Global Economic Outlook: update

Our base case is now the pandemic scenario

Contents

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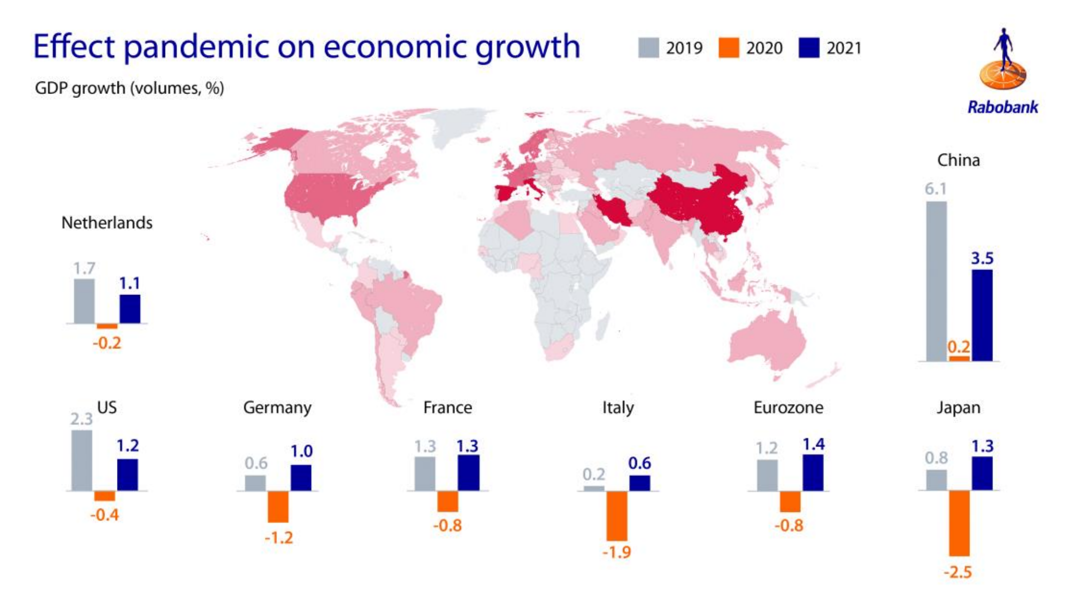
Summary

- We have changed our base case to the pandemic scenario and now expect a recession in virtually all G10 countries. We estimate that global economic growth will slow to 0.7% in 2020, down from 2.9% before the corona crisis
- Some financial markets have seen losses surpassing those during the global financial crisis
- Data on real economy impact is scarce, but the information that we do have points to a sharp slowdown in economic activity. Given the increasing number of countrywide lockdowns, this slowdown will is not likely to subside soon
- Governments and central banks seem to be using different approaches to fight the spread of COVID-19 and mitigate its economic impact
- There is a significant risk we have to tone down our forecasts in the short term, for instance if the current health crisis turns into a financial crisis. Yet, there are too many unknowns at this moment to make a meaningfully estimate of the economic impact at this point in time



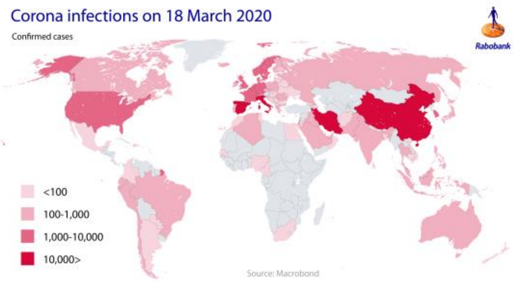
We are in the pandemic scenario

COVID-19 has turned into a pandemic, with over 220,000 confirmed cases in over a hundred countries and over 9,000 deaths. Things have really moved fast, with the virus becoming pandemic in just a number of weeks (compare Figure 1 and 2).

Figure 1: The virus spread...

Source: [Johns Hopkins University]

Figure 2: ...went pandemic in just a number of weeks



Source: [Johns Hopkins University]

In our previous outlook, we argued that in such a scenario, virtually all G10 countries could enter a recession and global economic growth could fall to 0.7% in 2020 (Table 1). We expect a rebound of 3.2% in 2021, but this hinges on the assumption that the economic fallout due to the coronavirus is limited to this year, which is far from clear. We expect China's growth to edge to zero in 2020. The largest decline in GDP is expected in Japan (-2.5%), Italy (-1.9%) and Germany (-1.2%).

Table 1: Economic growth of selected countries

GDP growth (volumes, %)	*'19*	*'20*	*'21*
Gross domestic product			
World	2.9	0.7	3.2
US	2.3	-0.4	1.2
Eurozone	1.2	-0.8	1.4
- Germany	0.6	-1.2	1.0
- France	1.3	-0.8	1.3
- Italy	0.2	-1.9	0.6
- Spain	2.0	-0.3	2.8
United Kingdom	1.4	-0.7	0.4
China	6.1	0.2	3.5
Japan	0.8	-2.5	1.3
Brazil	1.2	0.4	3.3
India	5.3	3.6	6.9
Australia	1.8	-0.6	2.1
Level in US dollar			
Oil	64	46	60

Source: Rabobank, IMF, Macrobond

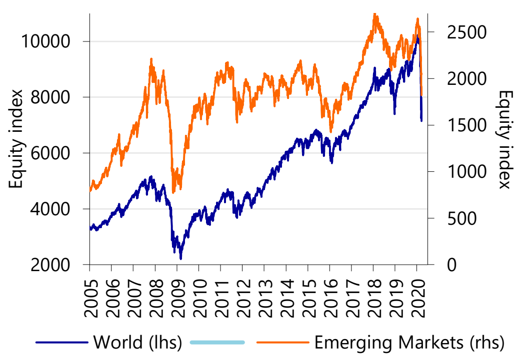
Financial markets in turmoil

Recent activity in financial markets has managed to surpass even the dramatic volatility seen during the global financial crisis of 2008-09. Whatever market and whatever measure one wants to look at, we are seeing jaw-dropping movements every day:

- Equity markets have collapsed into a bear market (Figure 3), albeit with massive day-to-day swings of +/- 10% in some cases, while equity volatility measures such as the VIX have reached their highest levels ever (see Figure 4);
- Government bond yields have seen enormous day-to-day shifts. Initially they collapsed, even the entire US Treasury curve falling below 1% for the first time, but in recent days they have seen major spikes at the longer end of the curve;

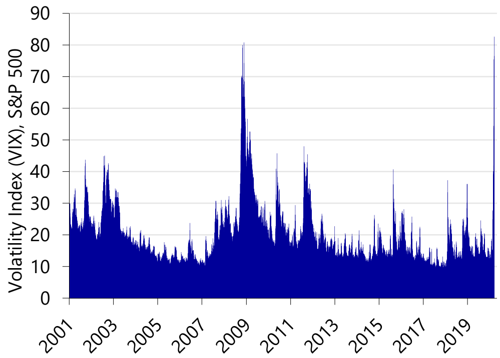
- Credit spreads have widened, with lower quality credit suffering the most, while even the largest corporations are trying to draw down their maximum revolving credit facilities;
- Major currencies such as GBP and AUD are moving by 3-4% a day, which one might expect in a year, while key emerging currencies such as MXN have moved up to 6% daily. Indeed, GBP is at a 35-year low, and AUD at a 17-year low, while most emerging currencies are at record lows vs. USD;
- Central banks have had to respond with emergency rate cuts and liquidity injections via new and old channels, or the extension of unorthodox policies such as QE even to smaller economies like Poland. Indeed, market commentators are now openly talking about radical policies such as "helicopter money" (central bank monetization of fiscal deficits) – something we had already argued would be inevitable in the next global downturn.

Figure 3: Stocks markets have crashed



Source: MSCI, Macrobond, Rabobank

Figure 4: VIX at record levels



Source: Macrobond, Rabobank

The underlying theme that runs through this all is that a highly-indebted, highly-leveraged global economy, which was already seeing severe structural strains, has run into an economic black swan in the form of COVID-19. We are now seeing a huge flight to quality, and unlike in 2008-09, this time not to government bonds, but to cash – and to the USD in particular. With uncertainty so high about how long the virus, and virus-fighting measures, will last, nobody wants to take a market position. Indeed, the signals sent by almost every corner of the markets are that liquidity is drying up, and confidence is drying up too despite the "Whatever it takes" pledges of governments and central banks.

Impact on the real economy

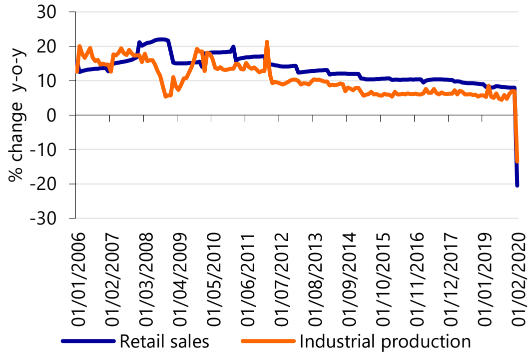
Data illustrating the impact on the real economy so far is limited. Nevertheless, we have some measures which indicate that the economic effects in several countries are severe. Below we will elaborate on some of these.

Data across Asia is pointing to a sharp contraction

For China, data released on March 16th showed that retail sales and industrial production fell by respectively 20.5% and 13.5% in January and February compared to the same period last year (Figure 5). Moreover, China's exports have fallen by 17% over the same period (Figure 6). Although there appears to be some pick-up in economic activity from the supply side, we expect ongoing sluggish demand and negative consumer and investor sentiment to hold back a strong economic recovery in the second half of this year.

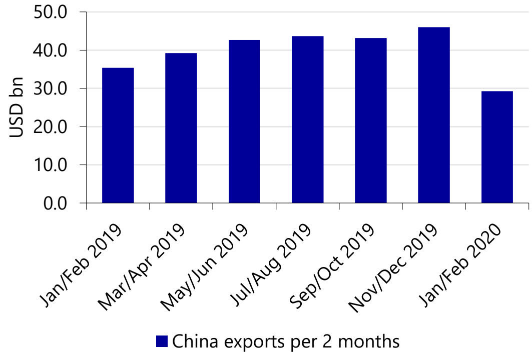
Moreover, the limited data we have for the countries that were affected early on (e.g. Japan) or enacted containment measures relatively quickly (e.g. Singapore) does show that economic activity is taking a big hit, at least as indicated by Purchasing Managers' Indices (PMIs, Figure 7). In Hong Kong, the story is even gloomier, where air traffic in February has dropped by 67% compared to last year (Figure 8). Together, these data give an indication of the magnitude of economic losses we might see in other countries which are forced to increase containment measures or have gone into lockdown as China did.

Figure 5: Retail sales and industrial production have plunged in China...



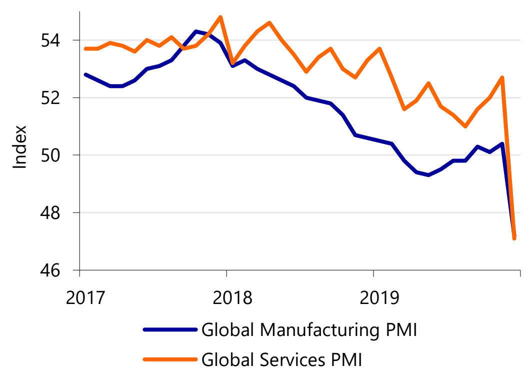
Source: Macrobond

Figure 6: ...as have Chinese exports



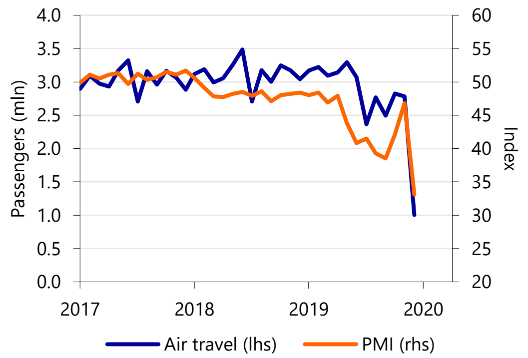
Source: Macrobond

Figure 7: Global PMI's have dropped



Source: Macrobond

Figure 8: Hong Kong takes a big hit in PMI's and air travel



Source: Macrobond

Lockdown in many countries

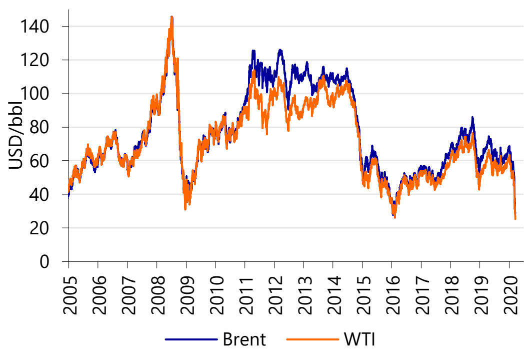
Countrywide lockdowns are now in place in Australia, Italy, Spain and France, while economic activity is severely limited (shutdown of café's, restaurants, gym's etc.) in other countries, such as the Netherlands, Germany and to a lesser extent in the UK.

Such measures will likely be taken by more countries and will severely hamper economic activity as consumers will buy much less products and services, companies will invest and produce much less, while investment premiums will be higher and working hours and productivity per worker are dropping (either because of being sickness or because people are forced to work from home).

Oil prices

Another indication of the heavy cracks in the global economy is the freefall in oil prices. Brent dropped from 60 USD per barrel at the start of the year to 25 at the time of writing (Figure 9). Crude oil has been bearing the brunt of the coronavirus, as the market was heavily affected by the sell-off in risk assets. The full demand impact of the virus is still unclear, but oil consumption is certainly under severe pressure as countries continue to escalate measures to stem the spread of the virus. Jet fuel demand will continue to suffer well into the summer months due to the widespread travel bans that have been put in place. Fuel oil demand will also suffer as the cruise-line industry slows dramatically. Even after the travel bans are lifted, we suspect it will be some time before a full return to normal business for the airline and cruise industry.

Figure 9: Oil price freefall



Source: Macrobond, Rabobank

The same can be said about gasoline and diesel consumption given the large scale quarantines currently in place in the US, Italy, Iran, South Korea, and with more European cities likely to follow suit in the weeks ahead.

On top of the virus-related demand concerns, oil markets are also contending with an imminent surge in supplies from Saudi Arabia and Russia as the two nations face off in a very public way. In fact, the Saudis announced extreme measures in recent days in response to Russia's unwillingness to participate in deeper supply cuts by drastically slashing "Official Selling Prices" (OSPs) to Asian refiners for April, thereby kicking off a three-way market share war between the US, Russia, and Saudi Arabia. In our view, the bold move is likely to lead to mutually assured destruction as all those involved will be feeling severe pain at current price levels

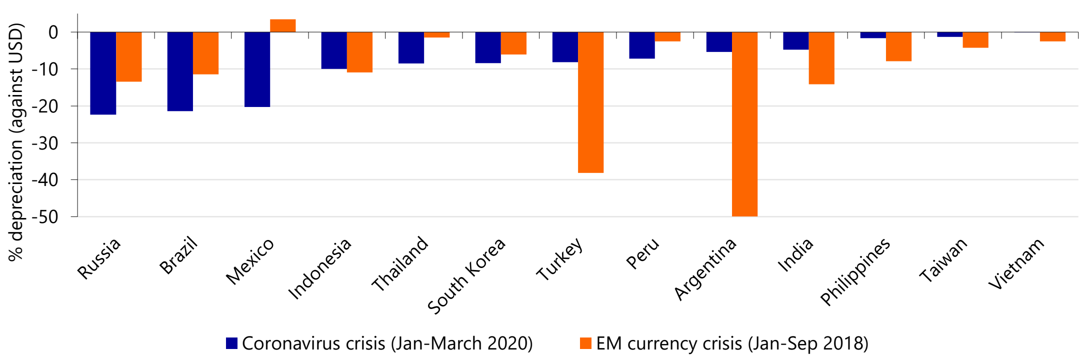
Looking forward, we expect the oil market to stay under pressure until specific fiscal measures are put in place to address the economic impact of the pandemic or until the OPEC+ members return to the negotiating table to correct the current oversupplied conditions.

Emerging market currencies are bearing the brunt

Emerging market currencies are feeling the sharp pinch of ongoing US dollar strength. This is problematic for the EMs that have large share of their corporate or public debt denominated in USD, such as Turkey (corporate: 54%) and Argentina (public: 81%). Other EM's, however, are faced with deteriorating terms of trade, which is especially challenging in case of necessity imports, such as medicine and food.

Commodity exporting EM's have been the most vulnerable so far, with the Russian rubble, Brazilian real and Mexican peso having lost more than 20% of their value against the dollar since the start of 2020 (Figure 10). Compared to the EM currency crisis of 2018, when the US Fed started to intensify its interested rates hiking cycle, the current crisis is already worse. Especially given the fact that we have measured the current depreciation over a much shorter time frame (2.5 months now compared to 9 months in 2018). Going forward, we expect EM currencies to continue to face downward pressure on the back of dollar strengthening for at least three months.

Figure 10: Commodity exporting EM's are vulnerable



Source: Macrobond, Rabobank

Governments and central banks stepping up

Central banks across the world have slashed their policy rates to prevent bank credit from drying up. Policy rates are now close to or below zero in US, the Eurozone and Japan. Moreover, G10 governments have announced various fiscal stimulus measures to dampen the economic effects of the crisis. Below we present a non-exhaustive overview of the most notable monetary and fiscal policy measures that have been taken so far.

Table 2: Policy action by governments and central banks

Country	Government	Central bank
US	Fiscal stimulus package of USD 1000bn (pending)	Cut fed funds target to 0.00-0.25% (-100bp)
	Invoke 1951 Defense Act	Increase Treasury holdings +500bn
	$8.3 bn spending bill aimed at R&D of vaccines, test kits and medical treatments and healthcare activities in general	Increase agency MBS holdings +200bn
	Coronavirus relief package signed into law by Senate on 18 March	Discount window: cut primary credit rate by 150bp; reflecting 100bp cut, and 50bp narrowing
		Discount window now offers up to 90 day borrowing
		USD liquidity swap lines enhanced
		Launch of CPFF, PDCF and MMLF
		Reduced reserve requirement ratios to zero as of March 26
China	Tax concessions for companies directly affected by COVID-19	Cut policy rates by 10bps
	Increased quota for issuance of local government bonds by CNY 290 bln	Cut banks reserve requirement ratio to 11% (big banks) and 10% (small banks)
		Liquidity injections for banks worth CNY 1.7trn
United Kingdom	GBP 330bn worth of loans to SMEs (15% of GDP)	Cut policy rate by 50 bps to 0.25%
	GBP 20bn worth of tax cuts	New four-year funding scheme to banks close to BoE interest rate
Eurozone	Guaranteed loans for firms	Cheap LTRO and easing of TRLO III conditions
	Cheap credit for travel sector	Pandemic Emergency Purchasing Program (PEPP) of EUR 750bn
	Payment deferrals: tax, mortgage, utility bills	
	Short-term work schemes and temporary layoff schemes	
	Income subsidies	
	Country-specific measures: investment in infrastructure and housing (Germany), bailout of state shareholdings (France), paid parental leave	
Japan	Aid package including special financing for SMEs worth JPY 1.6trn	Loans with maturity up to 1y at 0%
	Government looking into tax cuts and increased government spending worth JPY 30tn H26 (USD 280bn)	Increased purchases of CP and corporate bonds by JPY 2trn
		Increase annual pace of ETF purchases +12trn
		Increase annual pace of J-REIT purchases +180bn

Source: various

Most countries in the Eurozone have announced measures encompassing 1.2 to 2.4% of GDP in magnitude (see for an in-depth overview this report). Liquidity measures known thus far are ranging from 8-16% of GDP, but it should be borne in mind that these are contingent liabilities and it would require a much smaller amount of capital to be held on the part of the loan distributors. The most notable announcement by the ECB was the announcement of a Pandemic Emergency Purchasing Program (PEPP), which expands the existing asset purchasing by EUR 750bn.

In the US, President Trump signed a corona relief bill was signed into law on 18 March. This bill enables free testing and two-week paid sick leave for full-time workers who fall ill. Moreover, the White House is filling in the details of a USD 1,000bn stimulus package. This pending package might include a USD 2000 direct payment for most individuals and USD 300bn support for SMEs.

Possible new risk scenarios

We have seen the global situation deteriorating rapidly in the last couple of weeks and at the current juncture it is very uncertain what will happen next. Given the **unprecedented uncertainty** we are currently witnessing, it is too early to make meaningful estimates of what the global economy will do if things get even worse. That depends on what type of scenario we end up in. There are a number of downward risk scenarios, which we will briefly discuss below.

Risk 1: Financial crisis

The health crisis could turn into a financial crisis if the number of bankruptcies increases sharply, as we argued before in our previous outlook. Equally, a financial crisis can result from the simple act of firms and individuals hoarding capital rather than spending, breaking the flow of money through the economy. There are already some signs that both threaten to happen simultaneously – prompting extraordinary central-bank actions that are still barely keeping a lid on the problem.

Risk 2: Prolonged lockdowns

The shutdowns we are currently witnessing in many countries might have to be prolonged by several weeks or even months, which was necessary in China – who started to lockdown at a much earlier stage of virus transmission and is still under virus-control protocols some months later. If this is the case elsewhere, or worse given the different prevailing political systems, then this will increase the economic impact exponentially. The ECB said that one month of lockdown in the Euro Area will shave off 2.1ppts off of annual economic growth. If we use our pre-corona estimate for the Euro Area of 0.9% y/y, a lockdown of one month would result in economic contraction of 1.2% in 2020, which is pretty much in line with our forecast. However, a prolonged lockdown of three months, for example, could plunge the Euro Area into a recession of almost -5.5%. If the lockdown needs to be even longer, the effect would be of an economic depression. Hysteresis effects would only amplify this further.

Risk 3: The Rest of the World

China may have beaten the virus – for now. Yet it may return in autumn, as Spanish Flu did in 1918-19. Europe and the US may be struggling for the moment – but are starting to martial their resources. However, what of emerging markets? How would India, Pakistan, Brazil, sub-Saharan Africa, etc., cope with a rampant virus given their relatively weak public health systems? The results could be devastating. Moreover, even if the West can control the virus, this could still mean these areas would need to remain quarantined until a vaccine is produced. That would mean a bifurcated global economy, with all the inherent problems.

Risk 4: Poor policy response

Fiscal support packages are targeting direct spending or household transfers. If they are in the form of loans, then we will emerge from the crisis with an even higher level of debt, which will reduce potential growth rates even further from an already-low level. Equally, why should SMEs borrow, knowing the debt load must be repaid, rather than closing and waiting to reopen debt-free post-crisis? This might imply that SME's refrain from means they need to survive a prolonged crisis and we might see a rapid pickup in bankruptcies.

Risk 5: Eurozone frictions

There is a risk that tensions within the Eurozone will rise sharply and lead to a disintegration of the Euro Area as we know it (for example if countries cannot agree on measures to allow the free movement of people within the Schengen area, or the size of EU wide stimulus and who gets most of that stimulus). That case has big implications for the viability of the Euro. National borders are currently being sealed and foreigners kept out even despite the EU's external border being sealed for 30 days.

Risk 6: Supply of vital products

In a prolonged shutdown scenario, a rise in food and medicine scarcity can also not be ruled out. Although it seems likely that food safety would be one of the main priorities of governments, this is not easily achieved in a crisis where others are experiencing the same problems. Meanwhile, shortages of key medical goods, such as ventilators and masks, underline the precariousness of the global economic free-trade system, both in terms of long, China-centric supply chains and on reliance on imports in the case of emergency. As a result, we are already seeing a shift to more dirigiste state policy on the production of such key medical goods, and indeed there is a strong likelihood that a prolonged virus crisis could accelerate the rolling back of free trade and globalization already underway in recent years.

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