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ALLIANZ RESEARCH

COPING WITH COVID-19 IN DIFFERING WAYS

09 JULY 2020

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- **The light and targeted lockdowns to fight the second wave of Covid-19 infections will constrain the pace of recovery. We expect global GDP to contract by -4.7% in 2020, followed by growth of +4.8% in 2021**. Since April 2020, the global economy has been operating at 70%-80% capacity and we expect this situation to persist until Q4 2020, albeit to a lower extent, due to targeted lockdowns to combat new outbreaks and prolonged sanitary restrictions. A return to pre-crisis levels for the global economy is now expected only at the end of 2021. However, managing the risks of a second wave will be crucial in determining the size of the shock. Hot spots include Brazil, Mexico, the U.S, India, Indonesia, the UK and South Africa, countries that are particularly at risk of renewed outbreaks and false restarts.
- **Monetary and fiscal stimulus in response to the Covid-19 crisis has amounted to more than USD18tn in 2020, 1.3 times the Chinese GDP. But differentiated returns will create divergent recoveries**. Our proprietary monetary impulse indices show the record high levels in the U.S., the Eurozone and the UK. However, China's is still a far cry from the peaks reached after the 2009 financial crisis. Meanwhile, global fiscal support has amounted to USD10.4tn since March 2020 (12% of global GDP), ranging from 3%-18% of countries' GDP. This along with the size of automatic stabilizers will shape the future recovery trajectories by country. Germany, the Netherlands, Switzerland and Austria are expected to recover faster, while Japan, the U.S., Spain, the UK and Italy are likely to need even more fiscal stimulus to compensate for the weakness of automatic stabilizers. We expect Europe to reach its pre-crisis GDP level only in late 2022-2023 while China and the U.S. would reach theirs one year earlier, depending on the management of the second wave. The key question remains the recovery support to come, along with the targeted relief support for the hardest hit sectors until the end of the year. With higher solvency risks in H2 2020 and 2021, we expect global insolvencies to increase by +35% in 2020-21.
- **Global trade is not expected to return to pre-crisis levels before 2023 as international flows in the services sector will remain impaired for longer**. We expect a global contraction of trade by -15% in volume in 2020, with a recovery of +8% in 2021 and +4.1% in 2022. Export losses (USD4.5 trillion in 2020) will also reveal large asymmetries between countries and sectors. Service activities will take a much longer time to recover (2023 for travel and transportation services) compared with trade in goods, which is expected to return to its pre-crisis level by the end of 2022. We expect the energy sector to be hit the hardest (-USD733bn of export losses), followed by metals (-USD420bn) and transport services tied with automotive manufacturers (-USD270bn).
- **"Pavlovian markets" will generate a regime of high volatility**. Reacting to announcements of expansionary monetary and/or fiscal policy, markets tend to be overly reliant on the effectiveness of policy measures. We continue to believe global equity is over-valued. For 2020, we expect 10y Bunds to finish the year at -0.5% and 10y USTs at 1.0%, slightly above current levels.
- **In the medium term, we expect GDP growth to be impaired by the legacies of the crisis.** We see an accelerating zombification of companies, banks and labor markets, a deterioration of social and political risk and definitive losses in terms of capacities of production. Compared to other developed economies, the U.S. is likely to lose -1pp over ten years mainly due to a large accumulation of public debt. While we don't expect a trade regime shift (relocation/ reshoring) in the short term, pre-Trump tariff levels are unlikely to return despite reduced U.S.-China trade uncertainty after the U.S. elections.

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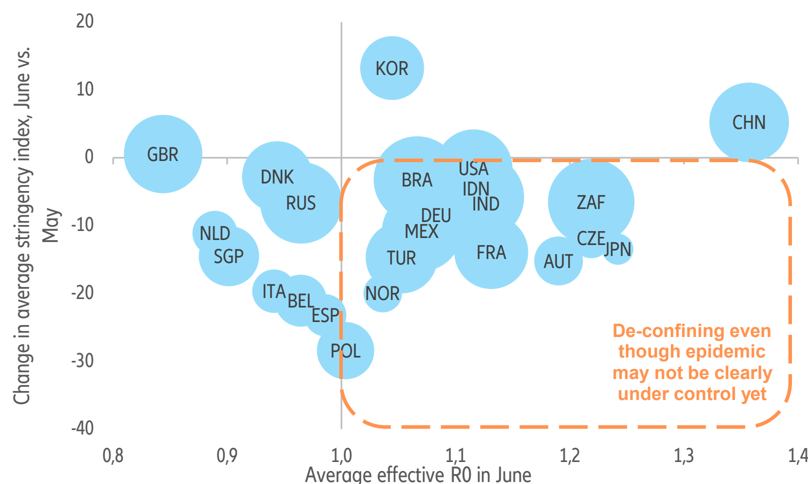
-4.7%

Forecasted global GDP contraction in 2020

LIGHT AND TARGETED LOCKDOWNS TO FIGHT THE SECOND WAVE OF COVID-19 INFECTIONS WILL CONSTRAIN THE PACE OF RECOVERY

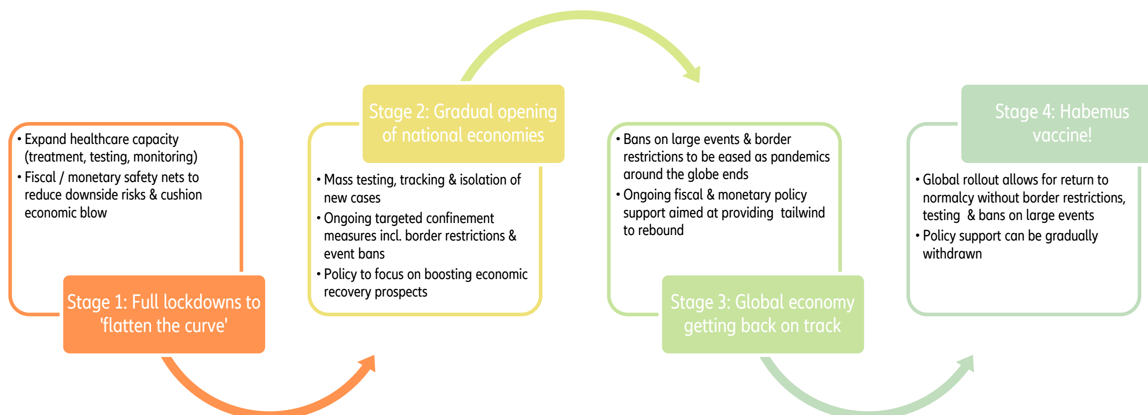
Back in April, we pointed out the gradual opening of national economies post lockdowns, which will prove long and cautious. Light and localized lockdowns are still likely, including border restrictions and event bans. Policy measures will be balanced between targeted relief measures for the hardest-hit sectors (hotels and restaurants, food and accommodation, transportation, leisure) and stimulus measures (VAT rate cuts, car scrappage schemes, green stimulus, public investment measures, company investment fiscal incentives…). Overall, the global economy is operating at 70%-80% capacity and we expect this to continue until Q4 2020 as countries could be forced to impose targeted lockdowns to combat new outbreaks of Covid-19 and to prolong sanitary restrictions until a vaccine is developed. Our analysis suggests that many countries still battle a too high effective reproduction rate (R0). Hot spots include Brazil, Mexico, the U.S, India, Indonesia, the UK and South Africa: these countries are particularly at risk of renewed outbreaks and false restarts as they do not yet have the pandemic under control. In the U.S. we expect the recession to be -2pp stronger (from the current -5.3%) should the lockdowns fighting the second wave be more generalized.

Figure 1: Deconfining: managing the effective reproduction rate (bubble size is latest available stringency index as of end of June)



Sources: Oxford university, Allianz Research

Figure 2: The phase 2 marathon



Sources: OECD, Allianz Research from April 2020

Currently high frequency indicators indicate a slow recovery in countries where initial conditions were weak and lockdown stringency the highest. The stringency index in China increased in June compared to May (one of only two of the main economies in this situation), reaching 79 vs. a global average of 66. Between the risk of renewed outbreaks and the extremely prudent deconfinement approaches, it is likely to be a long time before all containment measures are removed around the world. Stringency indices have been faster to rise than decline, particularly for international travel. Even in areas where lockdowns were not put in place, the stringency index still stood at an average of 30-40 in Q2 (e.g. Iceland, Sweden, Japan). This shows it will take time before we can witness a return to business as usual. We expect global GDP to fall by -4.7% in 2020, more than three times more than in 2009, and to grow by +4.8% in 2021. The return to pre-crisis levels is expected at the end of 2021 as the earliest, mainly driven by China and the U.S. Europe will need more time to reach pre-crisis levels, given the size of the shock — twice as high as in the U.S. — and the more limited stimulus response. We expect a return to pre-crisis levels only in late 2022-2023, with France, Italy, Spain and the UK being the laggards and Germany, the Netherlands and Sweden the fastest-growing economies.

Figure 3: Real GDP growth, %

	2017	2018	2019	2020	2021
World GDP growth	**3.3**	**3.1**	**2.5**	**-4.7**	**4.8**
United States	2.4	2.9	2.3	-5.3	3.7
Latin America	**1.0**	**1.0**	**0.1**	**-6.8**	**3.1**
Brazil	1.3	1.3	1.1	-7.0	3.0
United Kingdom	1.8	1.3	1.4	-13.3	5.0
Eurozone members	**2.7**	**1.9**	**1.3**	**-9.0**	**6.0**
Germany	2.8	1.5	0.6	-7.0	4.5
France	2.4	1.8	1.5	-10.8	7.4
Italy	1.7	0.7	0.3	-11.2	6.6
Spain	2.9	2.4	2.0	-11.0	7.0
Russia	1.8	2.5	1.3	-5.2	3.0
Turkey	7.5	2.8	0.9	-4.7	4.2
Asia-Pacific	**5.2**	**4.7**	**4.2**	**-1.3**	**5.9**
China	6.9	6.7	6.1	1.5	7.6
Japan	2.2	0.3	0.7	-5.7	2.2
India	7.0	6.1	4.7	-3.6	7.5
Middle East	**1.4**	**0.9**	**0.3**	**-6.3**	**2.2**
Saudi Arabia	-0.7	2.4	0.3	-4.0	2.0
Africa	**3.1**	**2.7**	**1.9**	**-3.1**	**4.0**
South Africa	1.4	0.8	0.3	-7.8	5.4

** Weights in global GDP at market price, 2019*
NB: fiscal year for India

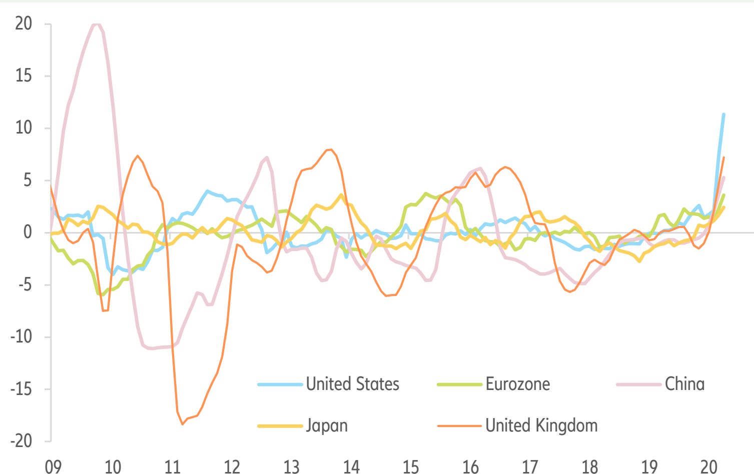
Sources: National sources, Allianz Research

MONETARY BAZOOKA: UNPRECEDENTED BALANCE SHEET EXPANSION, DIFFERENTIATED RETURNS

Central banks around the world have responded quickly and boldly to contain the pandemic-relatedcrisis increasing funding and injecting liquidity. The whole toolbox of classical and unconventional monetary instruments is now at work, including lower policy rates, regulatory flexibility (e.g. collateral policy, loan forbearance), forward guidance and large-scale balance sheet operations. Mirroring this trend, the size of major Central Banks' balance sheets will increase significantly, heading towards 50% of GDP in 2020-21.

While this scale of synchronized monetary policy is a first, our proprietary monetary impulse indices show that the intensities of support differ. In the U.S., the Eurozone and the UK, the indices have reached the highest levels on record, while in Japan the index is at the highest since the early 1970s. In China, however, while the index is moving in the right direction it is still a far cry from the peaks reached after the 2009 financial crisis.

Figure 4: Monetary impulse indices, pts



Sources: National central banks, Euler Hermes, Allianz Research

Going forward, we don't expect a renewed bazooka from central banks, but there will be no change from an extremely accommodative monetary policy. The Fed commitment to near zero interest rates through 2022 looks plausible. The ECB will continue to implement its QE & PEPP programs until 2021 and its balance sheet will continue to expand until the end of 2021 and beyond. It provided weak forward guidance (policy pause), but we believe its attention will switch to banks in order to avoid zombification following the expected rise in non-performing loans. The most vulnerable sectors post the Covid-19 crisis already feature elevated levels of non-performing loans and represent a high exposure for banks. Against low capital adequacy ratios in several European countries and deteriorated profitability, addressing NPLs (for instance via a European bad bank) would help prevent against a potential credit crunch in 2021.

The ultra-accommodative monetary policy will keep bond yields at extremely low levels. We currently estimate the dampening effect of QE for 10y Bund yields at -150bp and for 10y UST yields at -120bp. This effect will be lasting: Even when net purchases eventually come to an end, central banks will enter a multi-year phase of full reinvestment before considering a reduction of their bond holdings.

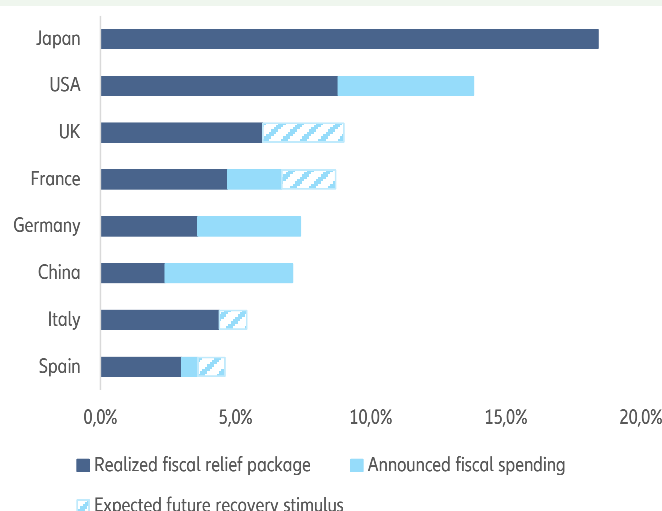
FISCAL BAZOOKA: PROMPT BUT UNEQUAL IN SIZE AND MULTIPLIERS. MORE TO COME?

Global fiscal support has amounted to USD10.4tn since March 2020 (12% of global GDP), ranging from 3%-18% of countries' GDP. This along with the size of automatic stabilizers will shape the future recovery trajectories by country. Countries such as Germany, the Netherlands, Switzerland and Austria are expected to recover faster, thanks to higher automatic stabilizers and above average fiscal support packages. In contrast, countries such as Japan, the U.S., Spain, the UK and Italy need to compensate for the weakness of automatic stabilizers with higher fiscal support.

As expected, policy support during the de-confinement period (May-July) has become more targeted, with a shift in focus from liquidity support to solvency support. Several European states have also announced an extension of partial unemployment schemes, along with direct loans to the most hit sectors. However, we believe much more policy action is required to lower the risk of the zombification of jobs and companies. Without ad hoc policy measures, partial unemployment schemes could only postpone mass unemployment[1]. In addition, a delay in implementing active employment policies and reskilling will continue to keep uncertainty high and feed into the precautionary savings of households. We estimate the savings rate in the EU to remain +6pp above pre-crisis levels at the end of 2020, which represents EUR370bn of excess savings, or 2.5% of GDP. These excess savings could put a damper on economic growth[2].

To date we find that the recovery stimulus remains timid, so a return to pre-crisis levels has been delayed by more than one year depending on the country. In addition, in the absence of enough stimulus measures, the risk of an insolvency crisis is increasing along with the zombification of companies[3]. Low equity ratios for some companies have pushed them into high indebtedness since 2009, which has increased to new record high levels due to the Covid -19 crisis. This coupled with already fragile company margins increases the risk of the zombification of the corporate sector. We expect global business insolvencies to increase by +35% in 2020-21.

Figure 5: Direct fiscal spending, % of GDP



Sources: Various, National sources, Euler Hermes, Allianz Research

[1] *See our recent report: The risk of 9 million zombie jobs in Europe.*

[2] *See our recent report: Europe should unlock excess savings from Covid-19 response*

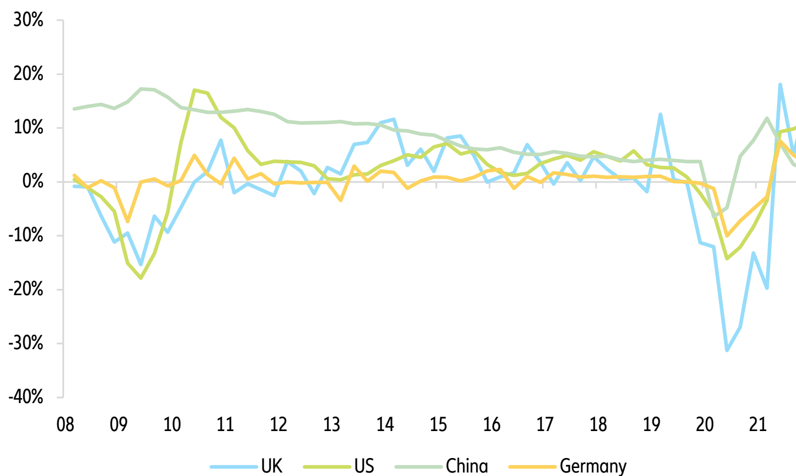
[2] *See our recent report: When Main Street makes it to Wall Street*

MIND THE INVESTMENT CYCLE: CONFIDENCE MATTERS

Companies are in a position to increase their investments during the recovery phase. Increases in net savings thanks to public support during the Covid-19 crisis and on pause investments have significantly reduced their fixed costs[4]. Going further, public support to reduce companies' fixed costs (lower social contributions, lower corporate taxes and/or fiscal incentives to invest) will be key. In addition, state guaranteed loans are likely to remain supportive for companies which want to increase investments, similar to recent announcements in Spain. However, the success of these policies will be dependent on renewed confidence and a pick-up in domestic and external demand.

Imbalances between supply and demand prevail even in July. The ratios of inventories to new orders remains above 1, in some cases voluntary in order to reduce the negative impact from continued supply-chain disruption. Indeed, these latter are likely to remain impaired in H2 as long as social distancing and barriers on international flows of goods and people are maintained.

Figure 6: Total investment, y/y



Sources: National sources, Allianz Research

[4] *See our recent report: European corporates loading up cash against uncertainty*

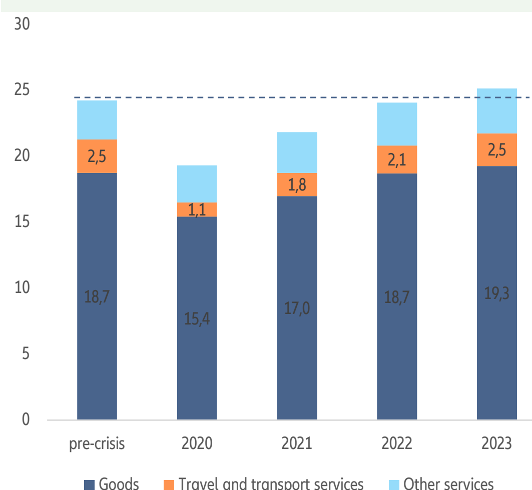
GLOBAL TRADE IS NOT EXPECTED TO COME BACK TO PRE-CRISIS LEVELS BEFORE 2023

In line with our expectations, the volume of global trade of goods contracted in Q1 2020 (-4.8% q/q and -5.4% y/y). In April, at the height of the global lockdowns: goods trade contracted by -12.1% vs. March, the strongest monthly drop ever recorded by the CPB Bureau of Analysis, and by -16.2% vs. April of last year. The hit to overall trade in Q1 2020 ought to be even stronger as the pandemic halted transport and travel services. As a result, we maintain our forecast of a contraction of trade in goods and services of -15% in 2020, more severe than in 2009 (-11%). Adding the oil and commodity price shocks, a stronger dollar and slower global demand, the negative price effects should bring the trade contraction in USD value terms to -20% this year, equivalent to massive USD4.5tn of trade losses. We expect the energy sector to be hit the hardest (-USD733bn of export losses at the global level), followed by metals (-USD420bn) and transport services tied with automotive manufacturers (-USD270bn). With the recovery of GDP growth, reopening of economies and higher commodity prices, we forecast a rebound in 2021 both in volume (+8%) and value (+12%), but this will be insufficient to compensate for the 2020 losses.

We estimate it could take until 2022 for merchandise trade to recover, i.e. a few quarters after GDP comes back to pre-crisis levels, but even longer for travel and transport services (2023, in line with the slow normalization of air travel). Our medium-term assumptions are reduced China-U.S. trade uncertainty from 2021 on but no return to pre-Trump import tariff levels, and no trade regime shift in the short-term i.e. no massive relocations and reshoring.

In fact, while the risk of "reshoring" ("relocation" or "bringing the production back home") exists, our baseline scenario assumes that policymakers would be talking the talk but not walking the walk. We do not expect a rapid structural shift in supply-chain dynamics after the crisis, except for the medical and food sector. It is not unusual that supply chains make the headlines during a crisis: in fact, during the three last recessions, mentions of supply chains and their disruptions in the media peaked. Moreover, we see no strong one-sided case for reshoring. Shortening supply chains can create resilience, but it is costly in terms of logistics and labor, which can push up consumer prices. Automation also means repatriation of production does not systematically mean job creation. Lastly, reshoring reduces diversification and hence increases concentration risk.

Figure 7: Medium-term trade in value terms (USDtn)



Sources: ITC, Allianz Research

MARKETS ARE PAVLOVIAN, PICKY AND DEFENSIVE

For money markets, a new cycle of interest rate hikes seems to be a long way off. For all major developed countries, they currently price stagnating short-term rates at least until the end of 2021. As we see the developed economies recovering from the Covid-19 crisis only by H1 2022, the current monetary policy stance will prevail for longer since hiking cycles usually start long after markets and economic activity have bottomed out. After this brutal recession, we believe central banks will be more cautious than ever when it comes to monetary normalization. They might well be inclined to take the risk of a temporary inflation overshoot rather than curbing the recovery too early. In this context, yields in developed markets are expected to remain on a long-term negative sloping trend. For 2020, we expect 10y BundS to finish the year at -0.5% and 10y USTs at 1.0%, slightly above current levels. While monetary policy, in combination with safe asset demand, has a strongly dampening effect on interest rates (stable short-term rate expectations due to forward guidance and compression of the term premium by QE), inflation expectations could provide some moderate upward pressure as both U.S. and EUR inflation expectations are currently close to the lower bound of our estimation range.

With central banks intervening to contain spreads on the corporate bond markets, both European and U.S. corporate bond issuance markets have now reached historical highs. This rush for credit can be attributed to overly low (because central bank-backed) funding costs, especially in the context of liquidity hoarding and increased risk of rating downgrades. Despite this greater supply, yields and spreads on corporate debt have generally declined even though only a relatively small proportion of that additional supply was actually bought up by central banks. For us, this proves "Pavlovian" markets are at work. This means that markets are trusting the central bank to such an extent that mere announcements can move them in one or the other direction. But this extreme reliance on central banks might become a source of vulnerability, especially in a context where the markets for risky assets (esp. equity) and rates exhibit strongly diverging expectations on the underlying economic momentum.

It seems that equity markets are not pricing in the lasting effects of the Covid-19 crisis on the economy. In the U.S. as well as in Europe, earnings per share (EPS) forwards are pointing to a quick recovery in 2020, followed by a return to the former growth trend, ignoring the risk of the second wave, not to mention darkening economic fundamentals. The magnitude of the bounce back is spread among various sectors. The energy sector is expected to outperform all others in 2021. Besides the sharp market correction in February and March, equities remain expensive, especially in the U.S. Bond and money markets on their part anticipate a cautious recovery where economies will remain below potential for some time.

All in all, we consider the current market conditions fragile. We see U.S. equity markets as the main source of instability as the decoupling from economic fundamentals has become so strong that they are very prone to negative news flow, especially in a context where the market momentum seems at least partially driven by new, volatile retail investors[5] while institutional investors have been piling up holdings in money markets funds. So is there a second market correction coming? Again, divergence is the main pattern here. Daily and weekly indicators (sentiment-driven) are showing the market trough might be already behind us. Structural indicators (monthly and quarterly) have not yet shown any signs of reversal.

[5] *See our recent report: When Main Street makes it to Wall Street*

IN THE MEDIUM TERM, WE EXPECT GDP GROWTH TO BE IMPAIRED BY THE LEGACIES OF THE CRISIS

Further zombification of banks and companies, excessive debt, persistently high protectionism and high political risk are likely to negatively impact the growth potential of major economies over the medium-term. For example, in the U.S., we calculate that the current trajectory of public debt is likely to make the economy lose -1pp of its growth potential over ten years. To this regard, political risk plays a key role. In both Emerging Markets and Advanced Economies, social discontent may be aggravated by the impact of Covid-19 lockdowns, affecting even those countries that have been politically calm in recent years[6]. People could become dissatisfied with weak government responses and/or mismanagement as the economic pain intensifies, and this combined with a generally poor health situation, increasing unemployment and poverty and rising prices (especially for food) could add to already existing social risks. This could could worsen the business climate in some countries (See Figure 8). There is therefore a high incentive among governments to increase the level of debt in order to tame social tensions, which in turn negatively impacts, alongisde high uncertainty, the growth potential.

Figure 8: Watch list for potential social tensions in 2020-2021

Systemic Social Rsik	Advanced Econmies	Emerging Europe	Emerging Asia	Middle East	Africa	Latin America
Significant to High AND Rising		Turkey Bosnia & Herzegovina	Pakistan Sri Lanka	Iran Bahrain	Nigeria Angola Gabon	Venezuela Mexico Colombia Brazil Guatemala Ecuador El Salvador Bolivia Panama Dominican Republic Chile
Significant to High BUT Declining		Russia Azerbaijan Romania Kazakhstan	Indonesia India Bangladesh Vietnam Philippines Thailand China	Lebanon	Congo (Rep. of the) Uganda Cameroon Morocco Cote d'Ivoire South Africa Algeria Kenya Senegal Ghana Tanzania Tunisia Egypt	Honduras Paraguay Argentina Peru
Low to Moderate BUT Rising	UK U.S. Iceland Belgium New Zealand Luxembourg Norway Sweden	Hungary Poland	Hong Kong	Saudi Arabia UAE Kuwait Qatar		Trinidad & Tobago Costa Rica

Note: 'Significant to High' refers to a SRI below 50.0; 'Low to Moderate' to a SRI above 50.0. 'Rising' and 'Declining' refer to the development of the SRI over the past five years.
In each cell of the table, the countries are ranked from highest to lowest risk according to the SRI.

Sources: Euler Hermes Allianz Research

[6] *See our recent report:* Social Risk index : Structural Determinants of social risk

REGIONAL OUTLOOKS

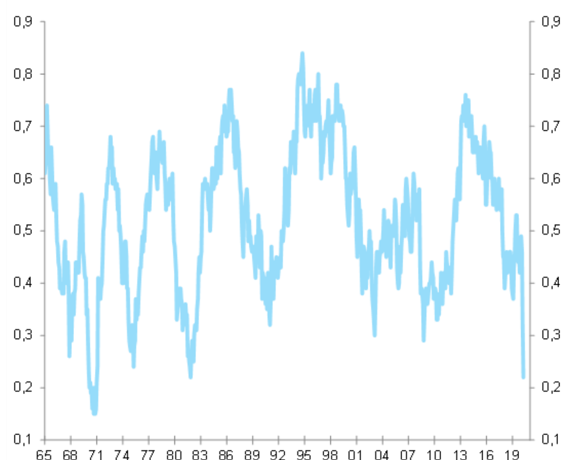
U.S.: The probability of Trump being re-elected has declined from 45% to 22.5% due to the Covid-19 crisis

The U.S. economy entered into 2020 with a -4.7% q/q annualized contraction of activity. We expect the trough of activity to be reached in Q2 2020, with growth possibly declining by -33% q/q annualized. We have revised our GDP growth scenario to -5.3% compared with -2.7% before for three main reasons, i.e. the delay observed in voting a new USD1.5tn infrastructure package, the resurgence of the pandemic in southern states and higher political uncertainty after a wave of protests related to the death of George Floyd. We are still convinced that a U-shaped recovery will take place, with U.S. GDP growth hitting +3.7% y/y in 2021. However, should the lockdowns against the second wave become more generalized and long-lasting, we think the recession could reach more than -7% in 2020. In our view, this pandemic represents a real turning point for the outcome of the upcoming Presidential elections. By aggregating deciles of performances in ten different macroeconomic variables, we estimate the probability of re-election for the incumbent President's party. This model has had a good track record in explaining the outcome of U.S. elections since 1960 and suggests that President Trump now has a 22% of chance of being re-elected, one of the lowest probabilities in the U.S. history.

As evidenced by Figure 9, the Covid-19 crisis plays a very important role in explaining the deterioration of President Trump's re-election prospects.
The probability of Joe Biden winning the election is therefore higher now. According to the Tax Policy Center, Joe Biden's tax proposals will increase fiscal revenue by between USD3.6tn and USD4tn between 2021 and 2030. It estimates that 93% of the tax increases would be borne by taxpayers in the top 20% of households by income. The top 1% of households would pay three-quarters of the tax hike. Another important feature of Biden's platform is the corporate tax rate, which is expected to increase from 21% to 28%.

Regarding fiscal spending, USD3.4tn of supplementary spending has been announced. To analyze the impact of this budget proposal (we compare with the CBO's own projections), we assume USD3.5tn of new tax revenues (negative multiplier of -0.5) and USD3.5tn of supplementary spending made up of USD1.3tn in infrastructure (multiplier 0.9), USD0.7tn in healthcare spending (multiplier 0.6) and USD1.5tn of measures equivalent to social transfers (student loans forgiven, increase of minimum wage, lower education fees… with a multiplier of 0.8). All in all, these budget orientations could generate USD1tn of revenues for the economy by 2030.

Figure 9: Probability of being re-elected for the incumbent U.S. President's party



Sources: Allianz Research

President Trump has proposed USD2tn of supplementary spending in infrastructure and USD800bn of additional military expenditure, with an extension of the tax cuts implemented during his first mandate (USD1.5tn), which should normally finish in 2025. Large cuts in healthcare, education and other social spending would amount USD3.3tn (including cuts in Medicare and Medicaid). All in all, the multiplier impact on the economy is similar to Biden's option albeit with radically different redistributive effects. The result would be close in terms of the evolution of the public debt. After record high deficits in 2020 and 2021 (16% of GDP and 10% of GDP, respectively), and in the absence of any willingness by any candidate to adopt a more conservative stance of budgetary policy, we expect public debt (held by the public), to increase from 80% of GDP to more than 100% of GDP at the end of 2021, and 120% of GDP by 2030.

Positive policy surprises in Europe, but the road to pre-crisis levels will be long

High-frequency data confirm that the gradual easing of containment measures across Europe from early May onwards has set the stage for a notable – albeit to a large extent technical – GDP rebound in H2 2020. After all, underlying growth dynamics are likely to remain sluggish as continued sanitary restrictions, lingering contagion fears, heighted economic uncertainty and the expected uneven global recovery will keep a lid on consumption and investment decisions. As a result, Eurozone GDP will only recover to pre-crisis levels in late 2022-2023.

While no country was spared from the crisis, the length and strictness of the respective national lockdown, the size and composition of fiscal stimulus plans and characteristics of individual economies, such as the importance of the services sector, set the stage for very different recovery prospects across Europe: Among the largest economies, on the one end of the spectrum is Germany, with GDP set to decline by -7% in 2020 and recover to pre-crisis levels in early 2023, whereas on the other end you will find the UK which will see a much sharper downturn at -13.3% in 2020. Here a return to pre-crisis GDP will take twice as long.

In recent weeks the economic outlook for Europe has clearly brightened, thanks to some important policy steps that should provide a boost to the economic recovery and keep a lid on divergence, though not eliminating it. The EU has taken an important step towards more fiscal solidarity: The proposed EUR750bn Next Generation EU funds should further brighten economic prospects as they will allow for a top-up of national fiscal responses - with a focus on investment - which will help in particular those economies that are most impacted by the Covid-19 crisis. Our calculations suggest that the fund could lift GDP levels by +0.4% per year until 2025.

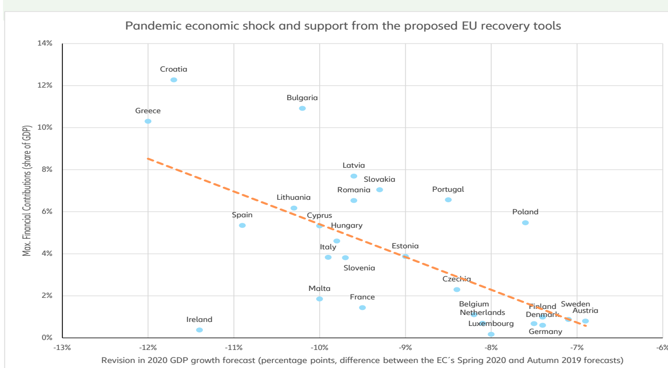
Meanwhile on the monetary policy front, the ECB pulled some new tricks out of its hat at its June meeting in an effort to keep a lid on lingering debt sustainability concerns and prevent unwarranted financial fragmentation. In a bold and pre-emptive move, it delivered a significant easing of monetary policy, justified by a sharp downward correction in its inflation and growth projections. For one, it announced a EUR600bn PEPP expansion, exceeding expectations of a EUR500bn boost. Furthermore, the ECB announced that maturing PEPP purchases will be reinvested until at least end-2022 and that the PEPP purchase horizon was extended to mid-2021. With these policy decisions, we expect the ECB to remain on hold over the summer months until September, when the next round of macro projections are likely to call for a reassessment of the policy stance, including the size of PEPP as well as the decision on whether the ECB should start to buy "fallen angels" i.e. bonds that lose their investment-grade credit rating, as collateral. Taken together, in our view, these policy steps have the potential to change the narrative of a Europe that is always doing too little, too late. Hence, we expect Eurozone GDP to rebound by +6% in 2021 after -9% in 2020.

Figure 10: Key factors driving short-term economic performance

	Germany	France	Italy	Spain	UK
Lockdown lengths (weeks)	6	8	10	10	12
Lockdown strictness*	73	89	87	81	73
Lockdown strictness x length	439	713	866	806	874
Fiscal stimulus (% of GDP)	7,50%	6,70%	4,50%	2,50%	5%
Services (% total gross value added)	69,30%	78,90%	73,90%	74,80%	79,80%

Sources: Oxford University, Eurostat, Allianz Research

Figure 11: Growth shock vs support from EU recovery fund



Sources: European Commission, Allianz Research

Germany continues its fiscal splurge and should recover faster than peers

Following a six-week lockdown aimed at slowing the spread of the virus, during which at times 30% of economic activity was put on pause, the German economy spearheaded the deconfinement trend from late April onwards. Thanks to a relatively short and less strict lockdown and an economy less dependent on services, Germany boasts favorable conditions to outperform most of its European peers. The most notable game-changer, however, has been Germany's fiscal response, which thanks to the decisive and comprehensive policy action (almost 35% of GDP in public guarantees and higher fiscal spending) on behalf of the German government has been key in limiting the economic fallout from Covid-19. Thanks to its front-loaded nature, the recently announced EUR130bn stimulus package (3.8% of GDP) alone should add 1pp to GDP growth in 2020 and another 0.5pp in 2021, with key trade partners likely to profit from positive spillover effects. Germany's economic outperformance explains to a large extent, why insolvencies here are likely to rise by only +12% till end-2021, while the increase for the Eurozone as a whole is expected to be more than twice as high at +31%.

But despite occupying the recovery pole-position, a quick return to 'business as usual' is not on the table. Even though private consumption in Germany is on course for a V-shaped recovery, thanks to additional tailwind from the VAT cut and the child benefit bonus, prospects for the export-dependent German economy are likely to be held back by the asynchronous economic recovery in global economic activity and in turn also trade. All in all, following a decline of -7.0% in 2020, the German economy looks set to grow by only +4.5% in 2021. Given the gradual and drawn-out nature of the recovery, German GDP will only reach pre-crisis levels at the turn of 2022/23.

Figure 12: Fiscal stimulus measures across European countries

Germany: Strong & timely tailwind for the imminent recovery
(fiscal stimulus: announced, expected, unlikely)

	DE	FR	IT	ES	UK
Taxes					
VAT	√	x	x	x	√
Income	x	x	x	x	x
Corporate	√	x	√	√	√
Spending					
Household cash transfers	√	√	x	x	x
Job rentention scheme	√	√	√	√	√
Car scrappage scheme	√	√	√	√	√
Vulnerable sector support	√	√	√	√	√
Public investment	√	√	√	x	√

Source: Allianz Research

The French consumer has the potential to support the recovery

France's GDP is expected to contract by -10.8% in 2020 before rebounding by +7.4% in 2021. The historic recession in 2020 will be mainly driven by the collapse of domestic demand. While investment is expected to fall strongly by -21.7% (y/y), the decline in consumption will be more moderate (-10.1%). We project the public debt-to-GDP ratio to soar to 120.6 % in 2020 (from 98.8% in 2019) and the unemployment rate to reach 12.5% (from 8.5%). French companies were already in bad shape before the outbreak of the Covid-19. Their debt-to-GDP ratio of 74% was already above the Eurozone average (60%). Companies were also tight on cash in the beginning of 2020: French SMEs only had the equivalent of two months of turnover in cash on average. To cushion the impact of the crisis, French companies had to make extensive use of treasury loans, in particular based on the state-guaranteed loan scheme (PGEs) implemented after Covid-19 hit. Given the size of the shock and the slow pace of the recovery, we expect a surge of insolvencies as of the third quarter of 2020. These insolvencies will naturally cause large loan defaults in sectors severely affected by the crisis (construction, accommodation, transport). The deterioration of the asset quality of banks could be problematic for the recovery as banks may start to tighten credit conditions in 2021. However, we do expect activity to recover in 2021, thanks to consumers regaining confidence and the support of the stimulus package that would be announced by the government.

Italy's outlook is exposed to several downside risks

Italy is poised to see a large GDP contraction of -11.2% in 2020, reflecting both the length and strictness of its lockdown. With +6.6% growth next year, the recovery will prove less vigorous than previously expected. At the end of 2021, Italian GDP should still remain 3% under its pre-crisis level. Italy entered the crisis in an already weak position and it will remain one of the laggards in the Eurozone on the way out. In response to the Covid-19 crisis, the Italian government has put together a decent fiscal package worth 4.5% of GDP. However, it remains biased towards employment protection and corporate tax relief. In terms of state-guaranteed loans, a large envelope of a maximum 35% of GDP has been mobilized. The guarantee level is on average 80%. However, so far only 7% of this amount (EUR42bn) has been called up. The hesitant use of the guaranteed credit scheme seems to be linked to the still weak and therefore risk-averse Italian banking sector. In addition, these loans have so far mainly been concentrated on large groups.

For the time being, our outlook for Italy remains associated with downside risks. There are several reasons for that. Firstly, with economic uncertainty persisting, household consumption might recover more slowly. Consumption-related high-frequency data indicate a rather subdued recovery in Italy compared to other European countries. Secondly, there is great uncertainty about the ability of the tourism sector to recover. Again, related high-frequency data point at a very gradual normalization. The return of foreigners remains a great unknown. Third, the Italian banking sector remains fragile. Pockets of vulnerability prevail, notably among medium and small regional banks. We see a risk, especially for SMEs, that this will affect the channeling of state guaranteed loans to companies. Finally, we still see non-negligible political risks as the coalition is still notoriously fragile. At the same time, a new dynamic emerges on the very right wing with for instance the foundation of a new Italexit-party. On top of this, the crisis is likely to increase social tensions between generations due to employment conditions or between regions as in certain areas mass tourism has become the almost sole source of income.

Relatively limited fiscal support and political fragmentation could slow the recovery in Spain

Sentiment and high frequency data suggest that April was the trough of the crisis but the economy could post a massive contraction in Q2 overall (-19% q/q) especially since localized lockdowns were prolonged in May (Madrid and Barcelona). Overall, the 2020 recession in Spain could be among the most severe in Europe (-11%) and the recovery will be gradual and only partial in 2021 (+7%). We see two main reasons why Spain is emerging as a laggard in the Eurozone despite its strong pre-crisis momentum (+2% GDP growth in 2019): (i) the direct fiscal relief package (now around 2.6% of GDP) was amongst the least ambitious in Europe; (ii) political fragmentation caused tensions during the crisis, and it could hamper the post-crisis momentum for reforms. A major risk ahead is the job market, given its duality, flexibility and reliance on the tourism sector (12% of employment). The unemployment rate could peak at 18.7% in Q1 2021 after most government support schemes expire.

The UK: Small is the "New Deal", Brexit-constrained?

The UK is among the countries with the longest (more than 10 weeks) and harshest lockdowns to fight the Covid-19 sanitary crisis. We expect Q2 GDP to fall by more than -20% q/q. Activity resumption has proved slower than elsewhere in Europe as the deconfinement strategy looks more cautious than elsewhere. Hence, we don't expect GDP to return to pre-crisis levels before H2 2023. Stimulus measures to the tune of 3% of GDP are expected to be announced until end-2020, but heightened Brexit uncertainty is just around the corner, constraining the government from announcing a policy bazooka as soon as this summer. We continue to think an extension of the transition period until at least mid-2021 is likely. In our view, the risk of "no trade deal" at end-2020 stands at 20% probability. However, this extension is likely to be required by the UK only in October, increasing the downside risks to the recovery in H2 2020 and pushing companies to prepare for the worst-case scenario by stockpiling similarly to 2019. Hence, we expect GDP growth to increase by only +5% in 2021 after a recession of -13.3% in 2020, one of the worst in Europe. Business insolvencies are expected to rise by more than +40% in 2020-21.

Emerging Markets: The Covid-19 QE programs could endanger central banks' credibility

The Covid-19 pandemic marked a turning point for 'unconventional' monetary policies in Emerging Markets (EMs). As the pandemic induced investors' panic in March 2020, EMs experienced unprecedented capital outflows (USD88bn) that dramatically destabilized their sovereign bond markets. The fire sales of foreign investors particularly hit countries where they hold a significant share of the local currency sovereign debt. For instance, this share is close to 40% in Czechia, Indonesia and South Africa. Against this background, some EM central banks announced that they were ready to step in and act as a lender of last resort by engaging in long-term government asset purchases, if needed, and a few have since done so. Foreign investors responded quite favorably to these announcements, which helped to restore the liquidity of the markets and stabilize the government bond yields. So far these QE-like monetary policies of EMs have been confined to small-scale purchases, mostly on the secondary market (see Table 1). Turkey is the outlier, having purchased government securities equivalent to around 9.4% of GDP since end-March. These securities represent 11.3% of the central bank's total assets in June 2020, versus 1.9% three months before. Thereafter, Poland pursued the most active "QE" (around 4.2% of GDP to date). In contrast, the U.S Fed and the ECB, for example, have been much more active and increased their total balance sheets to around 40% of GDP currently. Another difference from Advanced Economies is that EMs announced their government asset purchase programs at a time when they still had room to follow conventional monetary policy by lowering policy rates.

Are EMs playing with fire?

These long-term government asset purchases need to be implemented in a temporary manner with a clear framework. Otherwise, the short-term relief on local-currency debt markets can become counter-productive to attract, over the medium term, the resumption of international capital inflows. Moreover, systematic bond purchases by a central bank can open the door to debt monetization – especially if purchases are conducted directly on the primary market – and jeopardize the "hard-earned" monetary policy credibility. In that case, de-anchoring of inflation expectations and strong currency depreciations may impair the ability of a government to continue to borrow in local currency. Moreover, in countries highly indebted in foreign currencies, QE can bring about bigger problems by putting debt sustainability and the private sector's balance sheets at risk (e.g. Turkey). Against this background, we believe that Indonesia, which has already purchased government bonds on primary markets, as well as Turkey, Poland and Croatia, which have conducted the largest purchases (as share of GDP) among EMs, are potentially playing with fire. South Africa and Hungary also require close monitoring owing to their relatively high shares of foreign-owned local government bonds and/or total FX-denominated debt (see Figure 13).

Figure 13: Government bond purchase programs in EMs

Country	Policy rate	Gov. bond purchases by Central Bank		Foreign-owned local gov. bonds (% of total)	Total FX-denominated debt (% of GDP) *	Inflationary risk
		Size (% of GDP, purchased since March)	Primary / secondary market?			
Turkey	8,25%	9,4%	Secondary	10,1%	63,8%	
Indonesia	4,25%	2.8% **	Primary & secondary	38,6%	21,3%	
Poland	0,10%	4,2%	Secondary	23,4%	49,5%	
Croatia	2,50%	3,4%	Secondary	na	na	
Thailand	0,50%	2,4%	Secondary	17,2%	14,5%	
Philippines	3,25%	1,6%	Secondary	na	na	
Colombia	3,25%	1,1%	Secondary	24,5%	27,9%	
India	4,00%	0,8%	Secondary	3,6%	12,1%	
South Africa	3,80%	0,7%	Secondary	37,2%	35,3%	
Hungary	0,75%	0,3%	Secondary	18,6%	62,1%	
Romania	1,75%	0,2%	Secondary	19,3%	na	
Costa Rica	0,75%	Has started ***	Secondary	na	na	
Brazil	2,25%	Announced, not started	Secondary	10,4%	29,4%	
Chile	0,50%	Announced, not started	Secondary	na	52,6%	
Czechia	0,25%	Announced, not started	Secondary	40,6%	34,5%	
Malaysia	2,00%	Announced, not started	Unspecified	25,3%	32,5%	

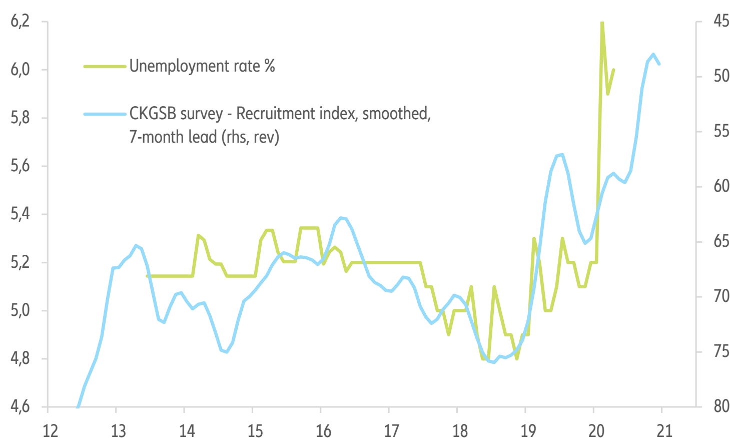
* Both public and private debt. ** Bank Indonesia already owns about 15% of tradable government bonds.
*** Central Bank of Costa Rica was authorized and approved purchases of up to 0.7% of GDP.

Source: Allianz Research

Several indicators already point to a recovery in China, although it is likely to remain uneven in the short term.

High frequency indicators suggest that economic activity has been operating at 95% of usual levels in June. The recovery in the manufacturing sector may be capped in the short term by subdued private consumption (due to lower consumer confidence and disposable income) and global trade being under pressure (as China's trading partners exited Covid-19-related lockdowns later). On the positive side, policy-driven sectors such as infrastructure and construction are rebounding more quickly. Although it avoided setting a growth target for 2020, the Chinese leadership has emphasized employment as a priority. Policy support is turning more aggressive to safeguard jobs. We estimate that fiscal stimulus in 2020 will amount to 7.1% of GDP (compared with 5.7% over 2018-19). monetary policy has also become more accommodative (although a far cry from the post-GFC impulse), with a spe cial focus on micro and small enterprises. Policymakers will continue to roll out reforms to make the country attractive externally, with the negative list for foreign investment shortened again at the end of June. Overall, we expect GDP growth at +1.5% in 2020 and +7.6% in 2021 (after +6.1% in 2019), as long as downside risks do not materialize. These include the risks of new Covid-19 outbreaks and rising protectionism (e.g. between the U.S. and China).

Figure 14: Unemployment rate in China, %



Sources: Wind, Euler Hermes, Allianz Research

In Asia-Pacific, we now expect aggregate growth for the region to decline to -1.3% in 2020 (down from -0.6% expected in April, and compared with +4.3% in 2019). This downwards revision is driven mainly by lower GDP growth forecasts in India (-3.3%), Indonesia (-1.5%), Thailand (-6.0%), Hong Kong (-5.9%) and Singapore (-5.1%). The changes are due to stricter and/or longer lockdown measures to contain the pandemic, and sometimes underwhelming policy responses to lead the economy towards a recovery. Idiosyncratic factors are also at play. In India, despite the significant cut in our forecast, risks remain on the downside. In particular, a pandemic not yet under control means that activity resumption could be even slower than in other economies, and could also imply the risk of new virus outbreaks. The policy leeway is limited by twin deficits and a vulnerable financial system. In Hong Kong, protests resuming faster than previously expected in the context of a pandemic will further delay the economic recovery (e.g. in the tourism and retail sectors). The U.S. potentially imposing the same tariff hikes on Hong Kong as the ones applied on mainland China over 2018-19 should have a limited impact (less than 1% of Hong Kon GDP). At this stage, we keep the central scenario that the implementation of the national security law will not materially impact Hong Kong's business environement. On the positive side in the Asia-Pacific region, we have revised up 2020 GDP growth forecasts for economies that have experienced looser and/or shorter lockdowns than initially expected. That is the case for Australia (-4.3%), New Zealand (-4.8%), South Korea (-1.5%) and Taiwan (-0.3%). These economies could also be supported by the comparatively earlier recovery of the Chinese economy. Trade data show Asia-Pacific exports to China outperforming those to the U.S. or the Eurozone.

Latin America is a laggard overall, but the crisis exacerbates regional differences

The region will emerge as a laggard, but the crisis should also accelerate the divergence between countries that had favorable initial conditions (low debt ratios, sound business environment, etc.) and the others. All major countries will fall into a deep recession as we revise our 2020 regional forecast downwards from -4% to -6.5% and project a modest 3% rebound in 2021. This is due to a more severe spread of the pandemic than projected in March, and stringent and/or prolonged lockdowns. Yet Peru, Uruguay or even Colombia to a lesser extent should probably emerge with fewer vulnerabilities and a better momentum than Brazil and Mexico. For the region, stimulus is at work and the credit crunch is avoided for now, yet we believe it will not be sufficient to avoid massive employment losses and insolvencies in the region.

Last March, we anticipated the recession in Brazil and high number of insolvencies and expressed doubts about the administration's ability and willingness to manage the crisis. We now forecast the deepest yearly contraction in Brazil's history (-7%). As of June, despite the reopening, confidence has barely recovered and activity is still 26% below pre-crisis levels, which signals a sluggish recovery. Localized lockdowns are still possible. Second, Brazil's vulnerabilities lie in its political and social risk, which is on the rise: the economic policy uncertainty index is at a three-year high. The crisis and its emergency funding needs rendered previous fiscal efforts obsolete. Political gridlock risk is higher than ever, and even the likelihood of impeachment after the crisis is rising, which could prolong the downturn.

Emerging Europe: unequal policy support to continue over the next two years

In the Emerging Europe region as a whole, annual real GDP is forecast to contract by -5.3% in 2020, followed by a moderate recovery to +4% growth in 2021. By and large, the curves of Covid-19 infections have flattened in most countries of the region for now, and lockdowns are gradually being eased. At the same time, monetary policy accommodation and fiscal stimulus have supported the economies, albeit to diverging degrees as there is uneven room for policy leeway. We expect the unequal policy support to continue over the next two years. Czechia and Poland are expected to stimulate the most. Both have announced large fiscal stimulus programs and lowered monetary policy interest rates close to zero. The Polish central bank has also purchased a noteworthy amount of government bonds (equivalent to just over 4% of GDP to date) on the secondary market to ensure a smooth functioning of bond markets. Meanwhile Slovakia, Slovenia and the Baltic countries will benefit from their Eurozone membership. Russia has cut its policy rate to a record low 4.5% but is reluctant to use its large sovereign wealth fund assets massively to stimulate the economy, keeping them as a last resort in case of need. Less room for policy manoeuvering is available in Turkey, Ukraine, Romania and Hungary, which will remain the higher risk economies in the region. In particular, the Central Bank of Turkey's purchase of government bonds on the primary market (1.1% of GDP), along with the burning of 30% of its FX reserves through massive intervention in currency markets to stabilize the TRY, bears the risk of raising inflation, further deteriorating investor confidence and triggering another balance-of-payments crisis, just two years after the previous one. In the medium term, the uneven room for policy manoeuvering combined with differing momentum at the start of the crisis, as well as individual countries' dependence on exports and tourism, will determine the depth and length of the recessions. Poland should reach its pre-crisis level of GDP at the end of 2021, Czechia and Turkey in mid-2022 and Russia only in 2024, mainly due to its overall lower growth regime.

The triple shock of Covid-19 in the Middle East will have long-lasting effects

In the Middle East region, the triple shock of Covid-19, the oil price slump in H1 2020 and the response to the latter – oil output cuts began in May – will hit exports and growth hard, in particular in the hydrocarbon-dependent economies. Stringent confinement measures against the spread of Covid-19 are being eased only very gradually, impacting domestic demand and tourism revenues markedly. Moreover, the oil price and output crisis will result in huge export losses in the oil-exporting countries. For example, these losses are forecast at more than -USD100bn in 2020 in both in Saudi Arabia and the UAE. And only one fourth of these shortfalls will be regained in 2021. As a result, annual real GDP in the Middle East as a whole is projected to decrease by -6.8% in 2020, followed by only a modest recovery to +2.2% growth in 2021. Another result is that fiscal and current account deficits will widen sharply in the GCC countries in the next two years. This is still manageable for Saudi Arabia, the UAE, Qatar and Kuwait, which have ample FX assets in their SWFs. But it will be a problem for Bahrain and Oman, whose reserve assets are much smaller and which therefore face increasing country risk.

Covid-19 crisis puts debt sustainability at risk for several African countries

In 2020, African GDP is expected to contract by -3.1%, which will be the first recession on the continent in 25 years. The strongest contractions will be seen in oil-exporting countries such as Nigeria (-3%), Angola (-4.7%) and Algeria (-6.7%). Restrictions on tourism will affect growth dramatically in Tunisia (-3.9) and Morocco (-3.9). South Africa is expected to go through one of the sharpest recessions on the continent (-7.8%) as a result of an unprecedented demand shock (internal and external) and capital outflows. The Covid-19 crisis also will put debt sustainability at risk in highly indebted countries such as Angola, Egypt, Tunisia. In 2021, we project Africa's GDP to rebound by +4%, with the support of stronger global demand, higher commodity prices and resuming tourism activity.

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