Economic Research:

Eurozone Economy: The Balancing Act To Recovery

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Key Takeaways

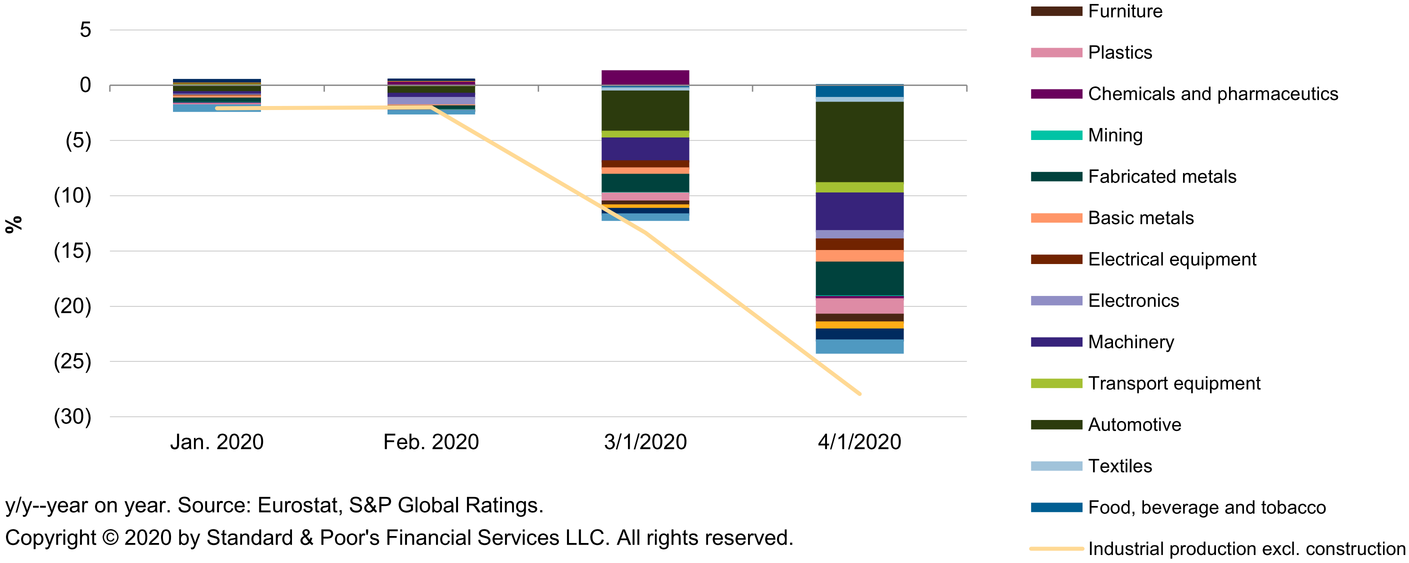
- We now expect eurozone GDP to decline a deeper 7.8% this year and rebound 5.5% next year, because the contraction in business activity has been more pronounced than we expected--even though the economy appears to be recovering as lockdowns are easing.
- The initial fiscal and monetary policy response to the coronavirus crisis has been successful at protecting workers' jobs and ensuring companies' access to liquidity in spite of the sudden stop in cash flow.
- Fiscal policy during the recovery will be a tricky balancing act because removing extraordinary measures too early could stop it in its tracks: Households might hold onto their savings, depressing consumer demand for longer and exacerbating firms' reluctance to invest.
- Economic divergence in Europe is set to grow, given that Germany has responded with a bigger fiscal stimulus than its neighbors. The EU recovery fund will likely help reduce divergence but in its current form will not be disbursed in time to finance the recovery.

The latest economic data is confirming S&P Global Ratings' view of a severe contraction in the eurozone economy in April and May because of lockdowns to slow the coronavirus pandemic. However, it's a little more pronounced than we expected, with economic activity likely to have dropped 11.4% in the second quarter, after a 3.6% contraction in the first. Therefore, we now expect eurozone GDP to contract 7.8% this year and rebound 5.5% next year (instead of our previous forecast of -7.3% and 5.6%). The services sector is taking the biggest hit because social-distancing measures are constraining consumers' ability to buy. That said, the manufacturing sector has been forced to adjust to a sharp drop in demand for consumer and capital goods as companies pull back investment (see chart 1). External demand has also collapsed, with the global economy facing a synchronized recession because of widespread containment measures (see chart 2).

Chart 1

It's Not Just Services, Industrial Production Has Also Been Scaled Down Amid A Drop In Final Demand

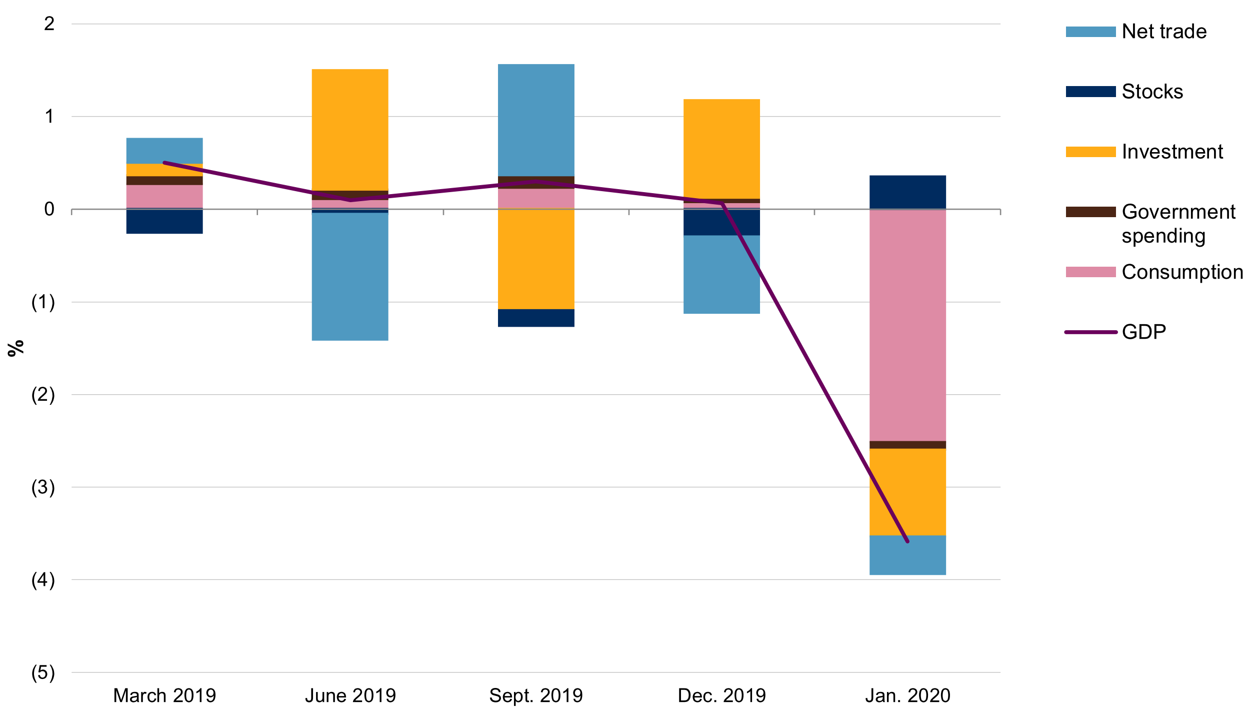
Contribution to growth of industrial production (y/y, %)



y/y--year on year. Source: Eurostat, S&P Global Ratings.

Chart 2

The Downturn In Economic Activity Is Affecting All Components Of Growth
Contribution to GDP growth (q/q, %)



q/q--quarter on quarter. Source: Eurostat, S&P Global Ratings.

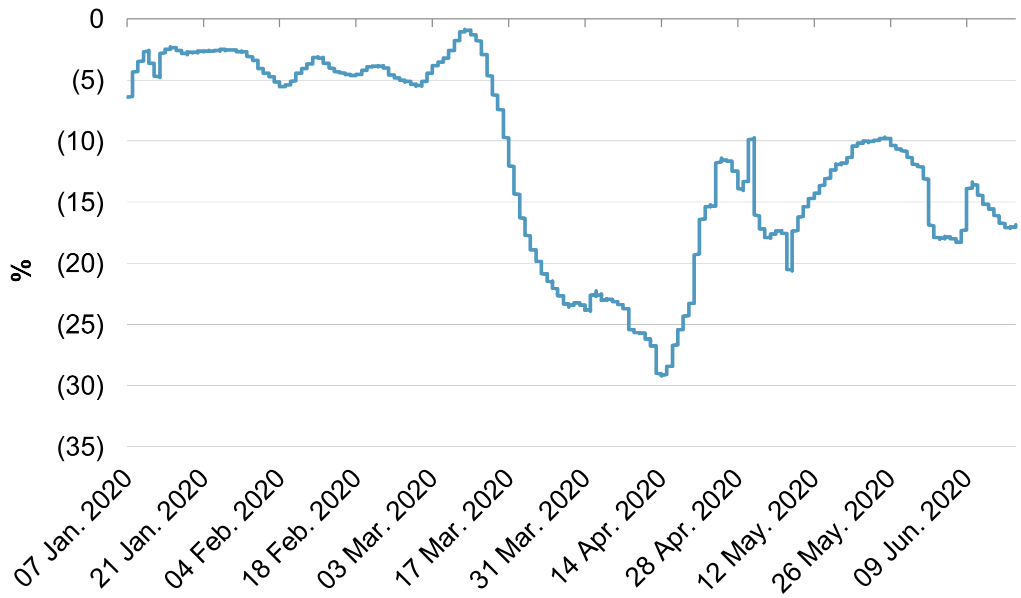
Short-term indicators are showing a slow return to normality as lockdowns are lifted

On the positive side, strict lockdown measures put into place mid-March have been broadly successful at controlling the spread of the coronavirus. The number of new cases of COVID-19 fell to 2,300 per day in the five largest European countries last week, which is less than 10% of the peak in early April. This has allowed European governments to gradually loosen restrictions on economic activity, signaling an equally gradual return to normality. According to Google mobility data, European transit is now only about 30% below normal, compared with as much as -85% during the initial phases of lockdown. We can also see that electricity consumption and truck mileage have picked up, suggesting a recovery in industrial production (see charts 3 and 4).

Chart 3

The Pick Up In Electricity Consumption And Truck Mileage Point To A Rebound In Industrial Production In The Eurozone

Italian electricity consumption 2020, % difference to 2017-2019

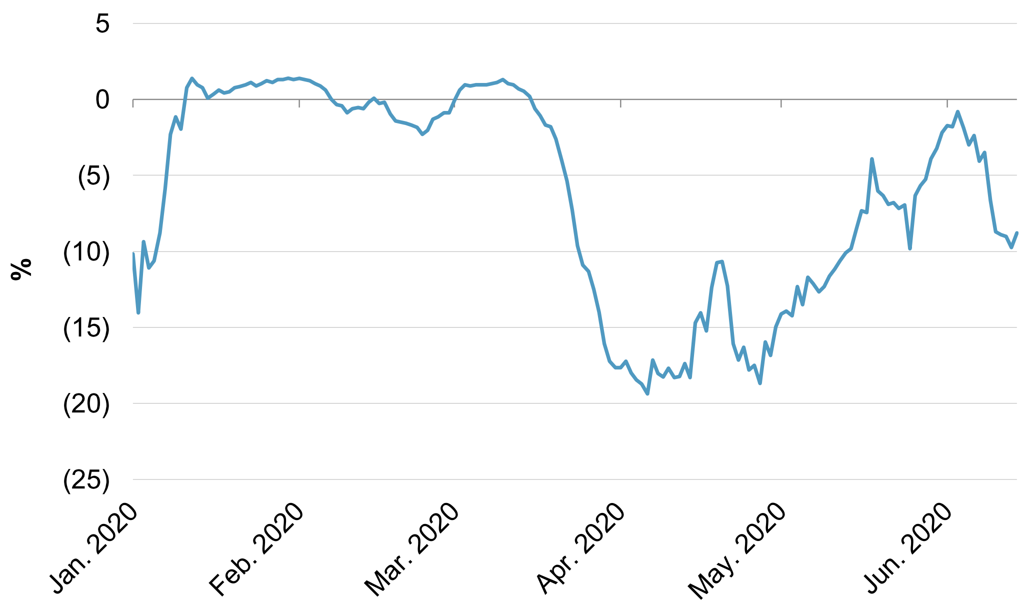


Sources: ENTSOE, S&P Global Ratings.

Chart 4

The Pick Up In Electricity Consumption And Truck Mileage Point To A Rebound In Industrial Production In The Eurozone

German truck mileage 2020, % difference to 2019



Sources: ENTSOE, S&P Global Ratings.

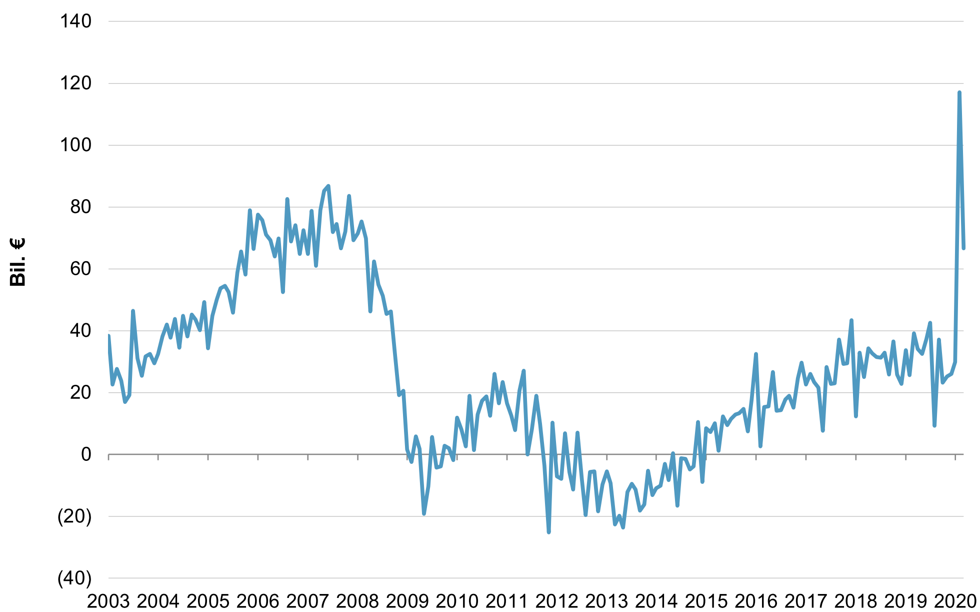
However, real-time data also shows that economic activity for June remains well below pre-COVID-19 levels. Despite the reopening of nonessential shops and restaurants in most European countries, we expect social-distancing measures to remain in place and constrain consumption and economic activity until a vaccine or effective treatment is found (maybe sometime in mid-2021). OpenTable data suggest that restaurant occupancy rates in Hamburg are still 25% lower than last year and even 99% lower in Dublin and London. Meanwhile, the summer tourism season is starting and EU internal borders have only just reopened. For countries like Spain, France, Italy, and Switzerland, relying only on EU tourists this summer is unlikely to make up for the absence of international tourists. This will be another drag on the recovery in the leisure and hospitality sectors.

The initial response to the crisis has been effective at retaining jobs and maintaining companies' access to liquidity

So far, fiscal and monetary authorities have been effective in managing the immediate problems raised by the crisis with a number of extraordinarily large and sweeping measures. The European Central Bank's liquidity injections and state credit guarantees have kept liquidity flowing to companies (see chart 5). This was key to avoiding a liquidity crisis that could have turned into a solvency crisis. To highlight the scope of these measures, the ECB has expanded its balance sheet by more than 8% of GDP in the three months following the start of the lockdowns in mid-March. The unprecedentedly high €1.3 trillion in TLTRO III (the third round of targeted longer-term refinancing operations) uptake by banks in June also suggests that we should continue to see dynamic lending activity in the eurozone.

Chart 5

The ECB And Governments Have Helped Support Corporates In Need Of Cash
Loans to private sector, flows adjusted for sales and securities



Source: Eurostat, S&P Global Ratings.

Meanwhile, as we had expected, short-time work schemes have also helped contain the rise in unemployment to 7.3% in April, just 0.1 percentage point above its February level. About 27% of the European workforce has benefited from those schemes, giving European consumers a steady stream of income and ensuring they retain some visibility about their employment prospects, which will help their return to their previous consumption patterns as well as make it easier for employers to restart their business (see "European Short-Time Work Schemes Pave The Way For A Smoother Recovery," published on May 20, 2020). That said, the muted rise in the unemployment rate is also linked to a drop in the participation rate, especially in Italy, where part of the working-age population was discouraged from looking for a job during lockdowns because part of the economy was shut down. Nonetheless, the slowdown in employment creation is nothing like that in the U.S., where the unemployment rate rose 10.3 points to 14.7% in April.

Furthermore, the ECB's asset purchases have been very effective at keeping government-funding costs low across the eurozone, compressing spreads, and pushing long-term yields downward. By increasing the size and length of its Pandemic Emergency Purchase Programme (PEPP) envelope to €1.35 trillion in June, the ECB has signaled that it will continue to ensure governments can finance their extraordinary fiscal measures at a low cost, even if they have high debt levels, making sure governments do not run into the vicious cycle that sparked the previous sovereign debt crisis. Note that PEPP also offers support to corporates, as 15% of the purchases are commercial paper and 4.5% are corporate bonds.

Finally, the EU has also contributed its own emergency measures, a €540 billion, three-layer safety net, providing another source of funding at low cost for governments own emergency fiscal measures and for small and midsize enterprises (SMEs). The SURE initiative (Support to mitigate Unemployment Risks in an Emergency) acts as a kind of reinsurance to help governments finance their short-time work schemes. Additional credit guarantees to SMEs are provided via the European Investment Bank to reinforce the ECB's liquidity injections. Then there's the European Stability Mechanism credit lines for member states of up to 2% of GDP, with the sole condition that they use those funds to support domestic financing of health costs related to the pandemic. This is another way to give more heavily indebted member states, which pay higher interest rates to borrow on financial markets, a cheaper way of financing. Moreover, the EU is currently discussing a €750 billion recovery plan for its economy. Taken together, we calculate that the EU safety net and the Next Generation plan represent a fiscal response of 9.3% of the union's GDP, made available over several years and with loans and guarantees comprising the bulk of the support (5% of GDP). We used to hear that ECB was the only game in town, but that cannot be said anymore.

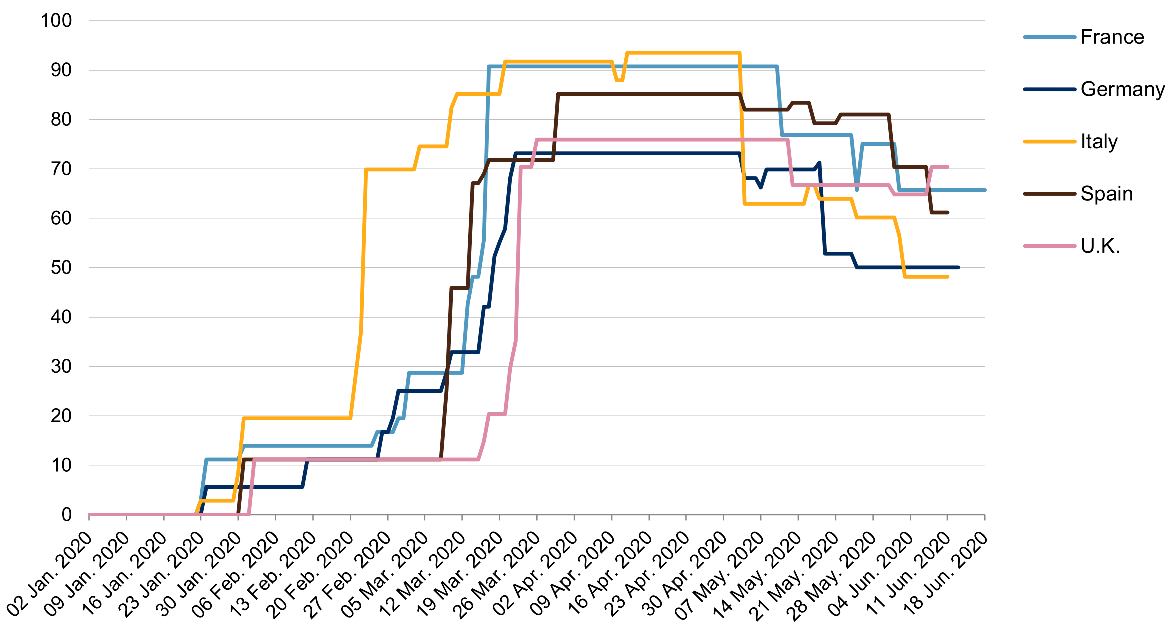
Managing the fiscal policy transition to recovery: a difficult balancing act

While the overall response to the crisis has been very effective so far, the transition to recovery will be a difficult balancing act for fiscal policy. As economies reopen, governments cannot keep the economy on life support indefinitely. This would not only be costly but would also undermine the optimal reallocation of capital and labor. At the same time, pulling the plug too early may precipitate a sharp rise in unemployment and bankruptcies, endangering the return to growth. Nevertheless, placing the economy back on a growth path will require some fiscal push because of the backdrop of high uncertainty that is feeding into low consumer and business confidence. Absent some sort of fiscal push, households might dedicate their accumulated savings into precautionary savings, depressing consumer demand for longer and exacerbating firms' reluctance to invest.

Another issue for the currency union is the possibility that economic performance diverges further across the eurozone. High-frequency data suggest the recovery is uneven, which reflects their differentiated response to the pandemic, their economic orientation (services versus manufacturing), and their fiscal space. On these metrics, Germany is better placed than its neighbors, having had less stringent lockdown measures, being less reliant on services, and boasting much lower debt (to GDP) at the onset of the pandemic (see chart 6). Germany has responded with more fiscal support than its European neighbors. Now, it has announced a €130 billion fiscal stimulus plan (or 4% of GDP) to revive growth, while other countries have yet to do so (France is expected to announce its plan in September) or are mostly counting on money from the EU recovery plan to finance their own--like Spain and Italy.

Chart 6

Germany Has Suffered Less From This Crisis Due To A Less Stringent Lockdown
Oxford Stringency Index (100 = max)

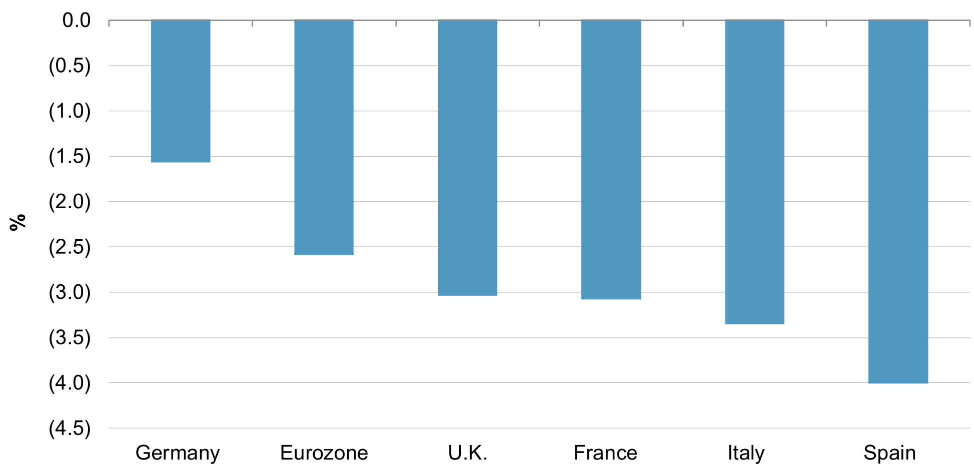


Source: Oxford University.

With this in mind, the EU's proposed €750 billion recovery fund may be key (see "The EU's Recovery Plan Is The Next Generation Of Fiscal Solidarity," June 8, 2020). By taking one step toward fiscal solidarity, the EU plan could reduce economic divergence--depending on the capital key chosen to allocate the funds. The proposal to earmark these funds to environmentally friendly and digital investments should ensure that European economies reestablish themselves on a path to sustainable, long-term potential growth. However, as it is set out, the financing is likely to come late to finance the recovery. In its current form, only one-quarter will become available in the next two to three years, not accounting for national hurdles to implementation. Therefore, we expect Italy and Spain to experience much bigger output losses in the longer term (see chart 7).

Chart 7

Long-Term Output Losses Will Be Bigger Where The Fiscal Stimulus Is Smaller
2023 GDP, difference to pre-COVID-19 baseline



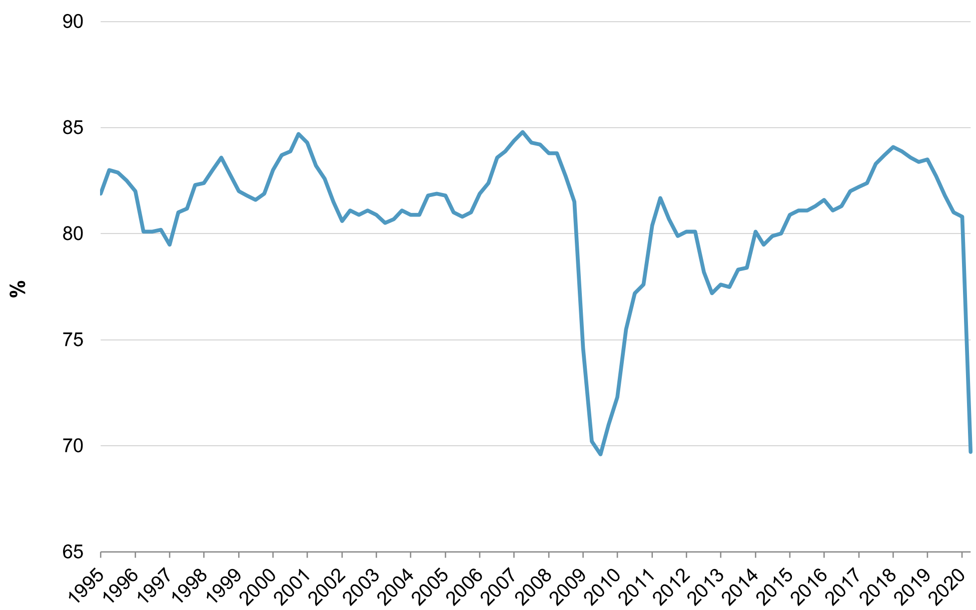
Source: Eurostat, S&P Global Ratings.

Monetary policy will stay lower for much longer

While our scenario hinges on continuation of fiscal support, continuation of monetary support is less critical. On the monetary policy side, the very large output gap that is forming today means the ECB's hands are tied and needs to keep stimulating demand at least until 2023. The collapse of demand and the resulting excess capacity (see chart 8) will keep consumer price inflation low for a long time. To start with, the fall in energy prices will shave off about 0.4 points from headline inflation this year in the eurozone. Meanwhile, companies will keep their prices in check to retain market share given depressed domestic and external demand. Additionally, labor costs will rise only moderately because firms will have a larger pool of unemployed to choose from, reducing workers' bargaining power for years to come (see chart 9). What's more, some fiscal stimulus measures aiming to revive consumption through lower value-added and lower electricity taxes, like in Germany, will mechanically slow inflation. That's why we expect eurozone inflation to continue to hover at about 1.4% in 2023, far below the 2% targeted by the ECB.

Chart 8

Firms Expect Capacity Pressures To Have Dropped To Below 70% In Q2
Eurozone production capacity utilization (%)

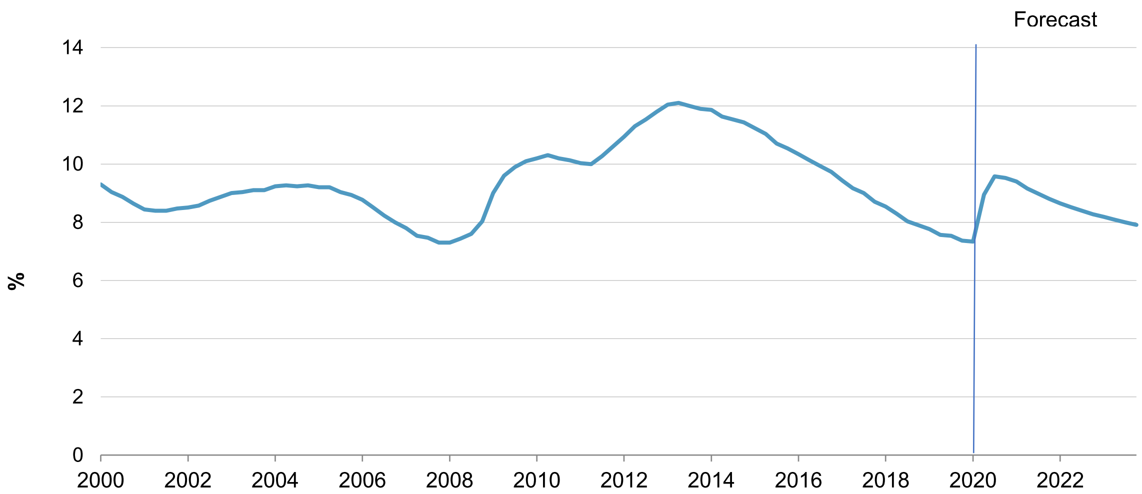


Sources: European Commission, S&P Global Ratings

Chart 9

Higher Unemployment Will Keep Worker's Bargaining Power Low And Thus Labor Costs Down

Eurozone unemployment rate (%)



Source: Eurostat, S&P Global Ratings.

Notwithstanding inflation trends, companies will come out of this crisis saddled with more debt, exacerbating the need for the ECB to offer ample monetary policy support. Any increase in financing costs, and therefore debt servicing, would endanger the economic recovery by triggering more bankruptcies and fueling unemployment. If anything, we expect the ECB to lengthen the timeline of PEPP reinvestments beyond 2022. Any hikes in the deposit rate are also unlikely to occur before 2024, in our view.

Table 1

S&P Global European Economic Forecasts (June 2020)

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
GDP									
2018	1.5	1.8	0.7	2.4	2.5	1.5	1.9	1.3	2.8
2019	0.6	1.5	0.3	2.0	1.8	1.4	1.2	1.4	1.0
2020	-6.2	-9.5	-9.5	-9.8	-5.9	-7.9	-7.8	-8.1	-6.3
2021	4.4	6.8	5.3	6.8	3.9	5.3	5.5	6.5	4.6
2022	2.6	3.1	2.3	3.8	2.8	3.7	2.9	2.6	3.4
2023	1.6	2.4	1.6	2.3	2.3	2.0	2.0	2.1	2.3
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	-0.1	1.0	0.3	0.3	0.7	0.6	0.3	0.5	-0.6
2021	1.0	1.4	1.2	1.2	1.5	1.4	1.2	1.8	0.3
2022	1.5	1.4	1.1	1.4	1.5	1.6	1.4	2.1	0.5
2023	1.5	1.3	1.1	1.5	1.7	1.6	1.4	2.0	0.6
Unemployment rate									
2018	3.4	9.0	10.6	15.3	3.8	6.0	8.2	4.1	4.7
2019	3.2	8.5	9.9	14.1	3.4	5.4	7.6	3.8	4.5
2020	4.2	9.8	9.1	17.6	5.0	6.4	8.8	6.0	5.6
2021	5.0	9.8	10.4	17.0	5.4	6.7	9.1	6.2	5.3
2022	4.8	9.3	10.3	15.1	4.7	5.9	8.5	4.9	4.8
2023	4.4	9.0	10.2	14.2	4.0	5.5	8.0	4.7	4.5
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	-0.4	0.0	1.6	0.6	-0.2	0.1	0.2	0.4	-0.4
2021	-0.3	0.1	1.7	0.7	-0.1	0.2	0.4	0.7	-0.3
2022	-0.1	0.3	1.8	0.9	0.1	0.3	0.6	1.1	-0.2
2023	0.1	0.5	2.0	1.1	0.3	0.6	0.8	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				
2018	1.18	1.34	1.13	0.98	1.15				
2019	1.12	1.28	1.14	0.99	1.11				
2020	1.12	1.26	1.12	0.95	1.07				
2021	1.15	1.24	1.08	0.96	1.11				
2022	1.13	1.27	1.12	1.02	1.15				

Table 1

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

2023	1.11	1.26	1.13	1.05	1.17

Policy Rates

	Eurozone (ECB)		UK (BoE)	Switzerland (SNB)
	Deposit Rate	Refi Rate		
2018	-0.40	0.00	0.60	-0.75
2019	-0.44	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	0.20	-0.75
2023	-0.50	0.00	0.46	-0.75

Source: S&P Global Ratings.

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic. The consensus among health experts is that the pandemic may now be at, or near, its peak in some regions but will remain a threat until a vaccine or effective treatment is widely available, which may not occur until the second half of 2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

This report does not constitute a rating action.