

From Vaccination to V-Shaped Recovery

Vaccinations will be a game changer, but more efforts are needed to produce and distribute vaccines. Policymakers need to continue to provide emergency support to households and firms. And they need to prepare measures to stimulate hiring and investment once the pandemic is under control. Such measures will foster a quicker and fuller recovery, by reducing scarring from unemployment, missed education and training, and low investment.

The Virus Strikes Back but Vaccination Begins

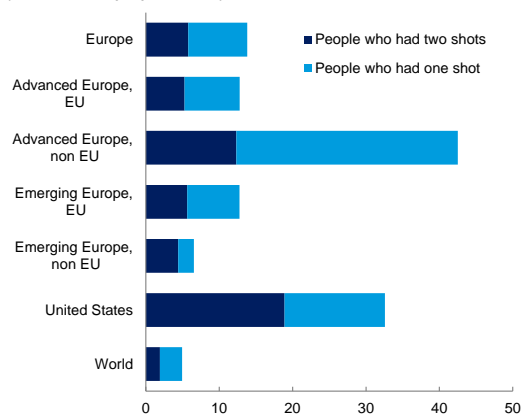
The coronavirus disease (COVID-19) pandemic continues to pose extraordinary challenges. New waves of infection have afflicted advanced and emerging European economies. Vaccination, a game changer, is under way but the pace of progress is still moderate and varies significantly across countries, with the biggest lags in several non-EU emerging European economies (Figure 1).

The Recovery Pauses

The reopening of economies in the summer triggered a rapid recovery of activity in the third quarter of 2020 and a resurgence of COVID-19 cases. Policymakers responded with new containment measures, including lockdowns,

that reduced mobility and slowed activity, although to a much lesser extent than in the spring of 2020, when Europe's economy suffered much more than the US economy (Figure 2; Box). Accordingly, GDP growth slowed less than projected in the fourth quarter of 2020.

Figure 1. Vaccinated People
(Percent of population)



Sources: Our World in Data; IMF, *World Economic Outlook*; and IMF staff calculations.

Note: Data as of April 5, 2021.

The recovery remains uneven. While industrial production has returned to pre-pandemic levels, services are still contracting (Figure 3). Accordingly, the recovery in countries with sizeable service sectors (for example, Croatia, Italy, Montenegro, Spain) lagged the rest of

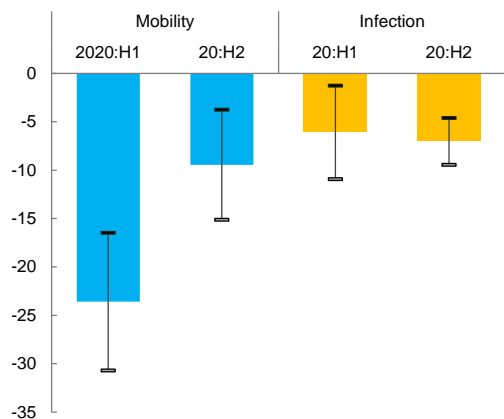
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Europe by about 1 percentage point in the second half of 2020.

Figure 2. Impact of Containment Measures on Mobility and Infections

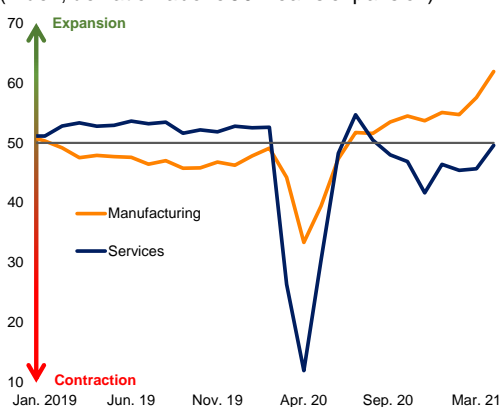
(Percent, reduction in mobility and infections)



Sources: Google Community Mobility Report; Johns Hopkins University; University of Oxford; and IMF staff calculations. Note: The bars denote the effect of tightening containment measures on mobility and new COVID-19 infections in Europe (over the first 30 days) with 90 percent confidence interval denoted.

Figure 3. EU Purchasing Managers' Index

(Index, deviation above 50 means expansion)



Sources: IHS Markit; and Haver Analytics.

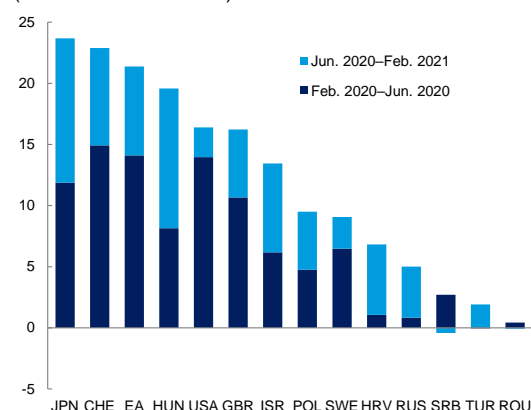
The Policy Response

Continued Policy Support

The unprecedented policy support (discussed in the October 2020 *Regional Economic Outlook: Europe*) was extended and expanded to address rising infections and the effects of new lockdowns. As a result, fiscal support in 2021 is now projected to be about 1.5 percentage points of GDP higher than in the October *World Economic Outlook*.

Figure 4. Central Banks' Balance Sheet Expansion

(Percent of 2020 GDP)



Sources: Central Banks; Haver Analytics; and IMF, *World Economic Outlook*.

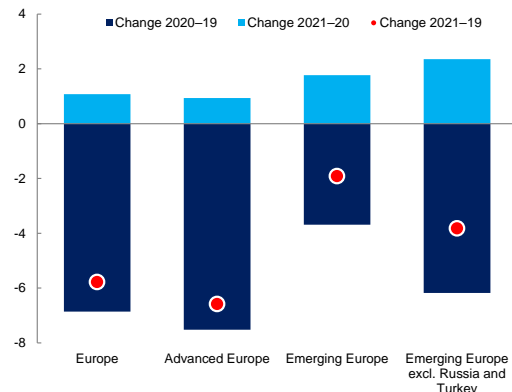
Note: Expansion is calculated based on central banks' assets value. Data for Israel is as of December 2020. Country abbreviations are International Organization for Standardization country codes. EA=Euro area.

Several central banks cut policy rates further (for example, Iceland, Moldova, North Macedonia, Romania, Serbia); the exception was Russia, which has hiked rates reflecting higher-than-expected inflation. Turkey has also hiked rates in response to foreign exchange and inflation pressures, reversing its strong monetary stimulus in 2020. Central banks also continued implementing unconventional monetary policies (Figure 4). The European Central Bank increased the pandemic emergency purchase program by €500 billion to €1.85 trillion and extended the targeted longer-term refinancing operations to mid-2022. Central banks in emerging European economies (Hungary, Poland, Romania, Turkey) continued to expand their balance sheets in various ways. As a result, financial conditions remain highly accommodative. The announcement of US fiscal stimulus has so far had limited spillovers on European yields.

Fiscal policy (through automatic stabilizers or discretionary policies) provided support of about 7.5 and 6 percentage points of GDP in advanced and emerging European economies (excluding Turkey and Russia), respectively, in 2020 (Figure 5). Support was somewhat lower in Russia and Turkey, where activity held up better than expected. Budgetary plans for 2021

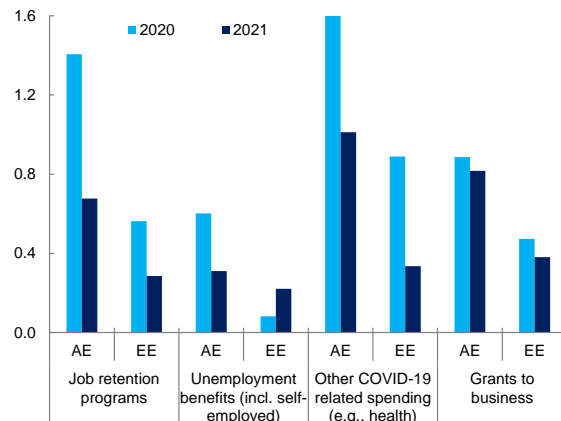
envisage lower support by about 1 percentage point of GDP for European economies, as the economic rebound is projected to gradually reduce crisis-related expenditures and increase revenues.

Figure 5. Fiscal Policy Support
1. Change in Primary Balances, 2021–19
 (Percentage points of GDP)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
 Note: Oil-related items are excluded from primary balances of Norway and Russia.

2. Implementation of Spending Policies: 2021 Planned versus 2020 Implemented
 (Percent of GDP)



Sources: IMF, *World Economic Outlook*; And IMF staff calculations.

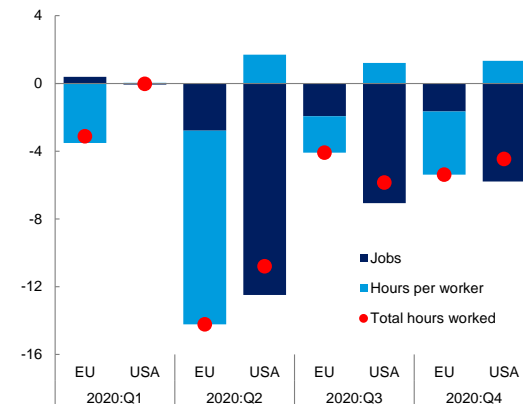
Effective Policies Cushioned the Economy in 2020

The exceptional policy response helped protect the structure of the economy. Europe's activity contracted by 5.2 percent in 2020, 1.8 percentage points less than forecast in the October's *World Economic Outlook* (Table 1):

- Job retention schemes, deployed by about 40 European countries, protected 68 million jobs at their peak (Figure 6).

- Corporate sector policies (including guaranteed credit to firms, debt moratoria, and job retention schemes) provided lifelines to firms, with the number of corporate bankruptcies declining in 2020 despite the downturn (Ebeke et al. 2021).
- Financial policy measures, together with support to households and firms, helped shield banks from the shock thus far (Aiyar et al. 2021). Nonperforming loans have remained largely contained, common equity Tier 1 capital ratios showed resilience, and credit has continued to flow.

Figure 6. Working Hours Growth Decomposition
 (Year-over-year percent change)



Sources: U. S. Bureau of Labor Statistics; Eurostat; Haver Analytics; and IMF staff calculations.
 Note: Country abbreviations are International Organization for Standardization country codes.

Outlook and Risks

Activity to Rebound in 2021, Cutting Losses

Europe's GDP is expected to rebound by 4.5 percent in 2021. This is 0.2 percentage point less than forecast in October 2020, reflecting the new COVID-19 waves and lockdowns. On the assumption that vaccines become widely available in the summer of 2021 and throughout 2022, GDP growth is projected at 3.9 percent in 2022, bringing Europe's GDP back to the pre-pandemic levels. Long-term output losses relative to the pre-COVID-19 trend are projected at about 1.5 percent of GDP by 2025. However, these projections are likely to change as the full

impact of the pandemic on the economy becomes clearer. Inflation, currently contained by economic slack, is projected to edge up by 1.1 percentage points to 3.1 percent in 2021, partly due to higher commodity prices. Inflation expectations remain around or below targets, not least reflecting the strong credibility of major central banks, although they have risen from their historical lows in the euro area.

Risks Still Tilted to the Downside

Downside risks to the projections for activity appear larger than upside risks in the near term, while risks are more balanced in the medium term.

On the downside, virus mutations and vaccination delays are the biggest risk. Financial conditions could tighten, with a repricing of risk exposing vulnerabilities in financial systems. There could also be social unrest and more medium-term scarring of economies if the crisis lingers.

On the upside, speedier vaccine production and distribution could accelerate the transition to a post-pandemic world. Also, activity may continue to prove more resilient to the virus than expected (in line with recent evidence). Additionally, policies could have larger-than-anticipated effects (for example, with strong implementation of the Next Generation EU plan), perhaps supported by less uncertainty about international policy coordination.

Policy Recommendations

Fighting the Pandemic and Securing the Recovery

Accelerating the production and distribution of vaccines is the most critical policy challenge at this juncture. And policymakers need to continue supporting the recovery of output and employment. The faster the recovery, the less scarring people and businesses will suffer from unemployment, lost human capital, and lower investment and research and development. As monetary policy—close to the effective lower bound in several economies—becomes less

effective in boosting output, fiscal policy needs to play an increasingly larger role. Prolonged periods of loose monetary policy can also fuel financial stability risks. Fiscal measures to stimulate investment and to facilitate job creation and reallocation would speed up the recovery.

Labor market policies should extend lifelines while activity remains soft but should gradually shift toward fostering reallocation. Policies could promote job search, enhance training and reskilling programs, and provide well-targeted hiring subsidies.

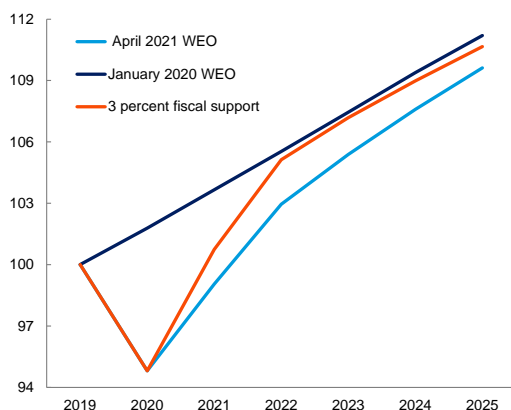
Monetary policy needs to remain accommodative as long as prospects for underlying inflationary pressure stay subdued. Central banks should credibly communicate their resolve to head off a premature pick-up in real yields, while allowing temporary increases in prices related to dislocations from the pandemic or volatile commodity prices.

Corporate sector support policies should become more targeted toward viable firms and focus on strengthening firms' solvency (including via hybrid instruments) instead of debt-increasing liquidity provision. An equity gap of 2-3 percent of GDP remains to be covered, lest 15 million jobs be put at risk (Ebeke et al. 2021).

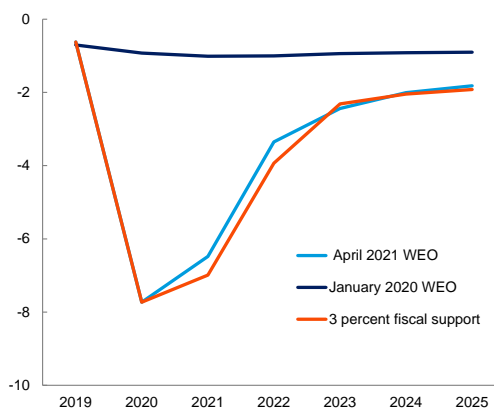
Financial policies, including macro-prudential measures, should continue to enable banks to keep credit flowing. Going forward, provisioning standards should be preserved, while providing time to replenish capital buffers as crisis measures expire.

There are potential benefits of redeploying a greater share of emergency fiscal support toward measures that accelerate the recovery and build forward better, than what is implicit in current plans for primary fiscal balances through 2022. This could then be followed by stronger consolidation once excess capacity has been reduced. Accordingly, IMF staff analyzed the effects of a fiscal package comprising additional transfers targeted at households in need; hiring subsidies to reintegrate the unemployed faster;

Figure 7. Fiscal Simulations:
1. Europe: Real GDP
 (index, 2019 = 100)



2. Europe: General Government Overall Balance
 (Percent of GDP)



Sources: IMF, *World Economic Outlook*, and IMF staff calculations.
 Note: WEO=World Economic Outlook.

temporary investment tax credits to bring forward investment; and equity support schemes for viable firms in need of capital. Such additional support to the tune of 3 percent of GDP over 2021–22 could lift output by about 2 percent by the end of 2022 and more than halve the medium-term scarring due to robust supply-side effects (Figure 7). This would have greater benefits for households with low incomes and fewer side effects than additional monetary stimulus. It would also bring inflation closer to target in many countries and help rebuild monetary policy space.

Investing in Post-Pandemic Growth

As the economy moves toward a new normal, policies will increasingly need to refocus on

tackling structural challenges that preceded or were aggravated by the crisis and build a greener, more equal, and more digital economy, while continuing to facilitate transformative reallocation.

Fiscal resources freed from temporary support should be redeployed to accelerate infrastructure investment, especially on digital and green technologies. When a robust expansion is firmly in place, policymakers need to roll back large deficits and rebuild fiscal buffers within credible medium-term plans, although debt service costs are expected to remain manageable and deficits to decline as the economy recovers.

And finally, renewed efforts should go into improving social safety nets and labor market institutions, forging a way toward a new social contract that will help cope with disruptive technological changes and accelerating automation and address inequality. This was on the agenda before the COVID-19 crisis—it is even more urgent now.

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Table 1. Real GDP Growth

(Year-over-year percent change; aggregation based on GDP in purchasing power parity terms)

	April 2021 WEO				October 2020 WEO			Difference		
	2019	2020	2021	2022	2020	2021	2022	2020	2021	2022
Europe	1.7	-5.2	4.5	3.9	-7.0	4.7	3.2	1.8	-0.2	0.7
Advanced European Economies	1.4	-6.7	4.5	4.0	-8.1	5.2	3.2	1.4	-0.7	0.8
Euro Area	1.3	-6.6	4.4	3.8	-8.3	5.2	3.1	1.7	-0.8	0.7
France	1.5	-8.2	5.8	4.2	-9.8	6.0	2.9	1.6	-0.2	1.3
Germany	0.6	-4.9	3.6	3.4	-6.0	4.2	3.1	1.1	-0.6	0.3
Italy	0.3	-8.9	4.2	3.6	-10.6	5.2	2.6	1.7	-1.0	1.0
Spain	2.0	-11.0	6.4	4.7	-12.8	7.2	4.5	1.8	-0.8	0.2
Nordic Economies	1.6	-2.4	3.2	3.2	-4.2	3.5	2.8	1.8	-0.3	0.4
Other European Advanced Economies	1.6	-7.9	4.9	4.6	-8.5	5.4	3.3	0.6	-0.5	1.3
United Kingdom	1.4	-9.9	5.3	5.1	-9.8	5.9	3.2	-0.1	-0.6	1.9
Emerging European Economies	2.4	-2.0	4.4	3.9	-4.6	3.9	3.4	2.6	0.5	0.5
Central Europe	4.5	-3.2	3.6	4.8	-4.1	4.5	4.4	0.9	-0.9	0.4
Eastern Europe	2.2	-3.1	3.6	3.6	-4.4	2.8	2.4	1.3	0.8	1.2
Russia	2.0	-3.1	3.8	3.8	-4.1	2.8	2.3	1.0	1.0	1.5
Southeastern European EU Member States	3.9	-4.5	5.5	4.8	-5.2	4.7	3.9	0.7	0.8	0.9
Southeastern European Non-EU Member States	3.6	-3.5	4.7	4.3	-5.0	5.5	5.2	1.5	-0.8	-0.9
Turkey	0.9	1.8	6.0	3.5	-5.0	5.0	4.0	6.8	1.0	-0.5
Memorandum										
World	2.8	-3.3	6.0	4.4	-4.4	5.2	4.2	1.1	0.8	0.2
United States	2.2	-3.5	6.4	3.5	-4.3	3.1	2.9	0.8	3.3	0.6
China	5.8	2.3	8.4	5.6	1.9	8.2	5.8	0.4	0.2	-0.2

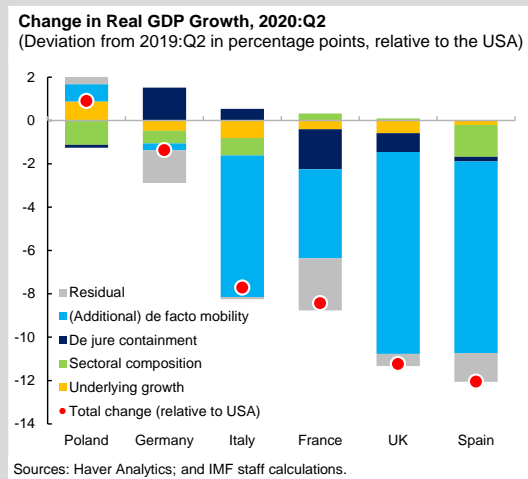
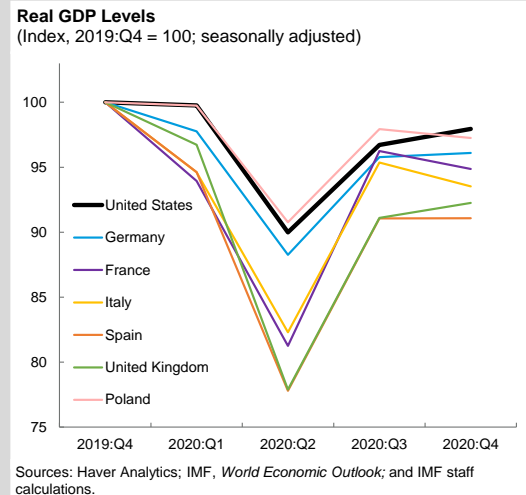
Sources: IMF, *World Economic Outlook*; and IMF staff calculations.Note: WEO=*World Economic Outlook*. Nordic economies include Denmark, Iceland, Norway, Sweden; other European advanced economies include Czech Republic, Israel, San Marino, Switzerland, United Kingdom; Central Europe includes Hungary and Poland; Eastern Europe includes Belarus, Moldova, Russia, Ukraine; Southeastern European EU member states include Bulgaria, Croatia, Romania; Southeastern European non-EU member states include Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.

BOX 1. DIFFERENCES IN OUTPUT PERFORMANCE BETWEEN EUROPE AND THE US DURING COVID-19¹

COVID-19 spared no country, but the associated economic losses were on average significantly larger in Europe than in the United States, especially in the Spring of 2020. What explains these differences: macroeconomic policies or the virus?²

IMF staff analysis suggests that differences in macroeconomic policies are unlikely to have explained the activity gap *vis-à-vis* the United States so far.² Rather, it seems that stricter voluntary *de facto* confinements in Europe, beyond what can be attributed to *de jure* containment measures, explain most of the activity gap. This has greatly lowered mobility and activity relative to the United States and largely reflects that the pandemic was more severe in Europe as hospitalizations and fatalities (for a given number of infections) were higher. Differences in pre-crisis growth and the structure of the economy also played some role.

The small residual gap likely reflects a higher adaptability of the US economy to operate in a context of reduced mobility (for instance, through greater scope for telework). Although the fiscal response in Europe was smaller than that of the US, it was effective in preserving households' disposable income and firms' liquidity, and thus it is unlikely to have played a significant role in the activity gap thus far.



¹ Carlos Caceres, Bertrand Gruss, and Sebastian Weber prepared this box.

² See online annex.