



Better Virus Control May Help Europe to Outperform the U.S.

Stricter lockdown measures could boost short-term performance.

July 2020

KEY INSIGHTS

- Although the U.S. fiscal response to the coronavirus has been larger than Europe's, lockdowns in Europe have been more aggressive and have lasted longer.
- Europe's tougher measures will hit the economy hard but are likely to result in a quicker recovery in consumer confidence.
- If consumer confidence recovers quickly in Europe, the Continent's economy is likely to rebound more quickly than the U.S. economy.



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The U.S. has historically recovered more quickly from recessions than Europe, but this time could be different. Although the Federal Reserve's (Fed's) fiscal response to the coronavirus pandemic has been significantly larger than the European Central Bank's (ECB's), lockdowns in Europe have been more aggressive and have lasted longer. This could mean that the European economy may outperform the U.S. in the short run, supporting a stronger euro.

One of the main reasons why the U.S. has historically recovered more quickly from recessions is that previous downturns have mostly been caused by a buildup of economic imbalances at a late stage of the business cycle. U.S. policymakers have not only enacted aggressive monetary and fiscal policies to mitigate such recessions, but also typically deployed measures that were directly aimed at the main imbalance in the economy.

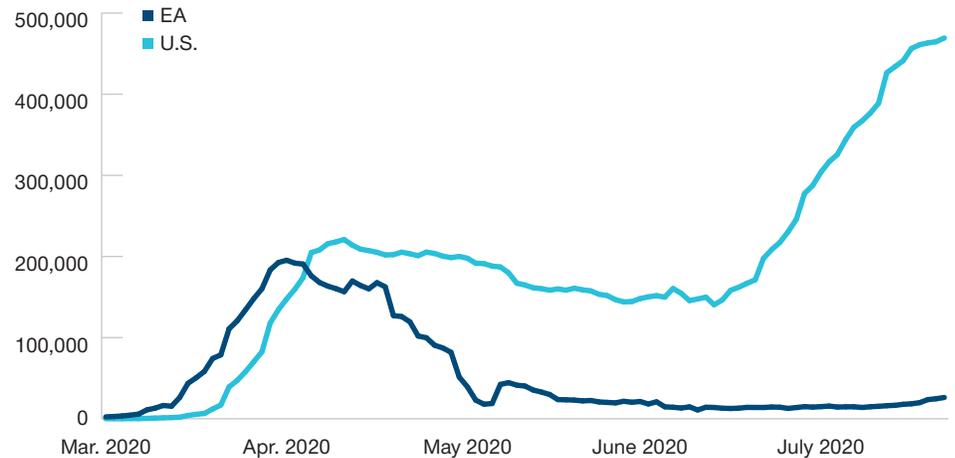
For example, in response to both the 1987 savings and loans crisis and the 2009 global financial crisis, the U.S. government quickly recapitalized viable financial institutions while resolving others in an orderly manner. Labor market flexibility in the U.S. has also helped to reallocate workers from shrinking to growing sectors, further hastening past recoveries.

Europe has traditionally taken a different approach. While the ECB has responded to negative demand shocks, it has not been nearly as aggressive as the Fed, and the fiscal measures taken have typically been applied unevenly across countries. In addition, Europe's greater labor market rigidity has meant that firms have been less willing to hire workers in the early stage of the recovery, while generous unemployment benefits incentivized workers to look for similar jobs to their last one, resulting in a lag in the economic recovery. After the global financial crisis, structural issues, such

“The coronavirus recession is different from previous business cycle recessions.

U.S. Case Growth Dwarfs Europe's

(Fig. 1) Stricter lockdowns in Europe seem to have worked



As of July 20, 2020.

Source: Johns Hopkins University/Haver Analytics.

as the eurozone's weak banking sector, were left unaddressed for a long time, which also impeded the recovery.

This Time It's Different

The coronavirus recession is different from previous business cycle recessions. The decline in output has been caused by government regulations aimed at preventing spread of the disease, such as lockdowns and social distancing, combined with a decline in consumer confidence from fear of getting sick. The fear of unemployment as government regulations have hit businesses has also contributed to lower consumer confidence. Although monetary and fiscal policies have traditionally been used to mitigate these confidence effects, they would likely be less successful in the current situation.

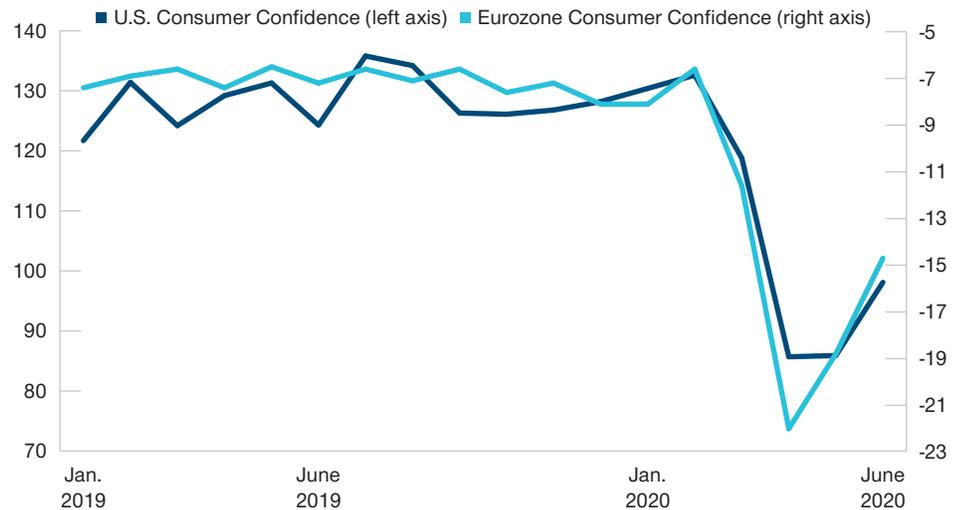
The most likely path to recovery from the coronavirus economic shock is to stop the virus's spread and then lift the lockdowns. When consumers are convinced that they can return to their pre-coronavirus lifestyle with very little risk of catching the disease, demand will likely return quickly and the supply side of the economy would also rebound. Timing is everything here: If lockdowns

end too early, a second wave of the virus could be triggered, which could dent confidence in public health authorities and suppress consumer demand for an extended period. If lockdowns end too late, the collapse of larger numbers of firms would severely hit the supply side of the economy.

State-level authorities in the United States appear to have taken the first approach. Lockdowns in many states ended when case growth was still elevated, albeit on a downward path. It was not apparent at the time, but it now appears to be clear that these early lockdown releases have triggered a second wave of outbreaks in the United States. An analysis of OpenTable restaurant reservations shows there is a statistically significant relationship between OpenTable reservations 14 days before June 18 and the seven-day moving average of case growth after that day. This one variable explains 40% of the variation in case growth across states in the U.S. 14 days later, suggesting that a substantial component of the resurgence in U.S. case growth is likely due to the earlier easing of lockdowns.

Eurozone Consumer Confidence Is Higher

(Fig. 2) It has rebounded sharply since April



As of June 30, 2020.

Sources: Eurostat and the University of Michigan/Haver Analytics.

“The European strategy of a more aggressive and prolonged lockdown is not a free lunch.”

European countries, on the other hand, have taken a much more cautious approach. Lockdowns were implemented at the country level, face masks were often mandatory in public, and travel between countries was banned. European countries also waited longer to only gradually release their lockdowns, doing so only when virus case growth was very low. While case growth in the United States began to re-accelerate in June, in European countries, case growth remains very low.

Not a Free Lunch

The European strategy of a more aggressive and prolonged lockdown is not a free lunch. It will hit the economy harder in the short term, probably causing a deeper recession. However, the maintenance of low case growth has strengthened European governments' credibility over virus control. This will likely help consumers regain confidence that it is safe to return to their pre-coronavirus social consumption patterns, even as social distancing measures are gradually lifted.

Consumer confidence is key here. As the saying goes: You can lead a horse to water, but you can't make it drink. This is also the case with policy responses to the coronavirus recession: Monetary and fiscal policies can lead the consumer, but only confidence will make them drink. Here, the European approach appears to be more effective. While consumer confidence in the eurozone fell faster than in the U.S. in March and April, it has recovered more strongly. We expect this pattern to be even more pronounced in July given the major difference in current case growth in the U.S. versus the eurozone at present.

Overall, I believe there is a much better chance of a rapid rebound in consumer confidence in Europe as a result of better virus control, which will likely result in the European economy outperforming the U.S. economy in the short term. In addition, the European monetary and fiscal policy response has been strong this time, further supporting the recovery. Indeed, German retail sales in May were already above their February pre-coronavirus levels. All of this suggests that the euro will likely continue to outperform the U.S. dollar in the next couple of months.

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