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Economic Insights
European economy: coming out of the shadows

Key takeaways

- Shadow unemployment has declined sharply across Europe, with the furlough rate falling to 5% of the labour force.
- As the improving trend in the labour market continues, we expect output in the euro area to return to pre-crisis levels in 4Q this year.
- We expect euro area real GDP growth to peak in 3Q 2021, and then moderate. We forecast euro area growth of 4.9% this year and 4.3% in 2022, with forecast that 10-year yields will remain negative at -0.4% and -0.2%, respectively.
- However, with pandemic risks on the rise, the balance of risks is skewed to the downside and targeted business closures may increase again, slowing the recovery.

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

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In a nutshell

The European economy has bounced back strongly with re-opening boosting output and consumption. As a result, labour market conditions have improved markedly also, with shadow unemployment halving in several countries over the past year. However, slack remains and after peaking in the third quarter, we see slowing but still strong growth next year, amid downside risks.

The European economy bounced back strongly in the second quarter (2Q) of 2021, with euro area real GDP up 2% from the first quarter. We expect the reopening boost will see GDP growth peak in the third quarter, and for economic momentum to then moderate. As people continue to come back to work, we forecast a return to pre-crisis levels of output in 4Q 2021. In the industrial sector, growth has been held back by bottlenecks in supply chains and we look for this drag to subside over the coming 6-12 months. We also see further recovery potential in the services sector, in particular in hospitality and travel. Additionally, the European Recovery and Resilience Facility should boost investment, which is forecast to yield 1-1.4% of additional GDP growth by 2023.[1] We therefore expect slower but still strong real GDP growth in the euro area into next year. We forecast 4.3% growth in 2022, down from 4.9% in 2021(consensus: 4.4% and 4.8%), and we see 10-year government bond yields negative at -0.2% and -0.4%, respectively (consensus: +0.1%, -0.2%).[2] However, the balance of risks is skewed to the downside: pandemic risks could lead to further business closures and hinder the labour market recovery.

The labour market has played an important role as an indicator of economic health. At the peak of the pandemic in 2Q 2020, employment was down 2.9% year-on-year, the largest quarterly contraction in the past 25 years. With support from furlough schemes and other measures, a large share of jobs could be retained and many companies were shielded from bankruptcy.[3] As COVID-19 unfolded, many businesses were mandated to close and send workers on furlough. This resulted in job-retention schemes covering almost one quarter of the labour force in the UK, and 15% in the euro area's four largest economies (EA4).

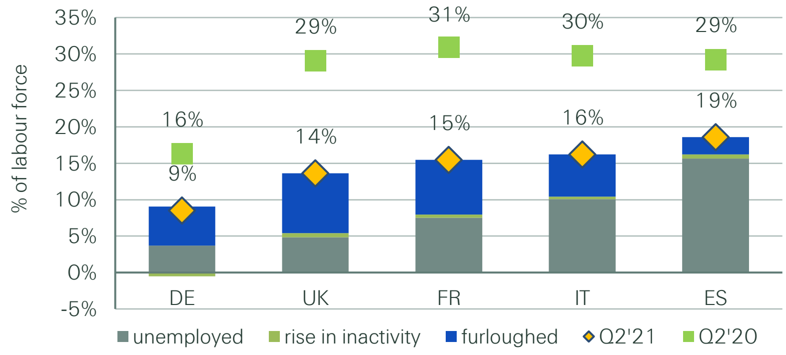
To gauge the remaining slack in the labour market we use a measure of shadow unemployment that takes into account not only unemployment, but also inactive and furloughed workers (see Figure 1). We estimate that by 2Q 2021, shadow unemployment had nearly halved in most countries, after reaching an average of almost 25% of the labour force in the EA4 a year earlier. The main driver of the decline was the reduction of employees on furlough to an estimated 5% of the labour force[4] in the euro area and 8% in the UK. With the further progress on vaccinations and economic re-opening, we

1 *Quantifying Spillovers of Next Generation EU Investment*, European Commission, July 2021.
2 Consensus refers to Bloomberg Consensus forecast
3 *Post COVID-19 recovery: focus on sustaining viable businesses*, Swiss Re Institute, May 2021.
4 *ECB Economic Bulletin Issue 5*, European Central Bank, 2021

2 September 2021

expect shadow unemployment will continue to decline over the coming year. Improvement potential is most in the UK and in France where furlough is still highest at 8.3% and 7.5% of the labour force, respectively.

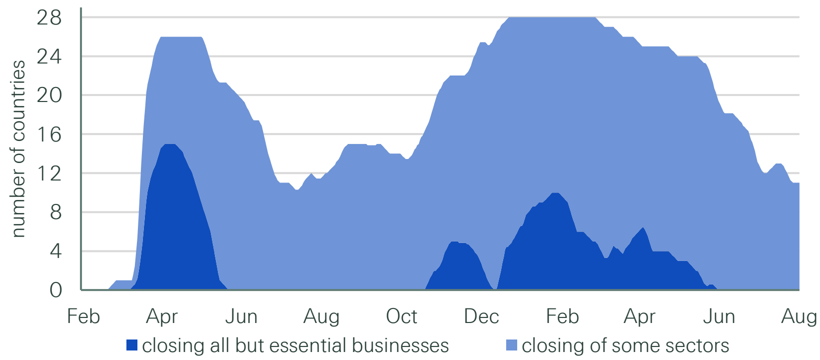
Figure 1
Shadow unemployment nearly halved since the peak of the crisis



Note: rise in inactivity refers to 2Q21 vs. 1Q20.
Source: Swiss Re Institute, based on national statistics

However, pandemic risks are on the rise again, with the Delta virus variant increasing global infection rates. Several markets, including China, have re-imposed counter-virus measures. In the euro area, we see the risk of renewed national lockdowns as relatively contained at this stage, as more than 60% of the population has been fully vaccinated and hospitalisation and deaths have remained relatively low in the most recent wave. However, a further rise in cases may dent consumer and business sentiment, and even only targeted business closures in specific sectors or regions (see Figure 2) could slow the recovery in the labour market and the overall economy. We therefore see the balance of risks skewed to the downside over the next 12 months.

Figure 2
Government mandated business closures in Europe



Note: The country universe includes 28 countries (EU+CH+UK). No data available for Malta.
Source: Oxford University, Swiss Re Institute