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Economic Research:

The Eurozone Is Healing From COVID-19

September 24, 2020

Key Takeaways

- The eurozone economy has recovered faster than expected from the first wave of COVID-19. We now forecast GDP will fall only by 7.4% this year and rebound by 6.1% next year. We are also lowering slightly our expectations for unemployment, which we forecast will peak at 9.1% in 2021.
- Yet, the eurozone is now entering a tricky transition period from gradual withdrawal of government support toward implementing the EU's economic reform program. Liquidity, households' behavior, and demand will be crucial in enabling the European economy to weather this transition, and much could go wrong along the way.
- As low inflationary pressures will persist, we don't expect the European Central Bank to tighten monetary policy any time soon, either in terms of interest rates or balance sheets.

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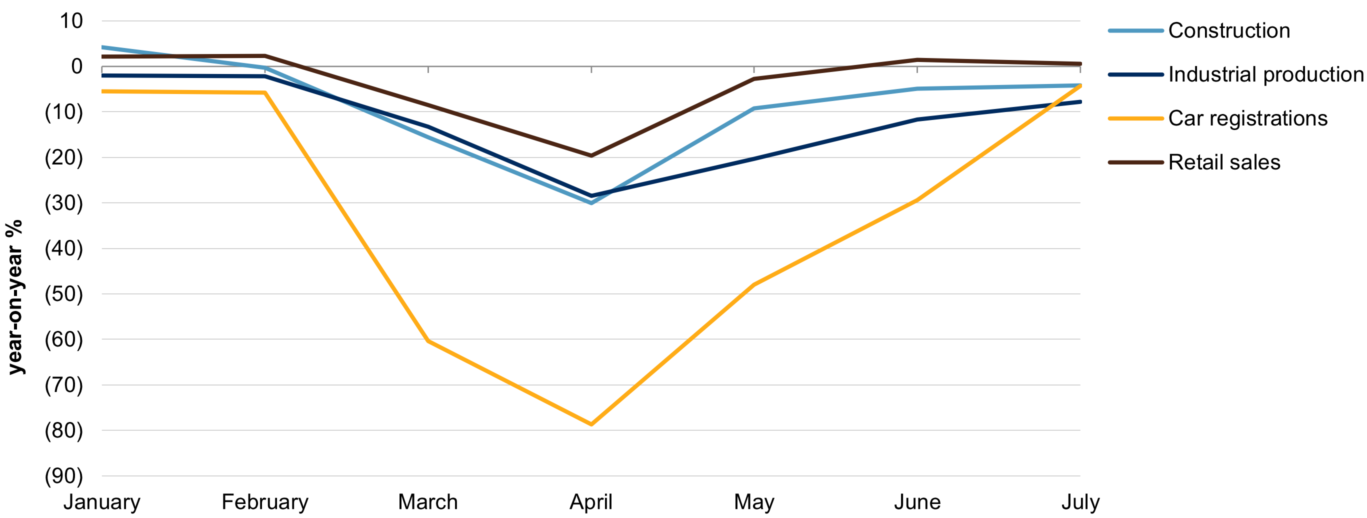
A Tick-Shaped Recovery

After experiencing the worst recession since WWII, the eurozone economic recovery from the lockdowns has been surprisingly fast. Since we published our last estimates in June, the more pessimistic forecasts, such as those of the OECD and to a lesser extent the ECB, have edged up closer to our view. We have also revised our expectations upward from June, and now expect GDP to fall by 7.4% this year and rebound by 6.1% in 2021. High-frequency and monthly data shows it clearly: as soon as lockdowns were lifted, consumers were quick to go out and spend. This, in turn, lead to a rebound in industrial production and construction activity (see chart 1). Current data suggests most European economies are operating at around 5% below their pre-COVID-19 levels. In July, retail sales had already surpassed those of a year earlier by 0.6%, while construction and industrial production were 4% and 8% down, respectively.

Chart 1

Back To Business After Three Months Of Lockdowns

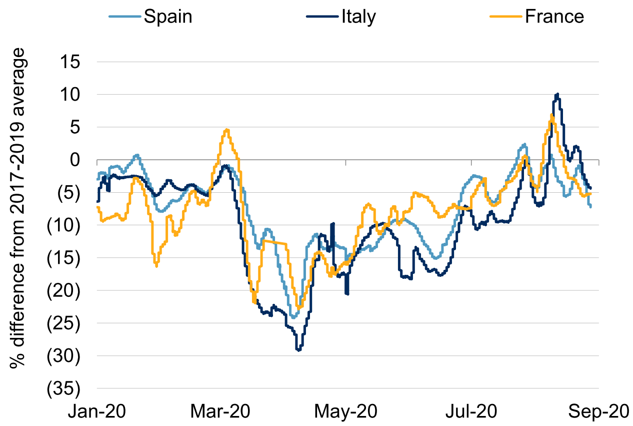


Source: Eurostat, S&P Global Ratings.

That said, high-frequency data also shows that, after a strong initial rebound in activity, the recovery has slowed at the end of the summer (see charts 2 and 3). On the positive side, the rebound in household spending appears not to have been short-lived. Statistics available on disposable income, consumer prices, and consumer spending for France and Germany suggest that the household savings rates increased by between seven and nine percentage points (pts) during the second quarter to reach about 24% of gross disposable income on average for the eurozone. Since retail sales volumes in July increased more than labor income, and consumer prices went down, we can reasonably assume that households have started to reduce their savings rate. Other indications of this are that banks granted €54.5 billion new loans to households between May and July, while new car registrations bounced back by 46% quarter on quarter in July and August.

Chart 2

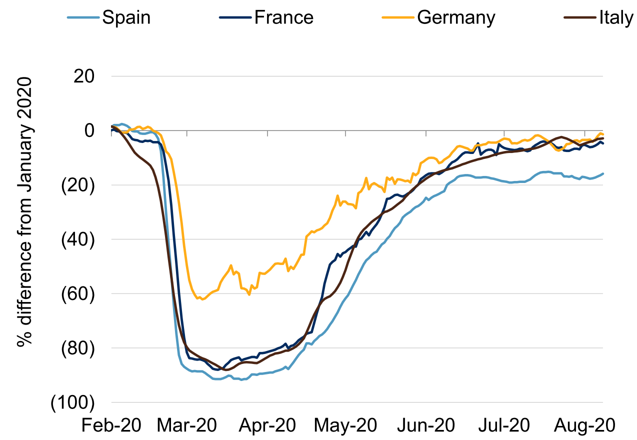
The Recovery Is Slowing Down
Electricity consumption



Sources: ENTSOE, S&P Global Ratings.

Chart 3

The Recovery Is Slowing Down
Retail and recreation*



*Google Mobility data. Sources: Google, S&P Global Ratings.

People are learning to live with the virus. And the less stringent social-distancing measures put in place in this second wave have likely helped confidence to hold up this time, thus also encouraging industry to ramp up production after some destocking. According to the German IFO survey, inventories in passenger cars were slightly too low (-8.7%) in August, after having been much too high in April (+53.8%).

However, the reopening of economies was the easiest part of the recovery. Current developments confirm our view that the recovery is tick-shaped: after a strong mechanical rebound in activity a flattening of growth is likely. This confirms our expectations that GDP will recover to pre-COVID-19 levels by 2022 in the eurozone, with a few countries, like Germany, leading the way. Nonetheless, a return to general lockdowns instead of targeted quarantines to contain the second wave would constitute a reasonable downside scenario. A postmortem of the past two quarters suggests that one month of general lockdown caused a 3.8% full-year loss in GDP--similar to what statistical offices estimated earlier this year. It is reasonable to suppose that business losses caused by a hypothetical second lockdown would take longer to reverse than the first lockdown because it would test the subsistence of small and midsize enterprises even harder. This is not our expectation now. The second wave of COVID-19 might affect as many people as the first, but fatalities are much lower (at 0.2% currently versus 15% in April and May) and social distancing measures are much less stringent now than back in April.

Not Time To Pull The Plug On Fiscal Support Yet

If the rebound in activity has been so smooth, it is thanks to the fiscal and monetary policy support put in place during the crisis. The furlough schemes have been successful in keeping most workers in employment. Five million lost their jobs in the eurozone--less than one-quarter the rate of job losses in the U.S. (21 million), although the labor market is the same size and the fall in economic activity in the U.S. was more contained. At the same time, companies have been able to survive lockdowns and reopen their doors quickly,owing to governments' credit guarantees, government delays in bankruptcy filing, and looser monetary policy set by the ECB.

Almost all of these support measures have been extended until the end of the year at least (see table 1). Although there is a risk that these measures could be keeping alive companies and jobs that are not viable in the future, they are key for now to avoid a collapse in confidence, demand, and supply chains until a vaccine is available and companies can operate normally. Thanks to this support, consumers have retained their income, and companies have access to cheap liquidity, meaning there is now ample liquidity in the real economy to keep the recovery going. As liquidity is ample, state-backed loan guarantees have not been extended either in size or duration, according to research by the Bruegel think tank.

Table 1

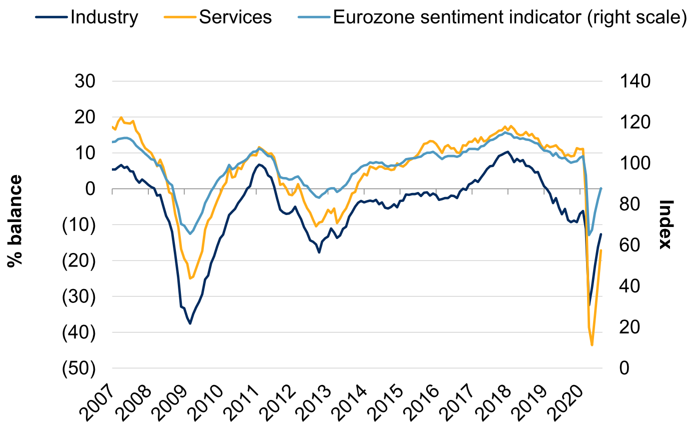
Main Forms Of Government Support By Duration

	--Furlough / Short-time work schemes--		--State-backed loan guarantees to corporates--		--Relaxation of the filing for bankruptcy--	
	Initial termination	**Extention until**	**Initial termination**	**Extention until**	**Initial termination**	**Extention until**
Germany	Dec-20	Dec-21	Dec-20	N.A.	Sep-20	Dec-20
France		Summer 2021; for a period of six to 24 months	Dec-20	N.A.	Aug-20	N.A.
Italy	Jul-20	Dec 2020; up to 24 months but with more constrained access from November	Dec-20	N.A.	Jun-20	Sep-20
Spain	Jun-20	Sep-20; plans to extend to Dec-20	N.A.	N.A.	Dec-20	N.A.
U.K.	Jul-20	Oct-20	N.A.	N.A.	Sep-20	N.A.

Dates are to the end of the month. N.A.--Not available. Source: S&P Global Ratings.

Chart 4

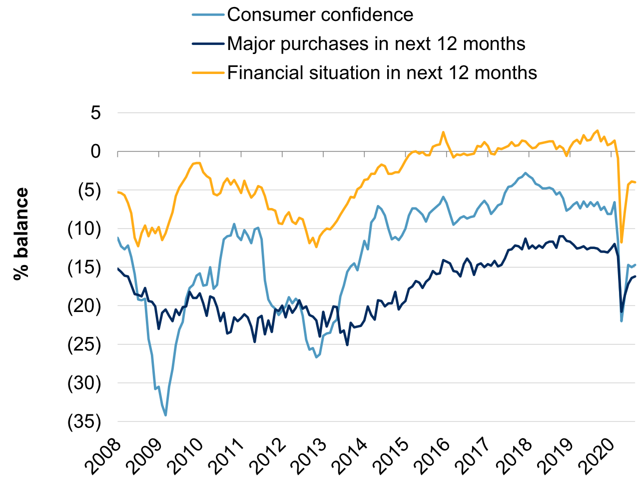
Business Confidence Has Not Tanked Again Despite COVID-19 Resurgence...



Sources: European Commission; S&P Global Ratings.

Chart 5

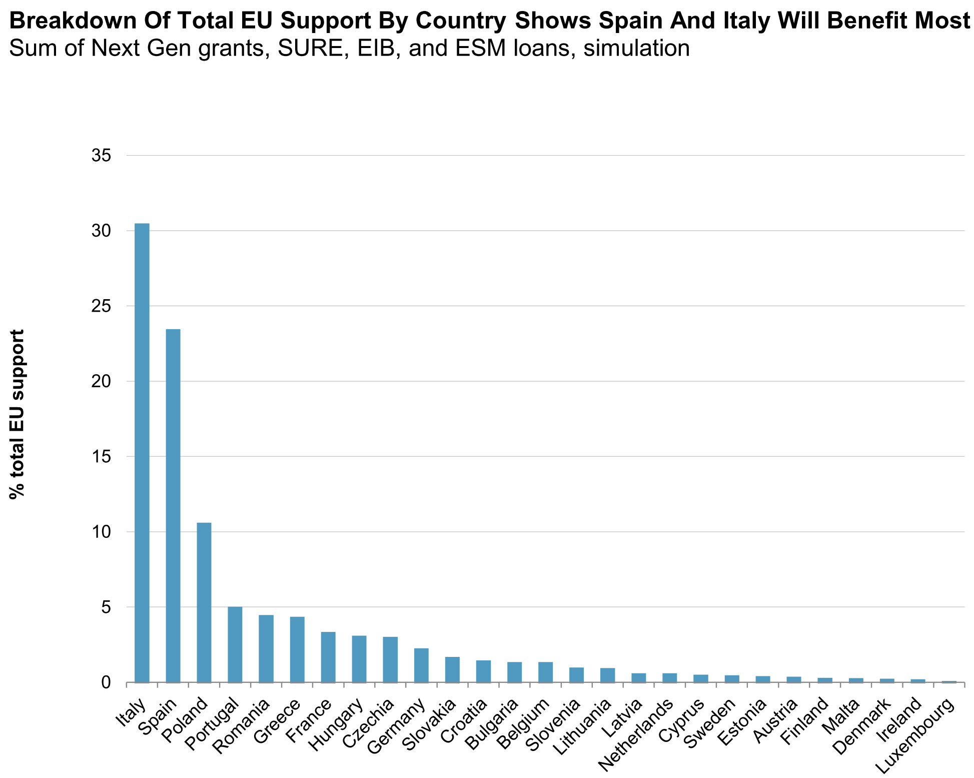
...Neither Has Consumer Confidence



Source: S&P Global Ratings.

Confidence is still improving despite a renewed surge in COVID-19 cases, likely because businesses and consumers do not expect governments to re-impose strict social distancing measures and expect them to boost aggregate demand next year. For Germany and France, stimulus packages of around 4% of GDP have already been unveiled, and it seems relatively certain that fiscal stimulus will occur in Spain and Italy too, given they are set to benefit the most from the EU Next Generation Fund (see chart 6).

Chart 6



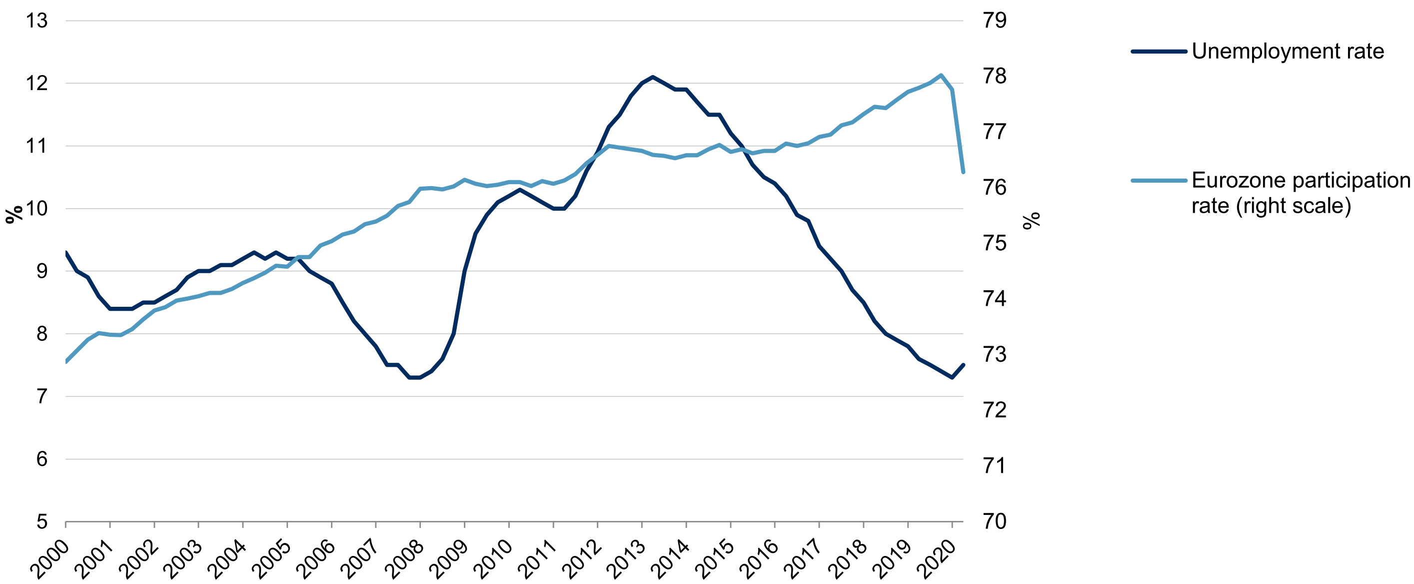
Source: S&P Global Ratings.

More Jobs, But Higher Unemployment Too

We had expected recession-led unemployment to be muted given the short-term work schemes put in place (see "Short-Time Work Schemes Pave The Way For A Smoother Recovery," published May 21, 2020 on RatingsDirect). Nevertheless, at the end of the second quarter, it was even more muted than our forecasts, at 7.9% in August. This is an increase of just 0.6ppt from February. Beyond the shield provided to workers through furlough schemes, another reason has been the sharp drop in the participation rate that we were not expecting. As a result, even though employment had dropped by 5 million by second-quarter 2020 compared with fourth-quarter 2019, unemployment only rose by 172,000 in the eurozone (see chart 7). During periods of lockdown, a large share of the working age population, especially younger workers and those on temporary or fixed-term contracts, seems to have been discouraged from looking for a job when activity appeared to be on hold.

Chart 7

The Muted Rise In The Unemployment Rate Can Be Explained By A Sharp Decline In The Labor Supply

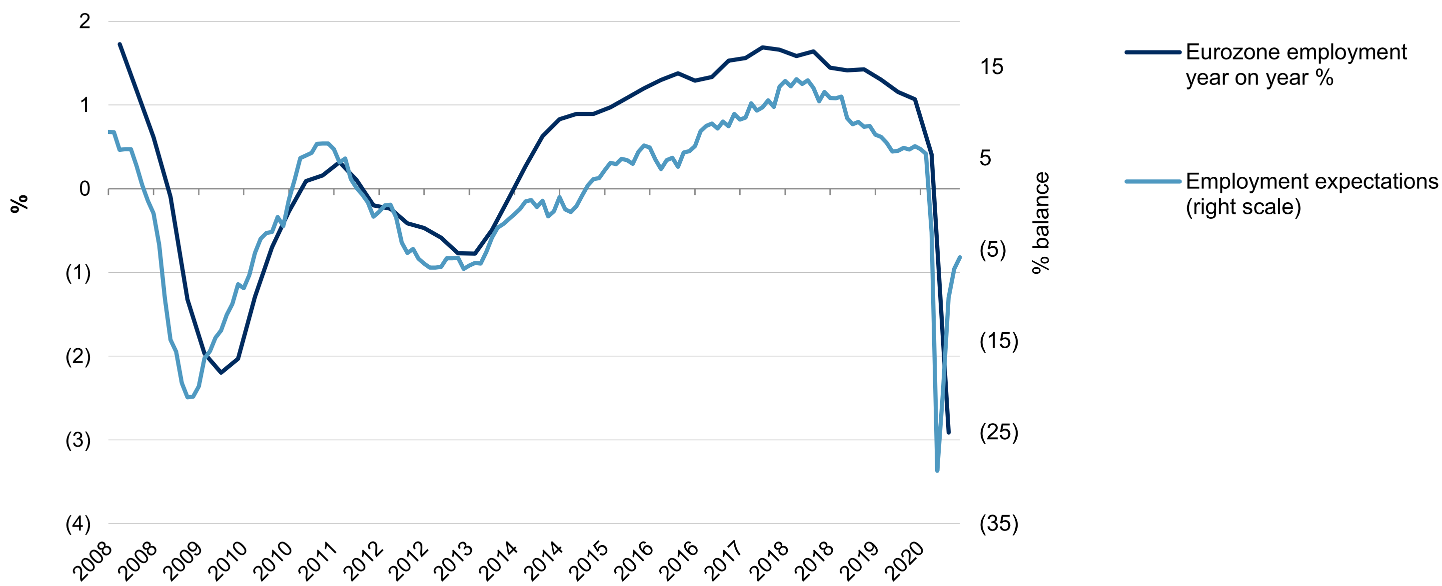


Sources: Eurostat; S&P Global Ratings.

Given the extension of short-time work schemes beyond this summer, job losses might be delayed further. In fact, high-frequency data show the labor market is recovering very quickly. For instance, new job postings were only 5% lower year on year in Germany by mid-August and 14% lower in France, after being 40% lower in June, according to the internet job broker Indeed. As employment expectations suggest, the quick economic rebound should also benefit the labor market. Many temporary jobs that became redundant during the crisis are likely to have been created again as lockdown measures were eased. However, more dynamic job creation is also likely to attract workers back into the labor market, leading to a rebound in the participation rate and thus a somewhat delayed rise in the unemployment rate (see chart 8). As a result, we expect the labor supply to rise quicker than employment in the next few quarters. We expect this will lead to the eurozone unemployment rate peaking at 9.1% in 2021, before gradually edging down to 8.4% in 2022 and 7.8% in 2023. This is an improvement of just 0.7ppt for 2020 and 0.1ppt in 2021 compared to our June forecasts.

Chart 8

Employment Expectations Show Job Creation Is Set To Rebound Quickly Reflecting The Economic Recovery



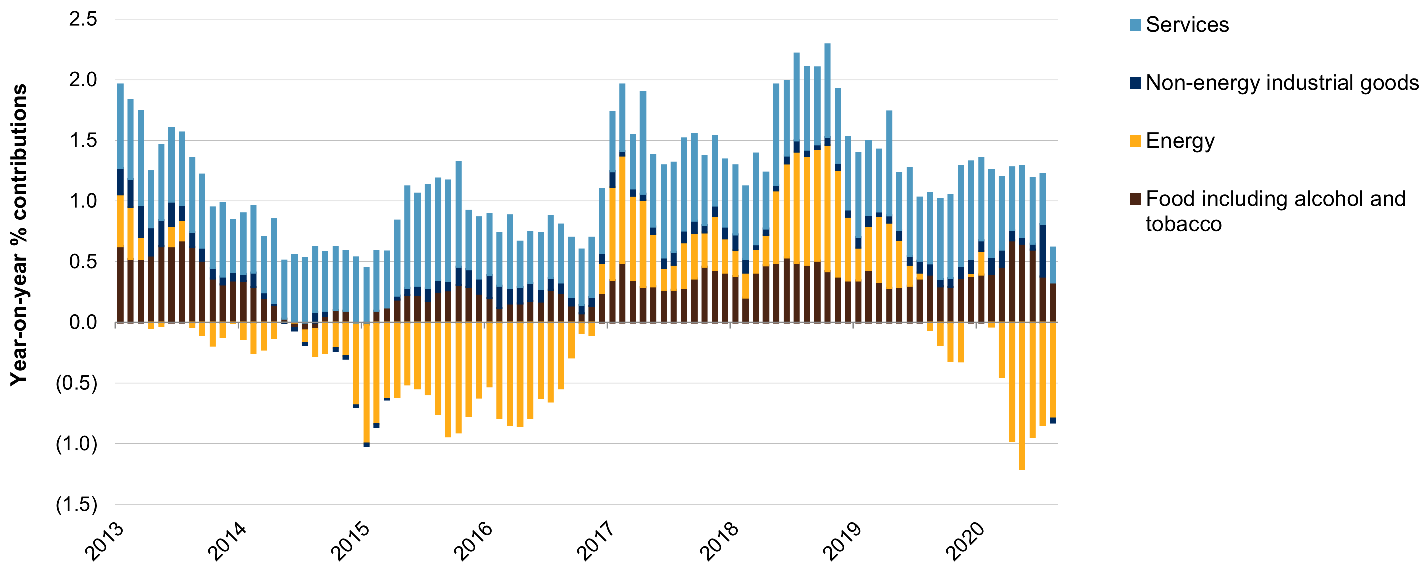
Sources: European Commission; Eurostat; S&P Global Ratings.

ECB On Hold Mode As Inflation Stays Low

With a labor market in recovery mode, inflation pressures will remain subdued over the next three years. Nonetheless, a few factors suggest inflation is likely to bottom out at around 0.2% year on year this year and start to rise thereafter. First, energy demand has recovered from the lockdowns and with it the oil price, which had been a big contributor to the fall in inflation this year (see chart 9). Second, the negative effect of lower VAT in countries such as Germany will fade away next year, along with that of delayed sales this year.

Chart 9

Inflation Has Turned Negative In The Eurozone With Lower Energy Prices And VAT Cuts



Sources: Eurostat; S&P Global Ratings.

That said, inflation is unlikely to meet the ECB's 2% target in the next three years. Even if companies have adjusted their stocks from the great lockdown, a large output gap will disincentivize them from raising their prices as they fight for market shares to survive. The same will be true in other countries outside the eurozone, meaning that import prices are likely to stay low too. On top of this, we expect the euro to appreciate a bit more to $1.2 next year and thus reinforce disinflationary import prices. As such, given both the ECB and the U.S. Federal Reserve interest rates are now at the Zero Lower Bound, monetary policy is unlikely to diverge further. With rates at a similar level, carry-over strategies are now much less attractive. Meanwhile, the EU fiscal recovery package and the resulting planned emissions of EU bonds has boosted the attractiveness of the euro, while that of the U.S. dollar as a safe asset has receded with global uncertainty dissipating. Thus, what is likely to drive the exchange rate is mostly diverging performance in growth. And in that respect, we expect the eurozone to do a bit better.

As a result of low inflationary pressures, the ECB is unlikely to tighten monetary policy any time soon. We don't pencil in any rate hikes or reduction of the ECB's balance sheet in our forecast horizon--that is, until 2024. The ECB might want to consolidate its two quantitative easing programs, but this is unlikely to affect the pace of weekly purchases. In the face of low inflation, we also expect the ECB to focus on defining a more appropriate inflation target in its strategy review next year, perhaps including house prices. It may also reinforce its pledge for a more symmetric target, instead of the close-to-but-below 2%.

Downside Risk Prevails

While we are now less pessimistic on the economic outlook, short-term risks remain on the downside for the eurozone economy. First, renewed lockdowns in Europe or abroad would quickly dent confidence and growth by prompting consumers and businesses to hold on to their savings. It is reasonable to assume that business losses caused by a hypothetical second lockdown would take longer to reverse than in the first lockdown. Second, a hard Brexit leading to new import and export tariffs, as well as non-tariff trade barriers, would add another layer of challenge for European companies, and be especially detrimental for the U.K. economy and small open economies that trade a lot with the U.K. Moreover, cliff-edge effects from the withdrawal of governments' support might materialize, the EU recovery plan might not be implemented in time or in full and U.K.-EU talks might fail.

Nevertheless, a quicker finalization and distribution of a vaccine, becoming widely available by mid-2021, would be a reasonable upside risk to our forecasts and could lead us to revise our projections for 2022-2023 GDP upward.

S&P Global Ratings European Economic Forecasts September 2020

GDP	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
2018	1.3	1.8	0.7	2.4	2.3	1.5	1.9	1.3	2.8
2019	0.6	1.5	0.3	2.0	1.6	1.4	1.3	1.5	1.2
2020	-5.4	-9.0	-8.9	-11.3	-5.2	-7.6	-7.4	-9.7	-4.3
2021	4.7	7.7	6.4	8.2	3.8	5.5	6.1	7.9	3.9
2022	2.4	2.8	2.3	4.3	2.9	3.4	3.0	3.0	2.8
2023	1.6	2.2	1.5	2.6	2.2	1.8	2.0	2.0	1.9
CPI Inflation									
2018	1.9	2.1	1.2	1.7	1.6	2.3	1.8	2.5	0.9
2019	1.4	1.3	0.6	0.8	2.7	1.2	1.2	1.8	0.4
2020	0.0	0.6	0.1	0.2	1.3	0.5	0.2	0.7	-0.7
2021	1.1	0.9	1.0	1.3	1.5	1.4	1.0	1.6	0.2
2022	1.5	1.3	1.1	1.4	1.5	1.5	1.3	1.8	0.6
2023	1.5	1.3	1.1	1.4	1.7	1.5	1.4	1.9	0.7
Unemployment rate									
2018	3.4	9.0	10.6	15.3	3.8	6.0	8.2	4.1	4.7
2019	3.1	8.5	9.9	14.1	3.4	5.4	7.6	3.8	4.4
2020	4.3	7.9	9.3	16.0	4.1	5.8	8.1	4.8	4.7
2021	4.5	9.4	10.8	17.5	5.4	6.4	9.1	6.3	4.5
2022	4.0	9.2	10.5	15.6	5.0	5.8	8.4	4.5	4.1
2023	3.6	8.9	10.0	14.3	4.5	5.5	7.8	4.2	3.9
10-year government bond									
2018	0.5	0.8	2.6	1.4	0.6	0.8	1.2	1.5	0.0
2019	-0.2	0.1	1.9	0.7	-0.1	0.2	0.4	0.9	-0.5
2020	-0.5	-0.1	1.3	0.4	-0.3	-0.1	0.1	0.4	-0.5

S&P Global Ratings European Economic Forecasts September 2020 (cont.)

2021	-0.5	-0.2	1.1	0.4	-0.3	-0.1	0.0	0.4	-0.4
2022	-0.4	0.0	1.2	0.5	-0.2	0.0	0.2	0.7	-0.3
2023	-0.2	0.2	1.4	0.7	-0.1	0.2	0.3	1.1	-0.2
	Eurozone	**U.K.**		**Switzerland**					
Exchange rates	**USD per Euro**	**USD per GBP**	**Euro per GBP**	**CHF per USD**	**CHF per Euro**				
2018	1.18	1.34	1.13	0.98	1.15				
2019	1.12	1.28	1.14	0.99	1.11				
2020	1.14	1.27	1.11	0.94	1.07				
2021	1.20	1.30	1.08	0.92	1.11				
2022	1.20	1.35	1.12	0.95	1.14				
2023	1.20	1.36	1.13	0.97	1.16				
	Eurozone (ECB)		**U.K. (BoE)**	**Switzerland (SNB)**					
Policy rates	**Deposit rate**	**Refi rate**							
2018	-0.40	0.00	0.60	-0.75					
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					

Related Research

On RatingsDirect

- Short-Time Work Schemes Pave The Way For A Smoother Recovery, May 21, 2020

This report does not constitute a rating action.