Swiss Re Institute

Issue 28/2021

Economic insights
Europe's new COVID-19 wave: déjà-vu, but different

Key takeaways

- Europe is again at the epicentre of the pandemic. This time, however, we expect the economic fallout will be less severe than in previous waves.
- We keep our forecasts for euro area real GDP growth unchanged at 5.0% for 2021 and 4.1% for 2022, below consensus.
- The Omicron variant has increased uncertainty globally, and the risks to the growth outlook are skewed to the downside.
- Today there is greater immunity to the virus across the euro area and the economy has adapted to better live with the virus.
- To this end, we believe consumers and businesses will prove more resilient to any further tightening of restrictions than before.

About Economic Insights
Analysis of key economic developments and their implications for the global re/insurance industry.

Managing Editor
Jérôme Haegeli
Swiss Re Group Chief Economist

Authors
Charlotte Müller
Chief Economist Europe

Diana van der Watt
Economist

We welcome your feedback. For any comments or questions, please contact: institute@swissre.com

In a nutshell

Another winter resurgence in COVID-19 cases and restrictions is enveloping Europe. We expect the hit to economic activity to be less severe than in previous waves of the ongoing pandemic, owing to higher population immunity, the economy having adapted to "living with the virus", and stronger growth and labour markets today. Still, downside risks have risen.

Europe is again at the epicentre of the pandemic. In recent weeks, a number of countries including Germany, Austria and the Netherlands have reported record highs in the daily count of new COVID-19 cases, and hospitalisations are rising. A more deadly surge has hit eastern Europe, where vaccination rates lag. The pendulum has swung back towards further restrictions, some familiar (mandatory masks, lockdowns of varying severity) and others new (vaccine passports). Meanwhile the Omicron variant has triggered a surge in uncertainty globally and sovereign bond yields have slumped amid growth slowdown fears. The return of winter cold brings a sense of déjà vu, but from an economic perspective, we believe the fallout in Europe will be less severe than in previous waves. This is due to higher population immunity, and businesses and consumers having learned to better live with the virus.

The upshot of these factors means that Europe enters the latest wave at a time when economic momentum is strong. Compared with last year, the euro area Purchasing Managers' Indices (PMIs), which measure business sentiment, are well in expansionary territory (see Figure 1),[1] and improving labour markets should support consumer confidence, with employment higher than last autumn.[2] In the UK, signs of disruption from the end of the furlough job retention scheme remain elusive. The paradigm shift towards higher debt-financed government spending over the pandemic suggests that governments are ready to provide more fiscal support should the situation deteriorate. The European Central Bank (ECB), which was already trailing behind the global hawkish move in central banks is likely to stay highly accommodative this winter and beyond. This will allow financial conditions to remain relatively loose and German sovereign bond yields to stay low.

A repeat of the shift in consumer demand from services to goods, as seen during last winter's lockdown, is not a given, even if restrictions do tighten further. Government mandated and self-imposed distancing imposes a hit to close-contact services activity, but the durability of already-purchased goods such as home-exercise equipment, home-office furniture, technology, DIY and kitchen gadgets limits how many more such items households can buy. Hence the same extent of substitution in demand is unlikely. If consumers save rather than redirect their spending, economic growth will disappoint.

[1] Euro area Composite PMI hit 55.4 last month, above the 50 threshold for "expansion" and up from October. Source: IHS Markit
[2] The euro area unemployment rate has come down to 7.3% versus its pandemic-peak of 8.6%. Source: Bloomberg

06 December 2021

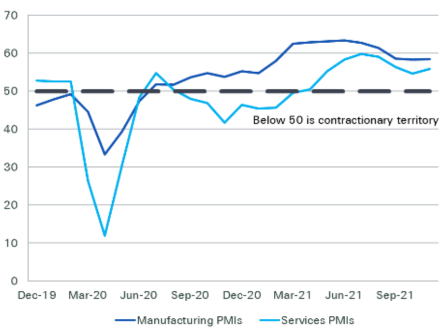
Pandemic risks are skewed to the downside in the next months, but by spring we expect the outlook to improve. We keep our Euro area real GDP growth forecast for next year unchanged at 4.1%, below consensus. Europe has a stronger economic backdrop today because it is learning to "live with COVID". The inflation impact is ambiguous. Goods inflation will likely stay high into the medium-term due to protracted supply chain issues, with the new variant lengthening the phase-out of Asia's zero-covid strategy. In contrast, near-term services prices could decline due to potentially weaker demand.

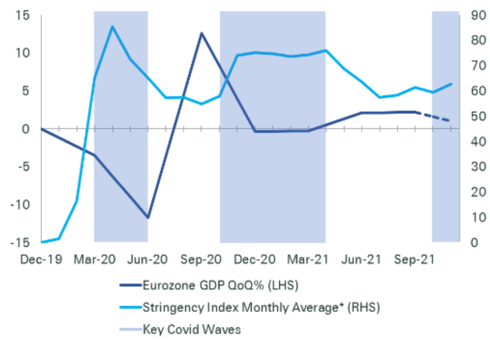
Greater population immunity is breaking the link between infection rates and hospitalisations. There is rising impetus behind vaccination campaigns and booster shots, while new antiviral treatment pills are set to reach quantity early next year.[3] If existing vaccines are less effective against the new variant, there is widespread expectation that they can be adapted, albeit over time.[4] Restrictions may still tighten over the coming weeks, but governments should be able to use more targeted measures or lighter and briefer "lockdowns".

The link between economic activity and mobility restrictions (illustrated by the Oxford Stringency Index) has weakened over time as Europe has adapted to living with the virus (see Figure 2). Companies are better operationally equipped (eg, working from home set-ups) and have adapted business models (eg, restaurants into food shops[5]), while consumers have adjusted (eg, e-commerce; lower risk aversion to the virus than previously). In our view, any tightening of restrictions will be less disruptive to euro area GDP this time. In addition, vaccine passports and mandates,[6] reduced hours and capacity limits will allow services to continue to operate, albeit more conservatively.

Figure 1 Manufacturing vs services PMIs for euro area (level, LHS)

Figure 2 Euro area growth is responding less to higher stringency restrictions as time passes (RHS)





*Weighted average of Oxford Stringency Index for Germany, Italy and France
Source: Oxford University Blavatnik School of Government, Bloomberg, Swiss Re Institute

[3] ~70% of EU population is vaccinated. Over 18m have received a booster shot in UK. Source: *ourworldindata.org*
[4] "Will Covid vaccines have to be updated for Omnicron?", *ft.com*, 1 December 2021; and "EU could approve shot against new coronavirus variant in 3-4 months", *reuters.com*, 30 November 2021.
[5] "Chef Ruth Rogers: The hardest thing for managers is telling someone they are wrong", *ft.com*, 21 February 2021
[6] Vaccines will become compulsory in Austria, and Germany also plans to make vaccines mandatory subject to a parliamentary vote.