CAUTIOUS BUT HOPEFUL

The resurgence of the Covid-19 pandemic halted the Eurozone's economic recovery. It looks like year-end 2020 will be harder than expected due to new social distancing measures and lockdown restrictions set up in most of the member states. Industrial output remains low compared to pre-crisis levels and companies in the tradeable services sector continue to be at the forefront of restrictions. As to the first half of 2021, uncertainty is still high. Faced with this environment, the European Central Bank (ECB) is expected to announce new monetary stimulus measures following its 10 December meeting as fiscal support measures are gradually reduced.

The second wave of the Covid-19 pandemic created a shock that halted the Eurozone's economic recovery, even though it was not as strong as the initial shock in March-April. The development of a vaccine is encouraging news, but it could take some time before it has an impact on the economy.

A YEAR AFTER THE PANDEMIC BEGAN, HOW IS THE EUROZONE ECONOMY FARING?

Economic growth in the Eurozone was especially erratic in 2020, depending on the number of Covid cases. How do things currently stand compared to the pre-pandemic situation? The catching-up phase has not fully run its course yet. The second wave of the Covid-19 pandemic has slowed the economy's momentum, and the Eurozone remains weakened. Yet compared to March and April, two months marked by an abrupt drop-off in supply and demand, the situation has begun to normalise. All cyclical indicators pertaining to business sectors, output and private consumption are rising towards pre-crisis levels (see chart 2). The second wave of the Covid-19 pandemic hit most of the Eurozone member states, but it was not as virulent as the first wave and supply capacity was not hit quite as hard (schools, for example, generally remained open, which enabled parents to continue working). Although they do not provide a perfect picture of households' consumption, retail sales rebounded strongly and have now surpassed year-end 2019 levels. Looking beyond the automatic rebound due to pent-up demand, fiscal support measures also helped limit the loss of households' purchasing power. Manufacturing output, in contrast, is still below pre-crisis levels, which reflects in particular sluggish corporate investment. In recent months, however, manufacturing keeps showing resilience, as illustrated by the sector's purchasing managers index (PMI)[1], which has been holding above the 50 threshold since July. Inversely, activity in the services sector continues to erode, and the sector PMI held far below 50 in November (41.7, down from 46.9 in October). These trends illustrate the asymmetrical impact of the crisis depending on the sector specialisation of member states.

All in all, the Eurozone economy is not out of danger yet, and we expect Q4 2020 GDP to decline again. Full-year GDP growth is expected to contract by 7.5%, before rebounding to 5.6% in 2021, and then slowing again to 3.9% in 2022. Eurozone GDP will not rise above pre-crisis levels before this horizon. These figures mask major disparities between member states and raise fears of greater divergences within the Eurozone. Germany, for example, should return to pre-crisis levels well before Spain. The development of a vaccine is encouraging news. Yet since it will take time to immunise a sufficient proportion of the population and it is uncertain how well the vaccine will be accepted, it could take longer for the economic impact of the vaccine to be felt.

GROWTH AND INFLATION (%)

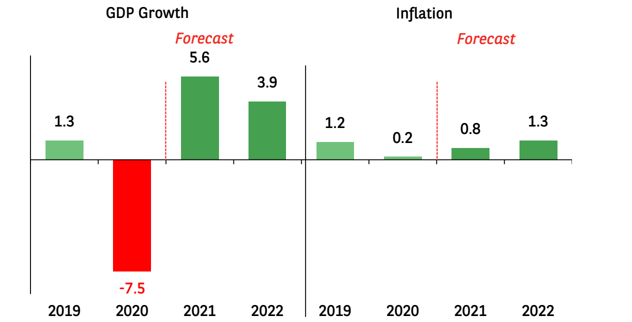

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EUROZONE ECONOMIC INDICATORS

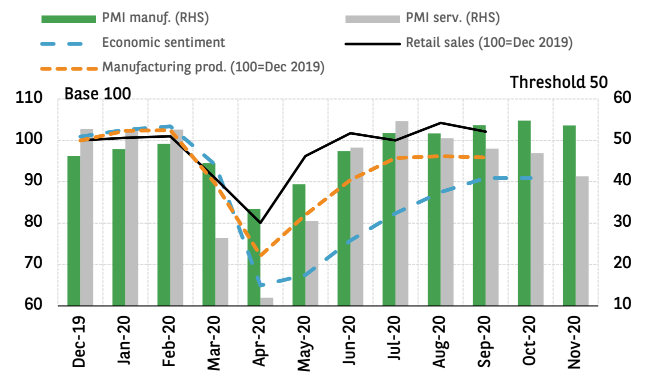

CHART 2 SOURCE: EUROPEAN COMMISSION, EUROSTAT, MARKIT

MONETARY POLICY WILL NOT BE NORMALISED ANYTIME SOON

The monetary authorities continue to worry about the disinflationary impact of the pandemic. In November 2020, Eurozone inflation held in negative territory for the fourth consecutive month (-0.3% y/y), while core inflation, i.e. adjusted for products with the most volatile prices,

1 The Purchasing Managers Index (PMI) is based on a survey of business leaders. The survey provides an accurate picture of the economic health of various business sectors (manufacturing, tradeable services, construction). A score of 50 is the threshold separating contraction from expansion phases.

remained positive but at historically low levels (+0.2%). Low inflation is especially prevalent in tourism-related services, which are at the forefront of social distancing requirements and lockdown restrictions that have been set up around the globe. Faced with this environment, the European Central Bank (ECB) has decided to take new measures at its 10 December meeting, as it has clearly announced. In particular, the envelope of its Pandemic Emergency Purchase Programme (PEPP) has been increased by EUR 500 bn and the horizon extended to at least the end of March 2022. The distribution of a vaccine is unlikely to trigger a tightening of monetary policy, since the ECB is still wary about the financing conditions of member states (see chart 3).

Major signals concerning future monetary policy decisions could emerge around mid-2021, when the ECB plans to finish its strategic review. This review, which follows in the wake of the one conducted by the US Federal Reserve (the Fed), will mainly focus on the inflation target and potential changes in monetary instruments to attain its targets. The ECB could change its tune by insisting more on employment and the symmetrical nature of its medium-term inflation target. Like the Fed, the ECB could be more inclined to accept inflation of more than 2% without tightening its monetary policy. That would introduce a new accommodating bias for monetary policy.

WHAT FISCAL SUPPORT CAN BE EXPECTED IN 2021?

The relationship between fiscal and monetary policies could be one of the themes covered in the ECB's strategic review. Member state governments are benefiting from the suspension of European fiscal rules, which has enabled them to absorb a big part of the shock in 2020. Measured by the change in the primary structural balance[2], there was a very strong fiscal impact this year, even though the size varied from one member state to the next. At the aggregate level, based on the European Commission's most recent estimates (which date back to 5 November), the Eurozone's fiscal impulse was about 3.5 points of potential GDP. This massive intervention was necessary given the size of the shock, and it helped limit the loss of household revenues and corporate bankruptcies. In 2021, support from government administrations will diminish dramatically: at the aggregate level the impact will be more or less neutral in the Eurozone (see chart 4). With the expected rebound in growth and the reopening of businesses, short-time working schemes will be gradually withdrawn. Questions about tightening fiscal policy or stabilising the public debt ratio will rapidly become hot topics of debate again. Yet even if the normalisation of the Eurozone economy were to accelerate in 2021 and beyond, for the moment it is still weak, and an excessively rapid withdrawal of fiscal support could be counterproductive. In the short term at least, maintaining favourable financing conditions limits the risks of public debt rollover. In any case, based on cumulative information currently available for the period 2020-2022, the Eurozone will probably maintain an expansionist fiscal policy (cumulative impulse of about 2.5% of potential GDP). The European stimulus fund Next Generation EU should begin to support national policies as of next year. The strong emphasis on investment should have a bigger multiplier effect on activity in the medium term.

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EUROZONE: 10-YEAR SOVEREIGN RATES

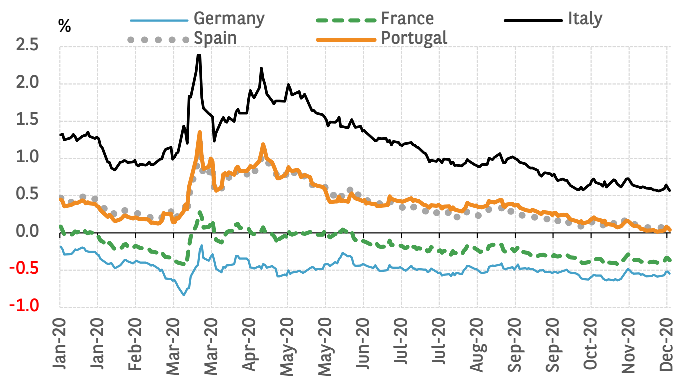

CHART 3 SOURCE: ECB

EUROZONE: CHANGE IN THE PRIMARY STRUCTURAL BALANCE (% OF POTENTIAL GDP)

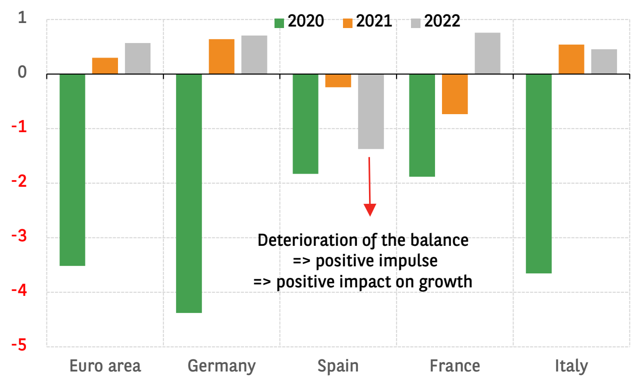

CHART 4 SOURCE: AMECO

2 The primary structural balance corresponds to the public balance adjusted for cyclical effects and interest charges.