Eurozone: Short-time work provides cushion to double-dip worries

Worries about a double-dip recession are increasing in the eurozone as disappointing survey data for August provides a reality check on the pace of recovery. Government support offers a significant tailwind for the economy though. While a double-dip is not unthinkable, it looks like growth can still continue albeit at a slower pace in the coming months

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As quick as it came, it went away again: optimism about the eurozone recovery.

After stellar recovery signs in May and July, August survey data indicates that the speed of the recovery has dropped significantly. The PMI even fell back to a reading just above 50, which indicates stagnation of output growth compared to July. This sudden reversal begs the question, is a double-dip recession in the making? To put the recent weaker survey indicators into perspective, it is important to keep in mind what is happening in the economy at the moment.

The rebound effect is wearing off

After the unprecedented period of lockdowns, the eurozone economy has reopened, which has caused many parts of output to recover. This means that compared to the bottom in activity which occurred in April, we see a strong bounce back, which happens almost mechanically as businesses reopen from a mandatory shutdown. As a consequence, the eurozone economy will experience strong growth in the third quarter even if economic activity were to freeze at its end of June level. However, this rebound effect is wearing off. And unless all Covid-19-related restrictions are dropped, growth should slow significantly in the fourth quarter. This raises questions about whether a slowdown could even result in another decline in output.

Short-time work schemes to the rescue

In our view, the risk of a double-dip is increased by the so-called 'cliff' effect, i.e. the ending of government support schemes, particularly at a time when the risk of a second lockdown is still possible. One of the most effective government support programmes, without doubt, has been the short-time work scheme. While the unemployment rate has risen markedly in the US, it has only gone up in the eurozone from 7.1% in February to 7.9% in July. Amid an unprecedented decline in economic activity, short-time work programmes have ensured continued income for the large majority of eurozone consumers.

These programmes follow the successful model of Germany in the 2008 crisis when it implemented its own version called Kurzarbeit. Back then, the programme helped Germany recover from the recession quite quickly and this has served as a policy model for other countries. The EU encourages the policy by providing cheap loans to fund the programmes, which can be costly. While it is difficult to estimate the precise effect of these schemes on the unemployment rate, we can estimate a counterfactual unemployment rate to see how far the rate would have run up without short-time work during this unprecedented economic shock.

Cyclical factors would cause unemployment to top out around 11%, but the curve is being flattened

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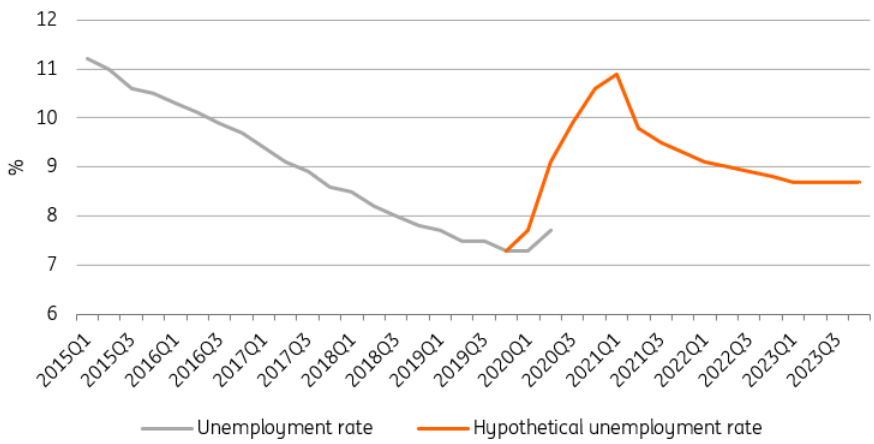

Our estimates – as you can see in the chart above – suggest that unemployment would have been around 10% without the programmes and that unemployment would run up to around 11% in the first quarter of 2021 before starting to decline again, in a scenario without a new round of widespread lockdowns. That would already be a lower peak than the 12.1% reached in 2013 at the height of the euro crisis, but as short-time work schemes flatten the curve, it is likely that the peak will be somewhat lower. At the same time, it is also likely that the peak in unemployment will be reached at a later point in time than it would have done without the short-time work schemes.

Lower unemployment rate provides a comfortable cushion for domestic demand

This lower unemployment rate provides a comfortable cushion for domestic demand in the recovery phase but, of course, the schemes will end at some point. Worries about a 'cliff-edge' scenario when schemes end and layoffs follow seem legitimate and also concern the European Central Bank, as this was mentioned in the minutes of the last ECB meeting. As many schemes are set to end around the turn of the year, expectations of increased unemployment are realistic, which increases the risk of a double-dip recession.

The good news is that policymakers are aware of this risk and the European Commission is offering financial assistance to member states through its borrowing programme (SURE), as mentioned above. The take-up for this programme is already substantial, with Italy, for example, requesting €28 billion from the fund thus far. This allows extensions of the programmes, which have been seen in quite a few large countries. France and Germany have extended into 2022 while the Netherlands has extended in a less generous form until mid-2021, lowering the chances of a cliff-edge scenario on the labour market around the turn of the year.

Don’t rule out a double dip altogether, it’s not an unlikely scenario

Still, while eurozone governments are determined to do everything they can to avoid a real double-dip recession, a small or more technical double-dip is not unthinkable.

Our current expectations for third-quarter growth are around 10% quarter-on-quarter, which is caused by the reopening of the economy and in part fuelled by catch-up spending. For some products, the drop in spending through the months of April and May could be recovered fully in the first months of reopening. But once that effect is over, a dip could be in the making as the bounce in spending is unsustainably high. That would not reflect the start of the next recession but merely bring the recovery back to its original trend. Alternatively, in a scenario with new lockdowns, a double-dip would probably be the least of the eurozone’s worries.

So while government support, especially in the labour market, is boosting the economy even as the recovery slows, the chances of a double-dip are still very real. For now, it looks like it may be enough to return the economy back to the level of output seen prior to the crisis, albeit at a slower pace than in the first few months.

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