitor how the stringency of measures influences economic growth. If lockdowns are in place, a return to normalcy is prevented, and a long duration of restrictions can affect potential output.

Fortunately, multiple vaccines will be distributed and administered in the coming months, and this is expected to lead to high levels of immunity. As a result, it may be less likely that by autumn this year we will once more see similar levels of infections as seen previously. In a response to this prospect, business sentiment improved recently, and financial markets have also responded positively, as witnessed by higher asset prices. However, the 'real economy' has not caught up with these developments yet.

What will the long-term impact be of the pandemic? This is still open to speculation, but a recent survey by the European Central Bank among "72 leading non-financial companies" provides some insight[3]. Over 40% of the respondents stated that more working from home is the greatest long-term effect, closely followed by "acceleration of digitalisation". Almost all respondents agree that the pandemic led to an accelerated take-up of digital technology and made their organisations more efficient as well as resilient. We can consider these to be positive changes resulting in greater productivity, growth and higher levels of competitiveness. However, there's also a darker side to the respondent's answers: slightly less than a third of respondents thinks demand will be lower, due to changes in consumer behaviour, and more than 20% stated that there will be less business travel due to virtual meetings. Further, more than half expects a decrease in employment. This suggests multiple structural changes will take place as a result of the pandemic.

A change that will likely occur after the pandemic is a different and reduced use of office space, because of increased working from home. This can have an impact on real estate, transport and construction. In sectors where demand will be lower, employees may be made redundant and forced to find employment elsewhere. Where can they go? Will increased digitalisation provide opportunities? We shall soon publish a study that will highlight the challenges and opportunities.

Earlier we discussed how the pandemic had a different impact on sectors. These differences have in several cases increased inequality in opportunity between groups of people. For instance, employees who were able to work from home have learned a lot about technology that can be used from home in order to collaborate and work effectively. However, working from home was not possible for all. Some people were forced to stay at home and could not work. They may have fallen behind in their personal development. The same is valid for young people unable to gain working experience via internships or employment. Some children may be facing significant delays in their education, as they could not get the coaching from a distance they would normally be able to receive. All these aspects may not resolve themselves in a recovery and will require specific attention or contributions by policy makers as well as organisations.

3 European Central Bank, "The long-term effects of the pandemic: insights from a survey of leading companies" 4 January 2021.

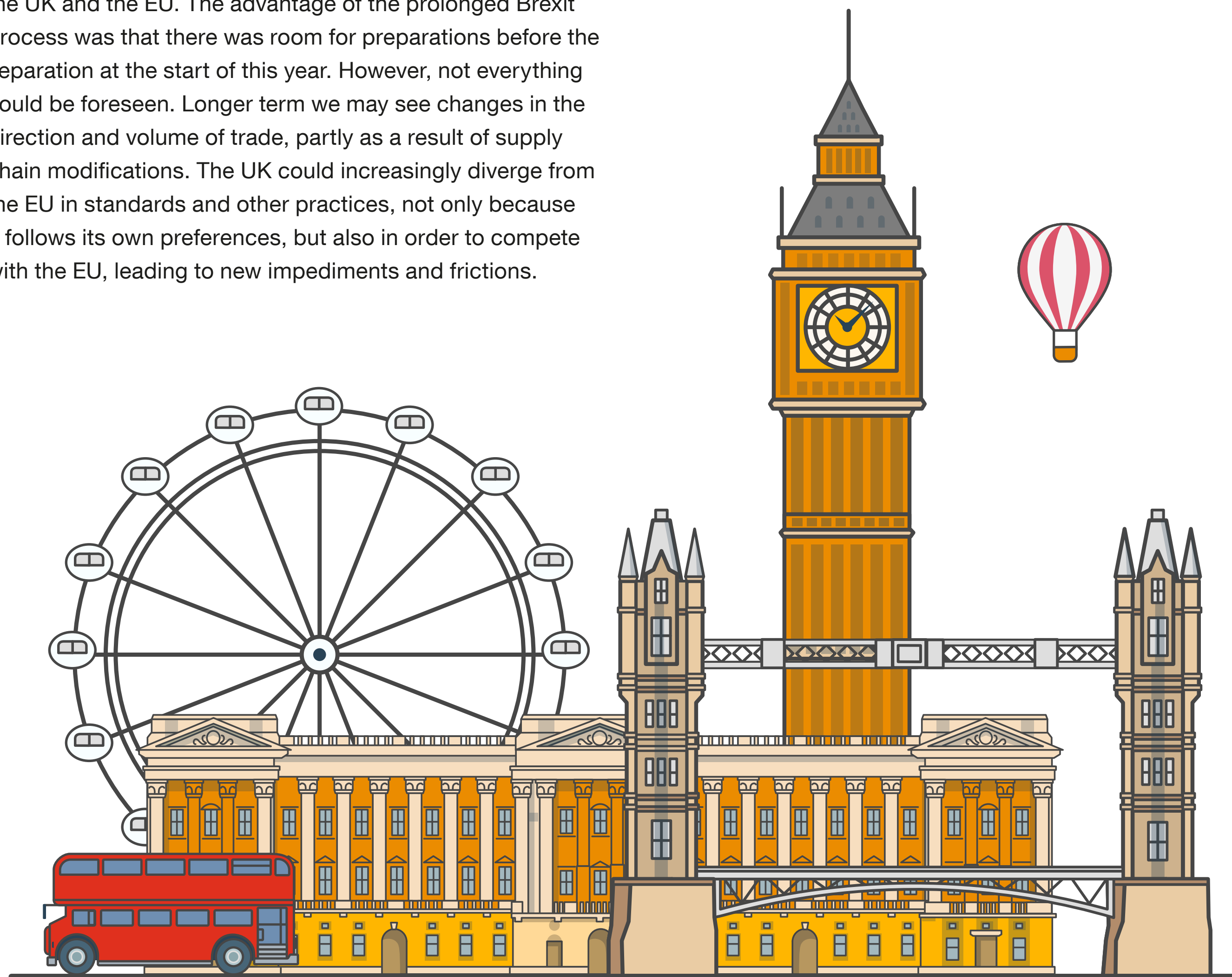
Brexit: done, but what's next?

At the very last moment, at the end of 2020, the UK and the EU reached an agreement with respect to the future relationship between both sides. With this, Brexit became a reality on the first of January this year, more than three tumultuous years after the referendum in the UK about stay or leave. With the Trade and Cooperation Agreement (TCA) a so-called no-deal Brexit was avoided, which was considered a worst-case scenario, but challenges remain.

The TCA is mainly a free trade agreement for goods, which means that trade duties are not levied, but there are more administrative processes for goods between the UK and the EU. This has already led to delays in bringing goods to consumers, empty shelves in Northern Ireland supermarkets, and somewhat higher transport costs. However, the TCA is still a much better outcome for all parties involved compared to a bleaker 'no-deal' alternative.

One key issue still to be resolved is a data adequacy decision, allowing for the flow of personal data between the EU and the UK. Currently there is a grace period until the end of June at the latest, that still allows for data transfers to take place as previously. Another important aspect is that the TCA is inconclusive about services. Especially for financial services and for the UK this is of relevance, given the fact that UK banks etc. have lost their so-called passport, which allowed them to provide services in the whole of the EU on an equivalent basis. In order to address this, negotiations have started between both sides to establish a framework for cooperation on financial services by 31 March this year.

Especially in the first half of this year uncertainty remains about further arrangements, and there will be hiccups because of adjustments to the new relationship between the UK and the EU. The advantage of the prolonged Brexit process was that there was room for preparations before the separation at the start of this year. However, not everything could be foreseen. Longer term we may see changes in the direction and volume of trade, partly as a result of supply chain modifications. The UK could increasingly diverge from the EU in standards and other practices, not only because it follows its own preferences, but also in order to compete with the EU, leading to new impediments and frictions.

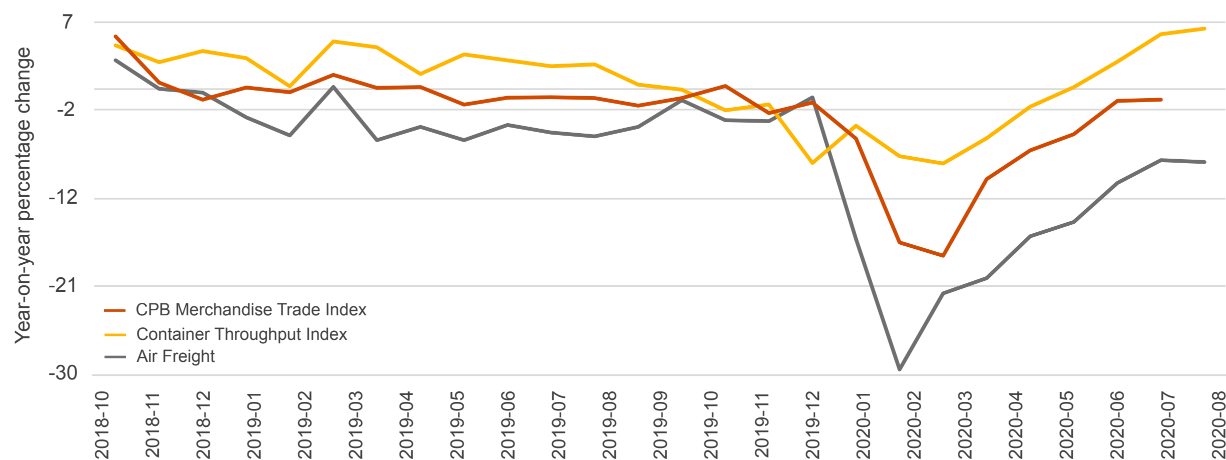


Trade: zigzagging onwards

Brexit and the restrictions president Trump imposed on China, are examples of events that negatively affected the globalisation trend of the past decades with increasingly free movement of goods, capital and people. However, recently there were also contributing developments, such as the Regional Comprehensive Economic Partnership between China, Japan, Korea, Australia, the ASEAN countries and New Zealand, as well as the Comprehensive Agreement on Investment between the EU and China. Since the second half of 2018 (*see figure 4*), measures restricting trade are increasing, leading some to speak of 'slowbalisation'.

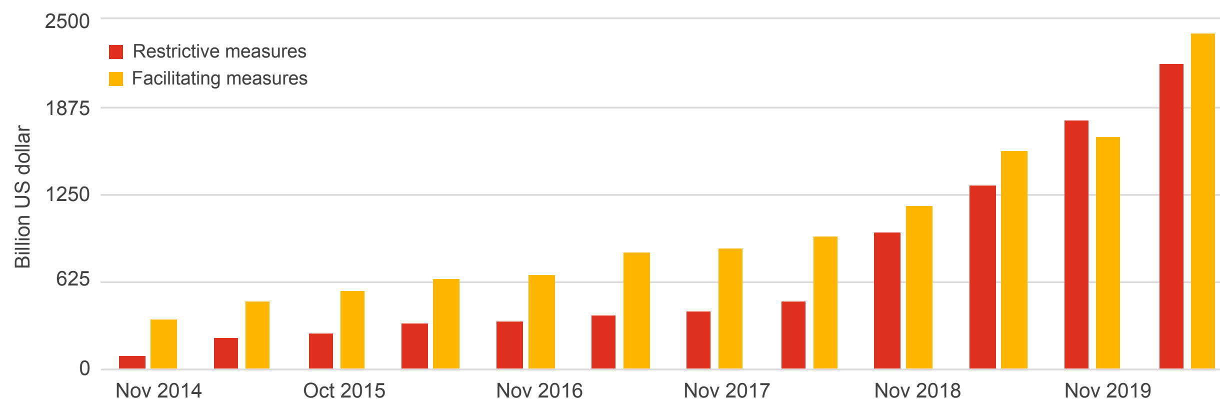
The COVID-19 pandemic initially led to a collapse in trade between countries, as economic activities slowed down significantly, but improved rapidly after the lockdowns ended in spring last year (*see figure 5*). The disruptions during the first lockdown phase led to shortages of e.g. medical protective equipment and laid bare international supply chain dependencies. China, which was hit first by the COVID-19 virus, restricted the export of goods it deemed necessary for domestic use. Consequently, the production of some items, such as protective masks, was taken on locally, outside of China. We expect the shift towards more local production of goods, that are now considered 'strategic' in value, to be sustained, and this will have some impact on trade volumes and directions. China does not seem to be affected by this though, given a 27% rise of its trade surplus in December 2020 to the highest level since 2015, and a 4% rise in total export last year[4].

Figure 5 Global trade recovery stalling at the end of 2020 due to new lockdowns



Source: OECD, CPB, RWI/ISL, IATA, PwC calculations.

Figure 4 Non-COVID-19 related import-restrictive measures continued to increase since 2018



Source: OECD, "Economic Outlook", December 2020.

4 Economist Intelligence Unit, "China economy; Exports hit new record in December", 14 January 2021.

With Joe Biden as the new president of the US, we expect policy to become more pragmatic and less erratic. It is unlikely though that Biden will swiftly unwind the trade and investment restrictions that president Trump put in place. These are still valuable bargaining chips for the new president and the US for use in shaping the relationship with e.g. China and the EU. Competition between the US and China will remain an important theme in the following years and will have a significant impact on not only bilateral relations, but also on those of European countries with both the US and China. President Biden is expected to take on a more constructive stance towards Europe, and this may benefit relations that suffered under president Trump.

Inflation and monetary policy

Inflation in the eurozone is foreseen to remain low this year at approximately 1% (*see table 2*). This is however a much higher level than the decline in inflation of on average 0.3% in the period August up to and including December 2020. The tide will turn because year-on-year comparisons in inflation will lead to positive numbers this year, also as a result of higher energy as well as commodity prices. Temporary tax cuts, such as the decrease in VAT in Germany, are expected to expire this year, contributing to higher prices too. Prices of selected products may further rise due to supply chain and administrative bottlenecks. However, this will largely be a temporary phenomenon. All in all, inflation remains in check in the eurozone as the output gap will be large this year, and the situation on the labour market will limit increases in wages.

These developments in inflation will allow the ECB to keep monetary policy very loose in support of economic activity. Next to low policy rates, the ECB's Asset Purchase Programme (APP) and Pandemic Emergency Purchase Programme (PEPP), in combination with the continued reinvestment of maturing securities, will help to keep market rates low. Thanks to low borrowing costs, both governments and companies can continue to gain access to affordable loans that allow them to cope with the pandemic conditions and its economic consequences.

In Turkey, the situation is quite different. Here inflation is expected to be well above 11% in 2021, forcing the Central Bank of Turkey (CBT) to keep its tight monetary stance, and hence elevated policy rate, until inflationary risks disappear. The CBT has been tightening its policy since August last year, raising the policy rate by 675 basis points in the last quarter of 2020. We expect this to gradually translate into lower inflation rates going forward.

Table 2 Annual average consumer price inflation

	2020	2021	2022
Eurozone	0.3	0.9	1.2
France	0.5	0.7	1.0
Germany	0.5	1.2	1.3
Italy	0.0	0.5	0.9
Netherlands	1.2	1.4	1.5
Spain	-0.3	0.7	1.4
Turkey	12.0	11.5	10.0
United Kingdom	0.7	1.4	1.7

Source: PwC UK and global analysis, national statistical authorities, Refinitiv Eikon, IMF, Consensus Economics and the OECD.
Note: figures for 2020 are estimates, those for 2021 and 2022 forecasts.

The growth impact of locking down

Stringency of the lockdown measures has a stronger causal relationship with output loss, than the length of the lockdown. This indicates a stricter lockdown scenario is likely to cause more output loss (even if it lasts for a shorter period), than a partial (and longer) lockdown.

The year 2020 has been the year of the great lockdown for most countries. Global GDP declined by an estimated 4.3% in 2020[5], with the maximum impact of the pandemic and containment measures being recorded in the second quarter of 2020. A large part of this growth decline can be directly attributed to the stringency of the lockdown measures that were necessitated by the pandemic early in the year. As many countries, especially in Europe continue, to be in the midst of the second wave of Covid-19, the effect of the second lockdown phase on GDP growth is inevitable, and is likely to have the maximum impact in the first half of 2021.

Short-term impact of lockdowns

Throughout the EU, the most stringent containment measures have been in place during April to May 2020 (phase 1) and then again in November – January 2021 (phase 2). While the containment and health measures have significantly impacted the GDP growth, the positive effect of economic measures are only expected to become evident after the lockdowns end, making the economies even more vulnerable in the short term[6].

We found the short-term effect of lockdowns on GDP to be dependent on many factors, for instance, how restrictive the containment measures have been, the structure and state of the economy going into the Covid-19 crisis, and to a lesser extent, the economic support measures already taken. We also found that the stringency of lockdown measures has a stronger causal relationship with output loss, than the length of the lockdown. This indicates a stricter lockdown scenario is likely to cause more output loss (even if it lasts for a shorter period), than a partial (and longer) lockdown.

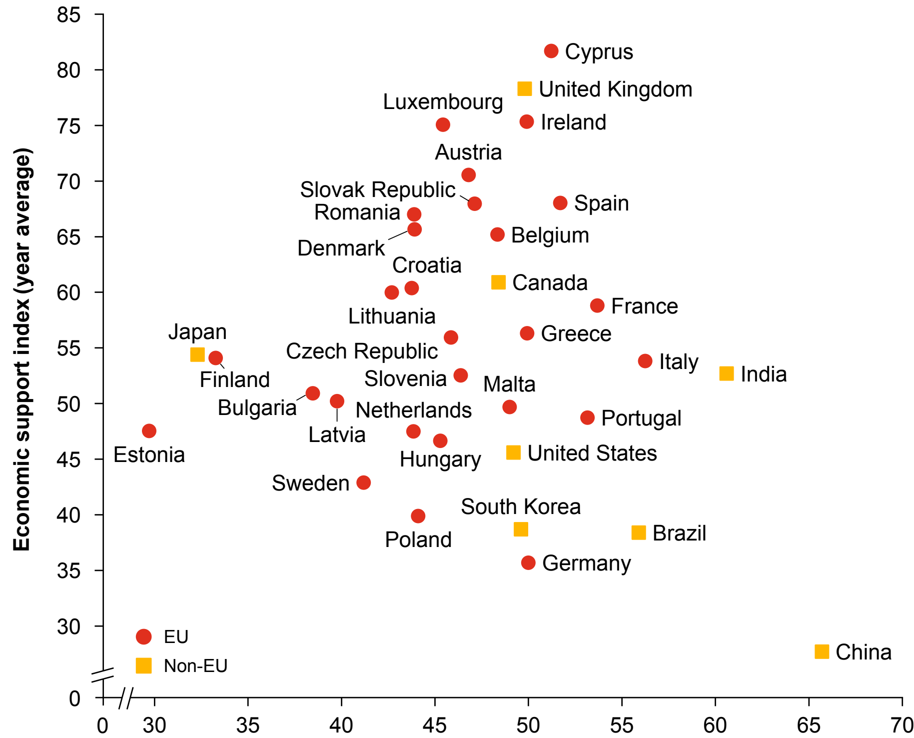
Different countries in the EU stood in very dissimilar positions at the start of the crisis, depending on how open or trade dependent they were, their fiscal balances and means to support the most impacted industries. All this and more will determine the impact of lockdowns on the GDP of various countries in phase 2.

How the second phase of lockdowns impacted the EU

For most countries in the EU, the first lockdown restrictions started in March and continued through June, leading to a steep decline in GDP growth in the second quarter of 2020. Household consumption nosedived, and so did investments and trade. Since phase 1, households and businesses have

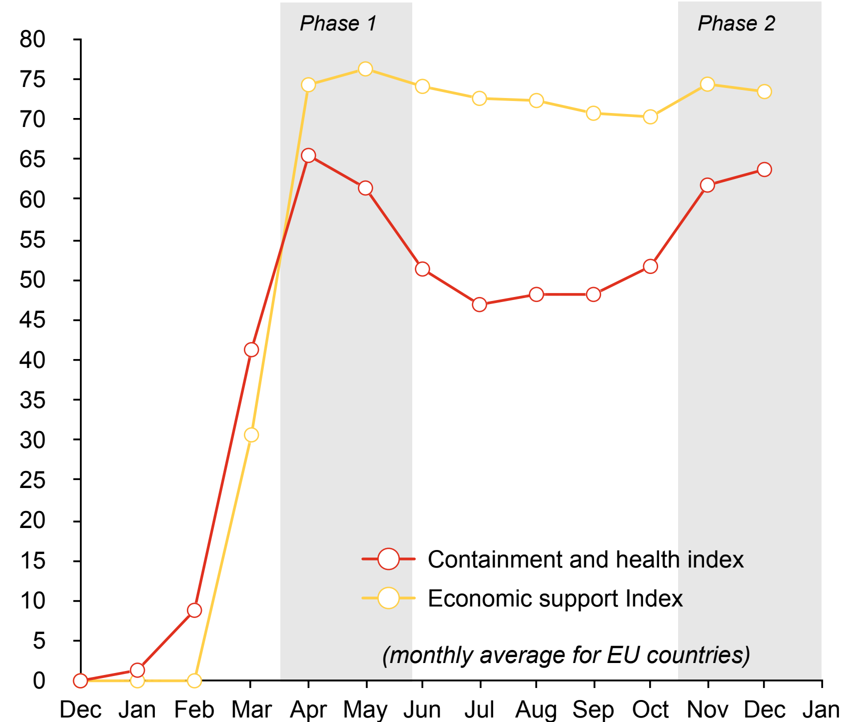
5 Global Economic Prospects, World Bank, January 2021.
6 Containment and health index, as measured by the Coronavirus Government Response Tracker, shows how many and how forceful the measures to contain the virus and protect citizen health are (this combines ‘lockdown’ restrictions and closures with measures such as testing policy and contact tracing). Economic support index shows the extent of economic support that has been made available (such as income support and debt relief), *Link.*

Figure 6 Governments' response to the COVID-19 crisis were very different, as was the impact on the economies



Source: Coronavirus Government Response Tracker, University of Oxford.

Figure 7 EU lockdowns in phase 2 are as stringent as phase 1



Source: Coronavirus Government Response Tracker, University of Oxford.

adapted their consumption patterns to the lockdown, and trade disruptions have smoothened. Because of some of these factors, the impact of the second lockdown, though still very strong, is not expected to be as severe as during phase 1. At this time, it is still unpredictable how long the current lockdowns might last, as infections continue to stay at a high level in many EU countries. Considering the uncertainty, we have devised three scenarios and estimated their likely impact on the GDP growth of the EU in the first half of 2021[7].

7 Analysis is for EU excluding UK

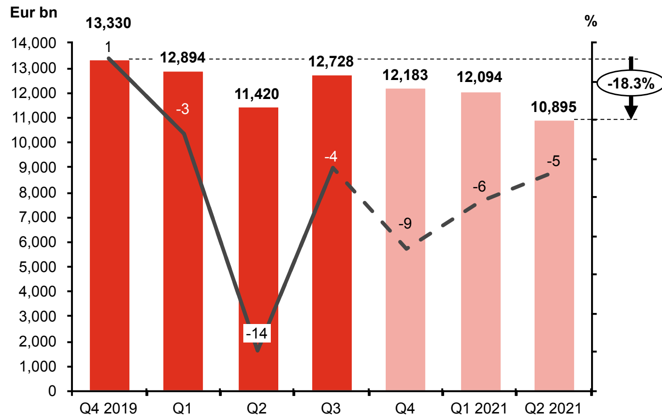
In the most optimistic scenario, lockdowns could be eased by the end of February, and be supported by rapid vaccine rollouts. We expect the recovery that follows to be almost complete by Q3 2021, assuming of course that there are no more large-scale lockdowns needed. The more likely the base case scenario, when lockdowns are eased much more slowly and vaccine deployment is rolled our gradually, the lengthier GDP recovery will be. Our pessimistic scenario assumes the entire first quarter of 2021 to be riddled with containment measures, and that the recovery effect from the vaccines will only begin from the second quarter of the year. This would mean growth only gradually picks up pace in Q3 2021. ■

Figure 8 Scenarios for the EU

Scenario 1: Base case

Lockdown continues till end-February and is gradually eased through rest of Q1 and Q2 2021. Recovery starts soon after lockdown is eased

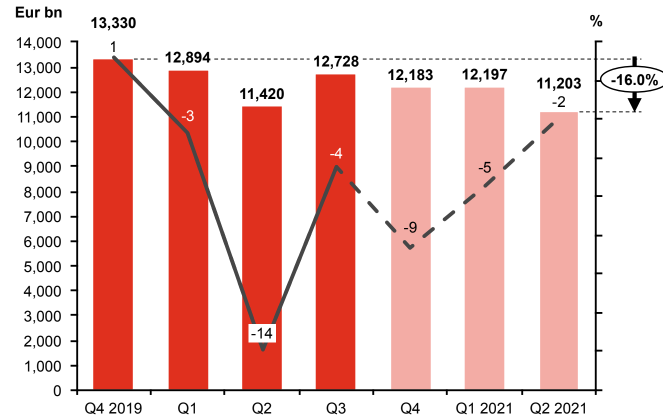
Real GDP y-o-y growth rate



Scenario 2: Optimistic recovery

Lockdown continues till end-February and is eased quickly afterwards, based on rapid vaccine rollouts

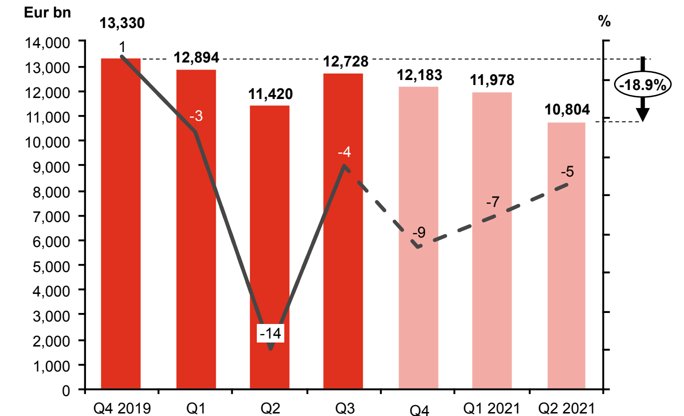
Real GDP y-o-y growth rate



Scenario 3: Longer restrictions

Lockdown continues through February and March, and is gradually eased with recovery only in Q2 2021

Real GDP y-o-y growth rate



Source: IHS, PwC analysis.

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