Economy

In the abyss of economic forecasts

Tuesday 31 March 2020

Bruno Cavalier - Chief Economist
bruno.cavalier@oddo-bhf.com
+33 (0)1 44 51 81 35

Fabien Bossy - Economist
fabien.bossy@oddo-bhf.com
+33 (0)1 44 51 85 38

https://www.oddosecurities.com

Seeing the initial economic data reflecting the shock of the coronavirus, it looks like there must be a typo. We double check, but no, these are the right numbers... Since lockdown measures were introduced in China, then in Europe and in the US, these economies have been operating 25% to 35% below their potential. Each week of confinement lops around half a percentage point off GDP. A month and a half of this regime (hard to do less) and then a gradual resumption of activity over a similar length of time, and this adds up to roughly 5 points of GDP that have evaporated. It will not take much to have an even more severe shock.

The duration of confinement is the key factor

Typically, in developed countries, one-year forward growth forecasts have a standard deviation of less than half a percentage point. When forecasters disagree, it is generally to the tune of a few decimal places. In twenty years, only two events have led to a rapid and radical revision of GDP growth forecasts, the 9/11 terrorist attacks and the demise of Lehman Brothers. Likewise with the coronavirus shock, but in an unprecedented proportion[1]. With the first macroeconomic and sectoral data published since countries have implemented containment measures, it is indeed possible to estimate, albeit very approximately, what the economic cost of combating the coronavirus pandemic will be. It is now certain that this will amount to several points of GDP. *Adieu* decimal places! To fine-tune the forecast, three parameters warrant examination: 1) the immediate impact of containment, 2) the duration of containment and the process of returning to normal, 3) the economic policy response.

➤ **The impact of confinement** – **For the most accurate estimate possible, the approach consists in breaking down the effects on supply or demand as much as possible in a disaggregated way.** On the supply-side, one can examine the degree of disruption to production by major sectors. The OECD estimates that tourism, retail and leisure services, including catering, construction and the transport equipment industry will experience contractions in activity of between 50% and 100%. On the demand side, one has to look at which segments of consumption are diminished (durable goods, transport services, tourism) and which are being boosted (some primary goods). Several studies are now available covering a wide range of countries[2]. Their results may differ depending on assumptions about the loss of activity in each sector. The INSEE study, for France, has the advantage of being based on field observations from various professional organisations, but the orders of magnitude of the other studies are plausible. It goes without saying that the immediate impact evolves if production processes are adapted to health requirements (example of the aerospace sector in France). The other source of difference between countries is the economic structure, for example the weight of tourism or the primary sector.

For the vast majority of G20 countries, the scale of the loss of business is in the range of 25% to 40%.

➤ **Length of the lockdown** – This parameter is primarily epidemiological in nature and is clearly the main uncertainty in the calculation. No health expert can say with any certainty how long the social distancing measures for slowing the virus's spread will last. In China, the quarantine in Wuhan is only supposed to end on 8 April, meaning it will have lasted for two-and-a-half months. In the rest of the country, the travel restrictions and closure of factories and then businesses were of a shorter duration (2-3 weeks), but

[1] *See our* Eco Note *dated 23 March 2020: "*Unidentified economic object*"*
[2] *See the following reports; OECD, "Evaluating the initial impact of Covid containment measures on activity", 27 March; IMF, "Europe's COVID-19 crisis and the Fund's response", 30 March; INSEE, "Point de conjoncture", 26 March; IFO, "Die volkswirtschaftlichen Kosten des Corona-Shutdown für Deutschland: Eine Szenarienrechnung", 22 March*

were only lifted gradually. Given the example of China and based on the latest government statements, **a strict (but not absolute) lockdown for a month and a half is now a conservative estimate for Europe and the US. If the epidemic – and the daily death toll – pass their peak in this interval, the lifting of the lockdown will be considered, but cannot be immediate. It might last for several weeks. It is difficult to imagine a return to normal life before the start of the summer. The alternative is a longer lockdown**.

The longer the lockdown, the greater the economic cost. **A recession is inevitable, but in a sense, it is part of the treatment of the public health crisis**. For good or for ill, everyone must agree on this, even Donald Trump who last week still wanted the US economy to be reopened rapidly. It goes without saying that if the epidemic continues to the point that healthcare systems are overrun, it would be unrealistic to imagine that, authorisation or not, the population will be willing to return to normal life. We would therefore lose on two fronts - a health crisis and an economic crisis[3].

➢ **Economic policy response** – Because of the lockdown, many economic agents, both consumers and companies, will see a drop in their income. Without public action, those without readily available savings would be forced to cut their spending or go bankrupt. **To prevent *permanent* damage from a shock that should only be *temporary* (no one imagines that the lockdown will go on for ever), the only sensible policy is to compensate the loss of income, maintain production capacity for the post-lockdown period and ensure that there is no shortage of liquidity for the real economy, banks or markets**. This is more easily said than done. Policymakers have hesitated a little over the past two to three weeks, but at present, the combination of the monetary and fiscal measures represents a significant sum (table).

Monetary and fiscal actions during the coronavirus crisis *

		Germany	France	Italy	Spain	US	UK
Monetary policy	Interest rates	no change at -0.50%				cuts of 150 bps to 0%	cut of 65 bps to 0.10%
	Liquidity (1)	Additional provision of liqudity on more generous terms (dual system on LTRO terms equivalent to a 25bp rate cut)				Several new facilities	New facility to suppot SME
	Liquidity (2)	dollar swap arrangements between central banks					
	QE	Additional QE of 120bn€ (March 12) + new programme of 750bn€ (PEP, March 19) + flexible stance to do more				New QE of 700bn$, then "no limit"	QE of 210bn£
Fiscal policy	Direct transfers	123bn€ (3.6% if GDP)	45bn€ (1.9% of GDP)	50bn€ (2.8% if GDP)	17bn€ (1.4% if GDP)	CARES Act (2.2tr$, or around 10% of GDP (2tr$)	30bn£ (1.4% of GDP)
	State guarantees	"unlimited" up to 822bn€ (24% of GDP)	up to 300bn€ (12% of GDP)	up to 350bn€ (20% of GDP)	up to 100bn€ (8% of GDP)		up to 330bn£ (16% of GDP)

** as of 2020, March 30*

However, the efficacy of these measures cannot be summarised as their sum total as a percentage of GDP. Decisions that are apparently "free" at first sight (for example the relaxation of banking regulations) may have major positive effects while fiscal measures may prove inadequate if they are poorly targeted. **In the short term, the point is not so much to stimulate demand (that would not make much sense as long as supply is constrained) as to limit as far as possible the loss of productive potential. This is why in most countries economic policy measures are aimed at encouraging short-time working rather than redundancies, spreading out companies' charges (tax, rents, loans) rather than pushing them into bankruptcy, and above all avoiding credit rationing.** An adequate supply of liquidity is what will make the difference in terms of the duration of the recession. We now know for certain that it will be harsh, but it is not inevitably destined to be lengthy.

Even though the current shock is of a different type and has a different origin from the 2008 financial crisis, lessons seem to have been learned from that era. We learned that it is preferable to provide support as soon as possible. That there is no point fantasising about imaginary dangers (for example the inflationary nature of the expansion of central bank balance sheets). **It is even certainly preferable not to hamstring the economy policy reaction because of moral hazard. There will probably be free-riders seeking to profit unduly from government assistance but it is not the primary problem**. In 2008, in the US a number of politicians were reluctant to bail out the

[3] *To measure the cost of a medical intervention or a healthcare programme, it is standard to estimate the value of the human life at stake (concept of "quality-adjusted life year"), in other words, carry out a cost-benefit analysis. At the current stage of the pandemic, we struggle to see which arguments could justify weighing up the number of deaths against the loss of points of GDP.*

financial sector, which was largely responsible for its own problems. In Europe, certain "virtuous" countries claimed, with undisguised glee, that the crisis in "lax" countries was punishment for their excesses. The same proponents of "virtue" are not far from wielding similar arguments this time, whereas the shock is purely exogenous and, moreover, affects all countries. Their position is not as strong as after the crisis in 2008, but it is probably sufficient to block better coordinated responses between countries.

All told, given the speed and amount of the economic policy response, it is not absurd to posit that a large share of production capacities will be preserved in the face of a shock that is spread over several months[4]. It is moreover possible that this response might be extended if needs be. **Under these conditions, a return to normal may be hoped for in 2021, i.e. a return to the pre-coronavirus level of activity. This convergence would begin in the second half of 2020, but would not be immediate**.

➢ **Forecasts radically upset** – Having established the forecasting framework, we can make calculations. A decline of around 25% in production capacity during the lockdown equates to saying that each month with things as they stand translates directly into a reduction of 2% in full-year GDP. **In six weeks, this would knock off 3 points of growth, an estimate which does not take account of the underlying or cumulative effects of the economy being closed (diminished potential). Assuming it takes as long to lift the restrictions, the shock equates to around 5-7 points of GDP in developed countries. These are, in our view, acceptable scenarios, with an alternative that leans towards a longer lockdown and a more spread-out recovery period. We could easily double the bet, as it were.** With a shock of this intensity, the few differences between countries are marginal (excluding the calendar effect which places the brunt of the shock in Q1 in China and in Q2 in the other countries). By way of illustration, we present here the profile of forecasts derived from our assumptions.

	Potential GDP growth (y/y%)	Assumptions on the lockdown			Implied Real GDP growth q-o-q %				y-o-y %	
		GDP fall	Start of lockdown*	End of lockdown*	Q1	Q2	Q3**	Q4**	2020	2021
US	2.0	-25%	March 22	May 4	-2	-13	8	7	-5.7	6.6
Euro area	1.4	-26%			-5	-9	7	6	-6.8	6.6
- Germany	1.4	-29%	March 17	April 27	-5	-11	8	7	-7.4	6.9
- France	1.2	-26%	March 17	April 27	-4	-10	7	6	-6.7	6.0
- Italy	0.4	-26%	March 9	April 20	-7	-5	5	5	-7.0	5.3
- Spain	1.4	-29%	March 14	April 27	-6	-10	8	7	-6.7	7.2
UK	1.6	-26%	March 23	May 4	-2	-13	8	7	-6.8	6.6
China	6.0	-19%	Jan. 30	Feb 24.	-9	9	-1	-1	-1.1	5.3
World	3.2	-23%			-5	-6	5	5	-5.0	6.4

* There is no national lockdown in some counries. Dates are indicative of the maximum impact of local measures
**we assume that all social distancing measures will be lifted around six weeks after the end of lockdown but GDP will only go back to its pre-crisis trend by end-2020 (an assumption on the optimistic side)

At the start of the year, the general view was that global growth, after two years of slowdown, had bottomed out and would accelerate over the course of the year. After all, the pause button was pressed on the US-China tariff war and sentiment among industrial groups was looking up. **Average global GDP growth of at least 3% was on the cards in 2020 (IMF: +3.4%). Three months later, it is hard to believe that a forecast scaled back to -5% may not even be the worst possible scenario**. It is no wonder that so many leaders have frequently referred to a war footing (though none of them has ever known one). This comparison does serve to highlight the prospect of a massive impact on public finances. Olivier Blanchard, the former IMF chief economist, recalled not long ago that from 1943 to 1945, the US ran three consecutive years of public deficit in excess of 20% of GDP (26%, 21%, 20%). While we may not go that far, **clearly all countries will emerge from this pandemic with higher debt levels. To a large extent, it will be held by central bank. Will we be very much worse off?**

[4] *See Focus US of 27 March 2020: "US economy on life support".*

Disclaimer:

Disclaimers for Distribution by ODDO BHF SCA to Non-United States Investors:

This publication is produced by ODDO BHF Corporates & Markets, a division of ODDO BHF SCA (“ODDO”), which is licensed by the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and regulated by the Autorité des Marchés Financiers (“AMF”).

This document, when distributed outside of the U.S., is intended exclusively for non-U.S. customers of ODDO and cannot be divulged to a third-party without prior written consent of ODDO. This document is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. This document has been developed by our economists. It does not constitute a financial analysis and has not been developed in accordance with legal requirements designed to promote the independence of investment research. Accordingly, there are no prohibitions on personal dealing ahead of its dissemination. “Chinese walls” (information barriers) have been implemented to avert the unauthorized dissemination of confidential information and to prevent and manage situations of conflict of interest.

At the time of publication of this document, ODDO and/or one of its subsidiaries may have a conflict of interest with the issuer(s) mentioned. While all reasonable effort has been made to ensure that the information contained is not untrue or misleading at the time of publication, no representation is made as to its accuracy or completeness and it should not be relied upon as such. Past performances offer no guarantee as to future performances. All opinions expressed in the present document reflect the current context which is subject to change without notice. The statements, assumptions and forecasts contained in this document reflect the judgment of its author(s), unless otherwise specified, and do not reflect the judgment of any other person or of ODDO. This document does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this document is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice.

This document is for institutional investors only. It may not contain information necessary for others to make investment decisions. Consult your financial adviser or an investment professional if you are not an institutional investor.

Disclaimers for Distribution by ODDO BHF New York Corporation to United States Investors:

Please refer to the most recent research reports on the subject companies for complete information and relevant disclosures.

This document is produced by ODDO BHF Corporates & Markets, a division of ODDO BHF SCA (“ODDO”). It is distributed to U.S. investors exclusively by ODDO BHF New York Corporation (“ONY”), MEMBER: FINRA/SIPC, and is intended exclusively for U.S. institutional customers of ONY and cannot be divulged to a third-party without prior written consent of ONY. This document is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. This document is being furnished to you for informational purposes only and should not be relied upon as sufficient to form a basis for any investment decision.

At the time of publication of this document, ODDO, and/or one of its subsidiaries may have investment banking and other business relationships with any of the companies in this report. While all reasonable effort has been made to ensure that the information contained is not untrue or misleading at the time of publication, no representation is made as to its accuracy or completeness and it should not be relied upon as such. However, ODDO has no obligation to update or amend any information contained in this publication. Past performance offers no guarantee as to future performance. All opinions expressed in the present document reflect the current context which is subject to change without notice. This document does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of particular clients. Clients should consider whether any advice or recommendation in this document is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice.

This document is not a research report as defined in FINRA Rule 2241(a)(11) because the material in it is limited to one or more of the exclusions of the definition of research report in Rule 2241(a)(11)(A). This document is for institutional investors only. Consult your financial adviser or an investment professional if you are not sure you are an institutional investor.

Disclosures Required by United States Laws and Regulations:

Rule 15a-6 Disclosure: Under Rule 15a-6(a), any transactions conducted by ODDO, and/or one of its subsidiaries with U.S. persons in the securities described in this document must be effected through ONY.

Contact Information of firm distributing investment recommendations to U.S. investors: ODDO BHF New York Corporation, MEMBER: FINRA/SIPC, is a wholly owned subsidiary of ODDO BHF SCA; Philippe Bouclainville, President (pbouclainville@oddony.com) 150 East 52nd Street New York, NY 10022 212-481-4002.

Statement of conflict of interests of all companies mentioned in this document may be consulted on Oddo & Cie’s research site .