Economic Outlook Europe Q2 2021: The Path To A Strong Restart

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Key Takeaways

- We now forecast the eurozone to grow 4.2% this year and 4.4% in 2022.
- We made small revisions factoring in a higher degree of business and consumer adaptation to COVID-19 restrictions, a gradual vaccination rollout, and strong external demand.
- Favorable financing conditions in the eurozone underpin our revised baseline forecast.
- Weaker economic fundamentals and the ECB's commitment to monetary accommodation are shielding long-term eurozone interest rates against the rise in U.S. yields.

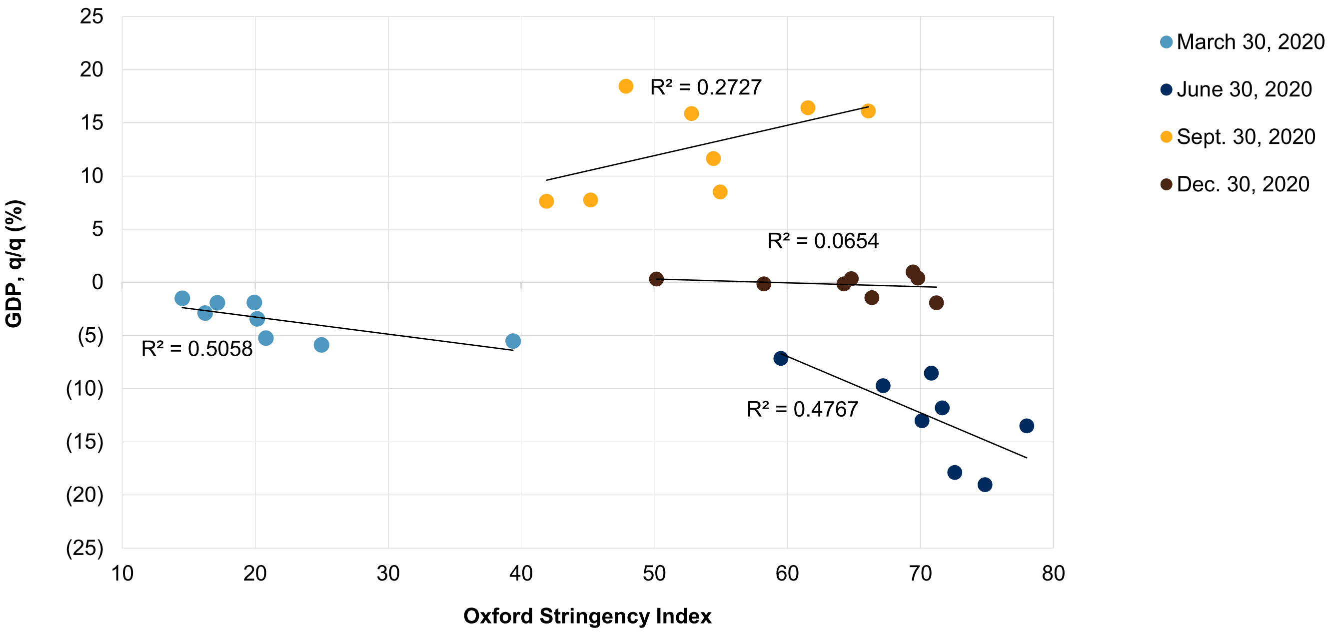
The eurozone economy is less sensitive to social-distancing restrictions than a year ago. Lockdowns are now restricting economic activity by about 10% since fourth-quarter 2020, according to S&P Global Ratings' estimates. That's less than one-third of the impact in second-quarter 2020, and we see the correlation between growth and lockdown stringency diminishing over time (see chart 1). The eurozone economy shrank only 0.7% in fourth-quarter 2020 despite a second wave of COVID-19. That was a much milder than our expectations of a 2% contraction back in December. Reflecting the lessened sensitivity to lockdowns, we still expect the eurozone economy to recover its pre-crisis levels of activity by first-quarter 2022 and made small revisions to our forecast for eurozone GDP growth to 4.2% for 2020 and 4.4% for 2022 (see table 1 at the end of the article).

Across Europe, firms have adapted to COVID-19 health and safety measures, enabling industry and construction to continue their recovery in the fourth quarter, which also supported activity in professional services. Meanwhile, eateries have introduced takeout services and consumers are more likely to shop online when under lockdown than before the pandemic. This dynamic is still visible in the data at the start of this year. Even if pointing to weakening activity, the services PMI (Purchasing Managers' Index) has stayed relatively resilient in the face of renewed restrictions in the sector, while the recovery in manufacturing has been gaining pace (see chart 2).

Chart 1

Social-Distancing Measures Are Reducing Growth Less As Companies And Consumers Adapt

Correlation of economic growth and stringency of lockdowns

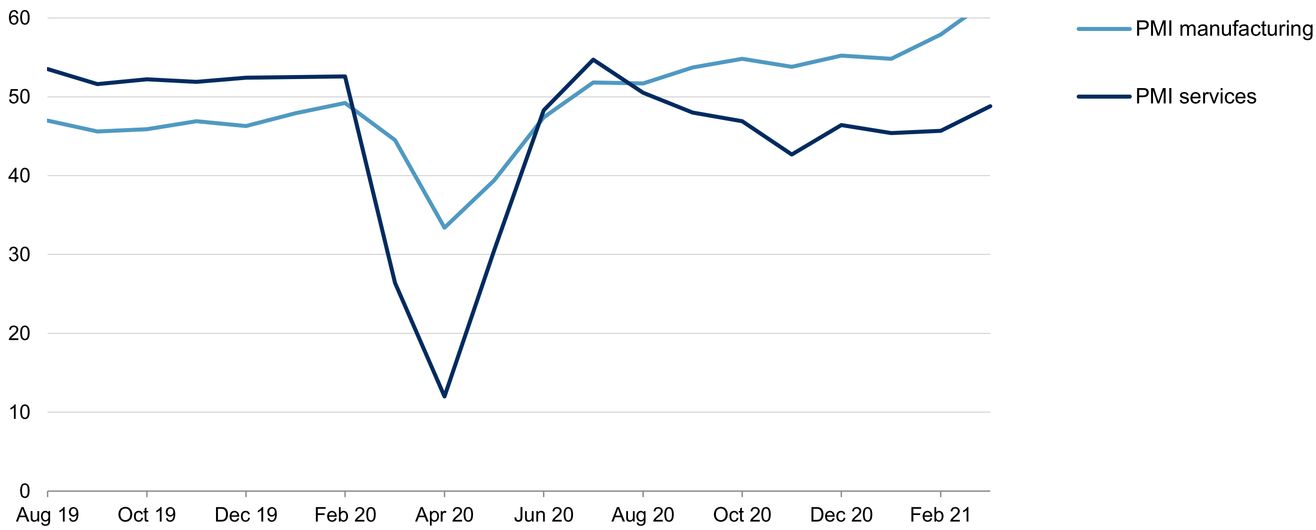


q/q--Quarter on quarter change. Sources: OSI, Eurostat, S&P Global Ratings.

Chart 2

Services Have Stayed Relatively Resilient Amid New Restrictions, While Manufacturing's Recovery Is Gaining Pace

Index: Above 50=expanding



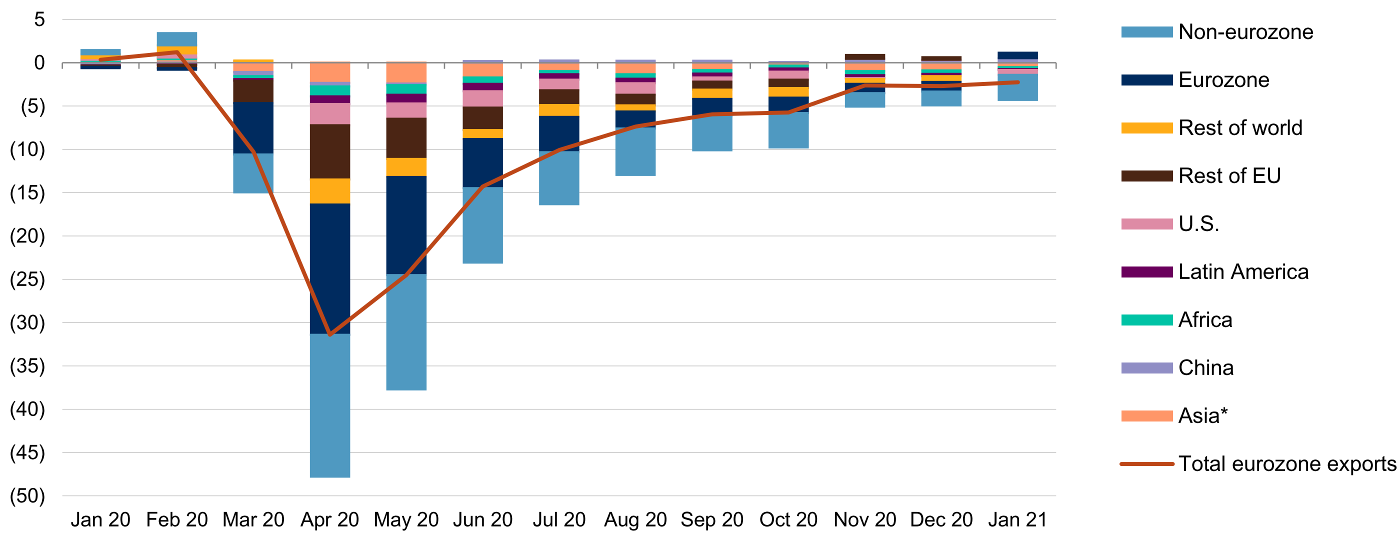
PMI--Purchasing Managers' Index. Sources: IHS Markit, S&P Global Ratings.

A faster economic recovery in the Asia-Pacific and U.S. as well as the need for restocking will continue to drive the recovery in eurozone industry this year. By the end of last year, European exports to China had risen above their pre-pandemic levels (see chart 3). Now, we also expect the region's exports to the U.S. to pick up on the back of the large fiscal stimulus under way there. That adds to the eurozone industry's production expectations, which were already at a two-year high in February (see chart 4). The industry has amassed a backlog of orders after last year's supply chain disruptions and factory closures, creating an impetus to catch up. This has been most visible among German manufacturers, whose order books and production expectations are much higher than a year ago, while its large European peers are taking more time to see their order books recover.

Chart 3

The Chinese Recovery And The U.S. Fiscal Stimulus Will Boost European Exports

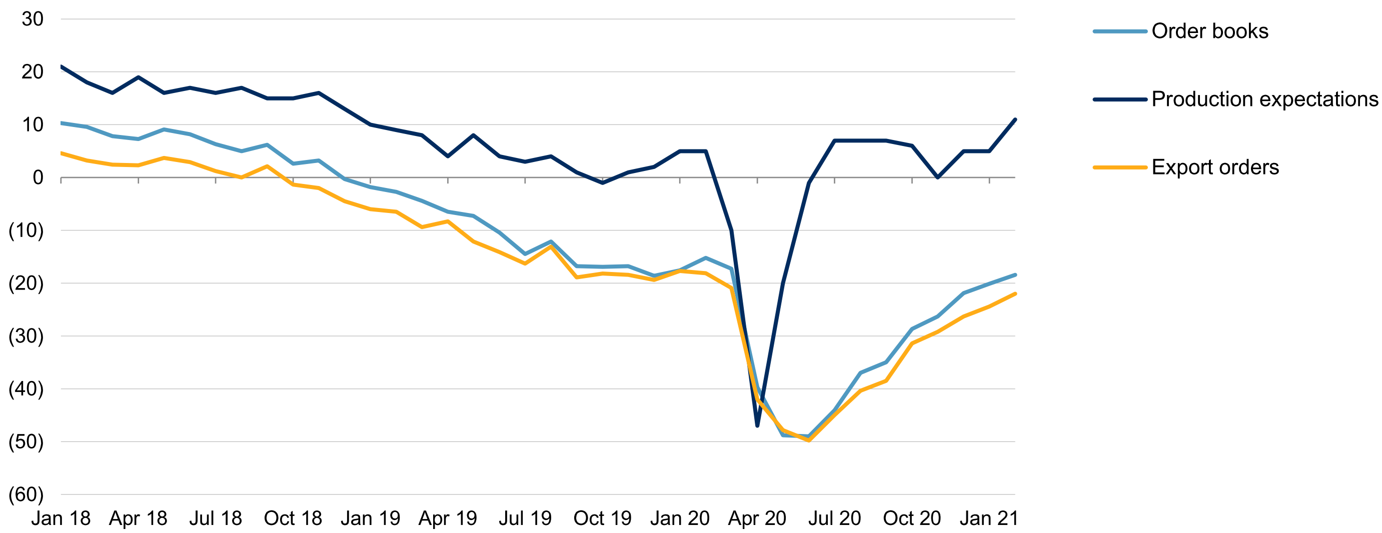
Contributions to nominal eurozone exports (y/y, %)



*Excluding China and Japan. Sources: Eurostat, S&P Global Ratings.

Chart 4

Industrial Orders In The Eurozone Are Set To Pile Up As External Demand Recovers
Index



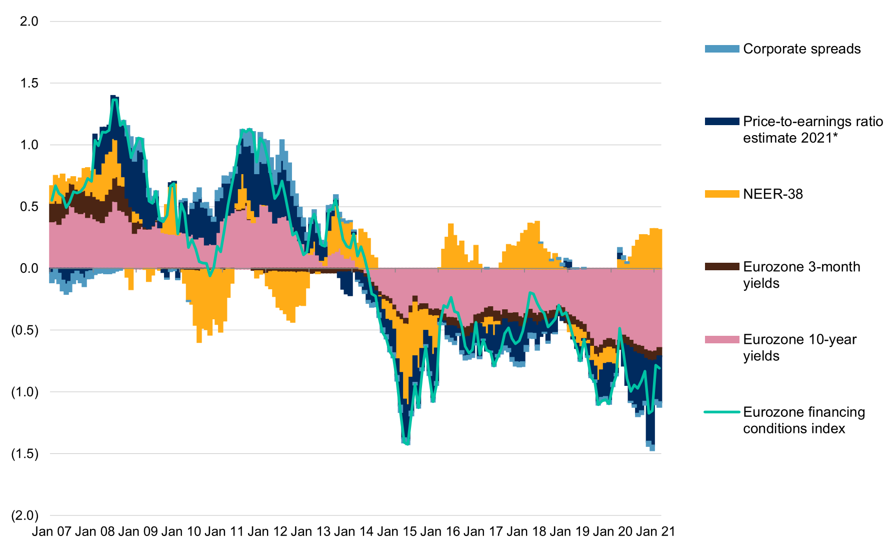
Sources: European Commission, S&P Global Ratings.

Aside from strong external demand, the domestic backdrop should also improve this summer. We assume an end to many restrictions to economic activity as the number of vaccinated increases. This should trigger a quick rebound in consumption and services activity as consumers can leave their homes again and spend some of their accumulated savings, similar to what we saw in third-quarter 2020. This should also enable a quick recovery in the labor market and household incomes, as short-time workers return full time and firms start reemploying laid-off temporary workers (see "This Time, Europe Is Set To Stage A Jobs- Rich Recovery," published on March 16, 2021). Nonetheless, while we expect the 2021 summer season to benefit from a large vaccination rollout, we still assume some restrictions to remain in place, such as test requirements and potential quarantine measures limiting international travel. This means that countries like Spain, Italy, and France are likely to have to wait another year before their tourism industries fully recover. And therefore, their economies will take more time to return to precrisis levels than the industrial hubs of Europe, such as Germany and the Netherlands.

Besides the race between the vaccine and the virus, another essential condition for our baseline scenario are continued favorable financing conditions in the eurozone. So far, European markets have been largely unmoved by the sudden rise in long-term U.S. yields. German 10-year yields ticked up only 30 basis points (bps) since the start of the year. They remain negative in nominal and real terms and 200 bps below U.S. Treasury yields. Financing conditions in the eurozone are historically loose across all asset classes, with ultralow government bond yields being the main driver, and with the sharp upward revision of the U.S. growth outlook having put a damper on the appreciation of the euro exchange rate (see chart 5).

Chart 5

Euro Financing Conditions Are Historically Loose Across All Asset Classes
Contributions to index, standard deviations from z-scores



*Bloomberg estimates. Note: Index is based on the ECB's simple financial conditions index methodology.

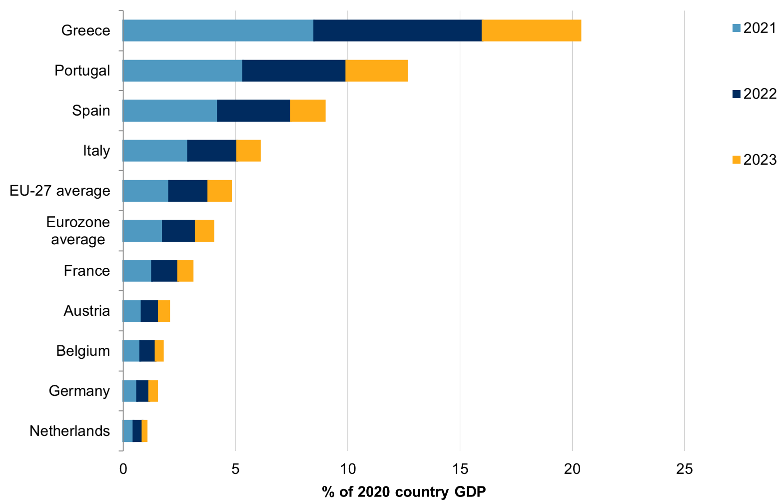
NEER-38--Nominal effective exchange rate of the euro against 38 of the eurozone's trading partners.

Sources: Bloomberg, Datastream, S&P Global Ratings' author's estimates.

Fundamental factors suggest that the decoupling of long-term yields on both sides of the Atlantic may linger. Consensus forecasts for U.S. GDP growth in 2021 have been revised upward due to the recent announcement of a new large fiscal stimulus package. In Europe, the fiscal expansion this year will not be as sizable as in the U.S. And, it will not increase compared with the level last year. The European Commission estimates a 3.7% of GDP widening of the structural budget balance excluding interest and one-offs for 2020. What's more, its source will change: According to European Commission data, EU Next Gen grants, taken together with other EU funds, would add 1.8% of GDP in 2021 and 1.5% in 2022 to eurozone countries' fiscal stimulus (and for the EU-27, 2.0% and 1.7%, respectively). However, we see a non-negligible risk that a substantial share of grant payouts originally scheduled for 2021 will take place in 2022. At the same time, the monetary expansion set for 2021 in the eurozone is to remain as bold as last year. As a result, the combination of stronger fiscal stimulus in the U.S. and ongoing monetary stimulus in the eurozone should not disrupt the gap in euro versus U.S. dollar interest rates in real terms. Second, inflation is not returning to the eurozone as quickly as many observers hope. Inflation spiked at the start of the year to an annual 0.9% from -0.3% on one-off factors (such as the normalization of German VAT rate, shift in the seasonal pattern of sales, changes in the consumer price basket) and the rise in oil prices. Energy prices will drive inflation close to the ECB target of 2% by the summer, but we expect the momentum to abate through the end of 2021, before a slide back to 1.2% in 2022, as pressure on wages will remain low and oil prices are assumed to stabilize.

Chart 6

EU Support To Selected Member States
Support under EU Next Gen, EU cohesion, and agriculture policies*



*Sum of RRF grants, React-EU, JTF, cohesion funds, Agriculture Guarantee Fund, and AFRD.
Assuming 70% of the EU Next Gen funds allocated equally in 2021 and 2022, the rest until 2026. Amounts from 2023 onward are subject to change, based on the countries' GDP performance by June 2022.

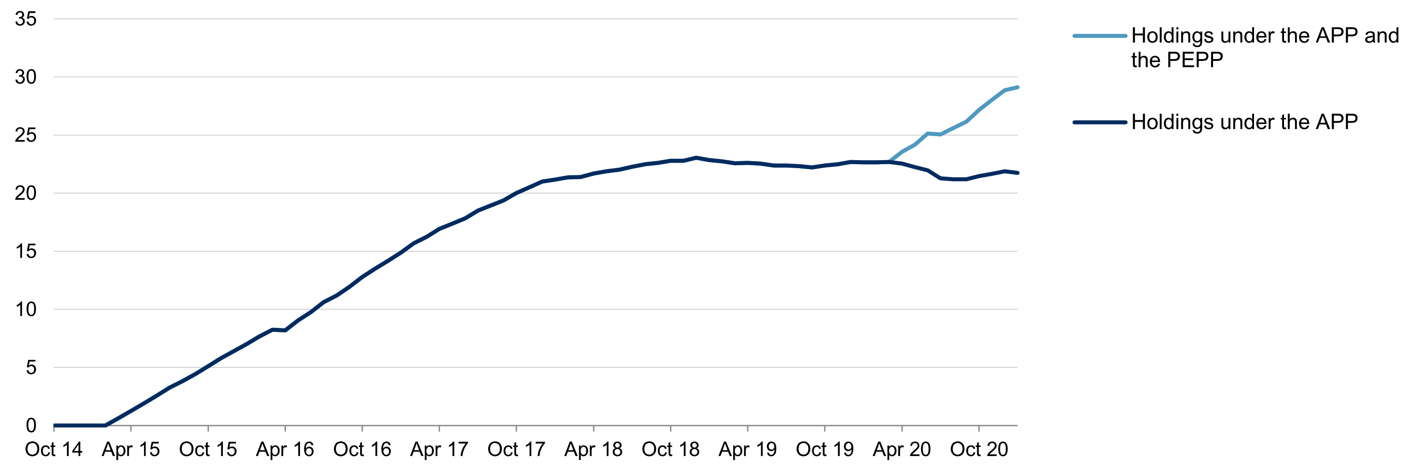
Source: S&P Global Ratings.

Market fundamentals for eurozone's government bonds also speak for stable European yields. The ECB reinforced its commitment to keeping financing conditions favorable by increasing the pace of bond purchases from April in the context of U.S. yields rising, after the pace of quantitative easing (QE) slowed to €19 billion a week in the past three months, from €23 billion the three months before. The remaining envelope of the ECB's PEPP program until completion in March 2022 (€1.04 trillion) is enough to cover almost the full amount of gross long-term commercial borrowing of eurozone governments that S&P Global Ratings expects in 2021 of €1.26 trillion (see "Sovereign Debt 2021: Developed EMEA's Commercial Borrowing Could Reach $1.4 Trillion," published on March 1, 2021). Under its two QE programs, the ECB is now holding 29% of eligible eurozone government bonds. Their continuation with the same composition of purchases (a cumulative 88% of government bonds) suggests a further increase in that share, whose scope will also depend on the amount of supranational bonds the ECB might purchase, as the EU is likely to step up issuance this year. The composition of purchases in national government bonds might change too, considering that ECB holdings vary sharply, ranging from a 24% holding in Belgium bonds to a 44% holding in Dutch bonds (see charts 7 and 8).

Chart 7

Share Of Euro Public-Sector Bonds Held By The Eurosystem

Percentage of eligible bonds, excluding supranational bonds

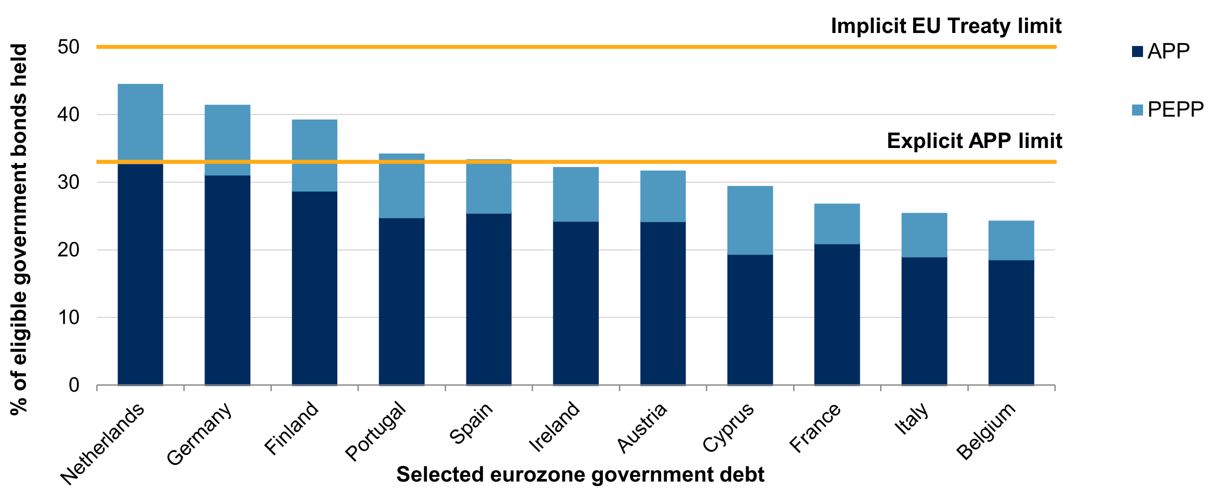


APP--Asset Purchase Programme. PEPP--Pandemic Emergency Purchase Programme. Source: S&P Global Ratings.

Chart 8

Euro Government Bonds Held By The Eurosystem

Sum of APP and PEPP portfolios

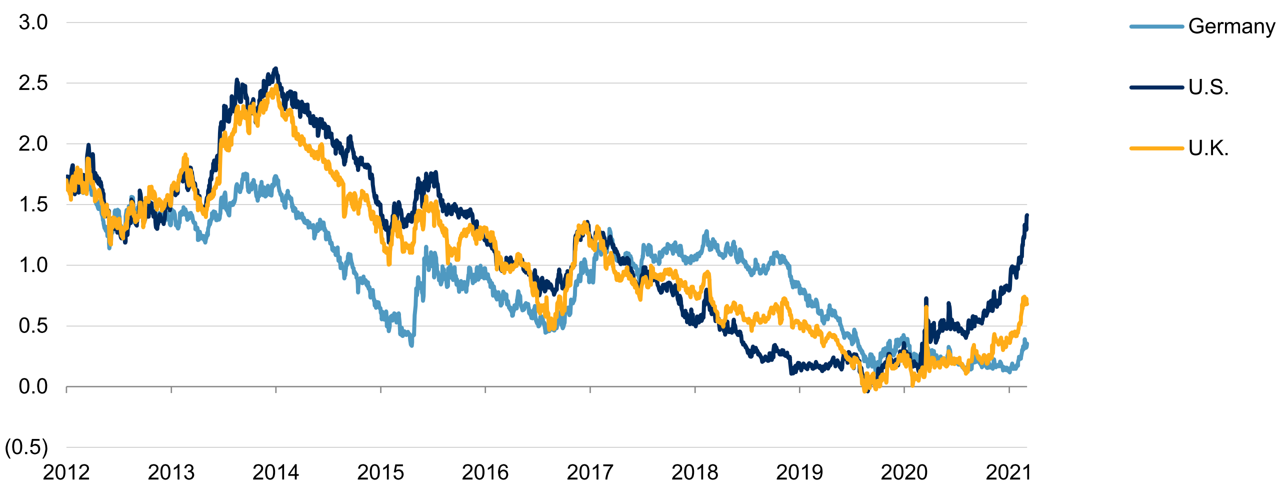


APP--Asset Purchase Programme. PEPP--Pandemic Emergency Purchase Programme. Source: S&P Global Ratings.

While the weaker fundamentals for the eurozone economy compared with those in the U.S. as well as the interplay of demand and supply factors on eurozone government bond market are supposed to shield long-term eurozone yields further from the rise in U.S. yields, it does not mean that European financing conditions will remain automatically favorable across all asset classes. Institutional investors might be willing to switch to U.S.-dollar from euro-denominated assets if yields move higher. For now, the pickup in yields between the two currencies just returned to its pre-COVID-19 gap (200 bps). A lasting gap would probably require the ECB to be very active in keeping financing conditions loose this year (see chart 9).

Chart 9

Yield Curve For German, U.S., and U.K. Government Bonds
10-year to 2-year term spread (percentage points)



Source: Refinitiv, S&P Global Ratings.

Table 1

S&P Global Ratings European Economics Forecasts, March 2021

(%)	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
GDP									
2019	0.6	1.5	0.3	2.0	1.6	1.7	1.3	1.4	1.1
2020	(5.2)	(8.2)	(8.9)	(11.0)	(3.8)	(6.3)	(6.8)	(9.9)	(3.0)
2021	3.2	5.6	4.7	5.7	3.1	4.3	4.2	4.3	3.6
2022	3.7	4.2	4.2	6.6	3.3	4.1	4.4	6.8	3.0
2023	1.8	2.0	1.8	2.9	1.9	2.0	2.1	2.2	1.8
2024	1.6	1.9	0.9	2.2	1.6	1.5	1.6	1.8	1.6
CPI inflation									
2019	1.4	1.3	0.6	0.8	2.7	1.2	1.2	1.8	0.4
2020	0.4	0.5	(0.1)	(0.3)	1.1	0.4	0.3	0.9	(0.7)

Table 1

S&P Global Ratings European Economics Forecasts, March 2021 (cont.)

2021	2.0	1.4	1.3	1.6	1.7	1.8	1.6	1.3	0.3
2022	1.3	1.2	1.1	1.3	1.4	1.4	1.2	2.0	0.3
2023	1.5	1.3	1.1	1.4	1.5	1.6	1.4	1.8	0.4
2024	1.6	1.3	1.3	1.5	1.6	1.8	1.5	1.7	0.6
Unemployment rate									
2019	3.1	8.5	9.9	14.1	3.4	5.4	7.6	3.8	4.4
2020	4.2	8.2	9.2	15.6	3.8	5.6	8.0	4.5	4.8
2021	4.4	8.9	9.9	16.6	3.9	6.0	8.5	6.3	5.2
2022	4.0	9.3	9.8	15.9	3.8	5.6	8.2	5.5	4.9
2023	3.6	8.8	9.4	15.2	3.6	5.4	7.7	4.4	4.8
2024	3.3	8.4	9.1	14.8	3.5	5.3	7.4	4.3	4.6
10-Year government bond									
2019	(0.2)	0.1	1.9	0.7	(0.1)	0.2	0.4	0.9	(0.5)
2020	(0.5)	(0.2)	1.2	0.4	(0.3)	(0.1)	0.1	0.3	(0.5)
2021	(0.4)	(0.1)	0.7	0.4	(0.2)	(0.0)	0.0	0.4	(0.3)
2022	(0.2)	0.2	1.1	0.6	0.0	0.2	0.3	0.5	(0.2)
2023	(0.1)	0.3	1.3	0.8	0.1	0.4	0.4	1.1	(0.1)
2024	0.0	0.5	1.6	1.0	0.3	0.5	0.6	1.5	(0.1)
Exchange rates									
	Eurozone	**U.K.**		**Switzerland**					
	USD per euro	**USD per GBP**	**Euro per GBP**	**CHF per USD**	**CHF per euro**				
2019	1.12	1.28	1.14	0.99	1.11				
2020	1.14	1.28	1.13	0.94	1.07				
2021	1.19	1.32	1.11	0.93	1.10				
2022	1.20	1.34	1.12	0.94	1.13				
2023	1.20	1.36	1.13	0.95	1.15				
2024	1.20	1.38	1.15	0.96	1.15				
Policy rates									
	Eurozone (ECB)	**U.K. (BoE)**		**Switzerland (SNB)**					
	Deposit rate	**Refi rate**							
2019	-0.43	0.00	0.75	-0.75					
2020	-0.50	0.00	0.23	-0.75					
2021	-0.50	0.00	0.10	-0.75					
2022	-0.50	0.00	0.10	-0.75					
2023	-0.50	0.00	0.10	-0.75					
2024	-0.50	0.08	0.15	-0.75					