ERASING THE LOSS OF ACTIVITY WILL TAKE A LONG TIME

Although the Eurozone member countries seem to have the first wave of the Covid-19 pandemic well under control, they are now facing major economic hardships. The most recent leading economic indicators are showing signs of a turnaround but the road ahead will still be long. It will be hard to fully absorb the loss of activity reported at the height of the crisis. Public policies will play a crucial role. In the months ahead, the probability is very high that there will be a sharp increase in the jobless rate, especially for long-term unemployment, and a series of corporate bankruptcies. The European Central Bank (ECB) is providing member states with very favourable financing conditions. A response at the European level must come through, and the Recovery Fund needs to be set up rapidly.

It is still too early to know all the economic consequences of the current health crisis. Although there has been a massive loss of activity in the short term, the latest economic statistics available to date indicate that the worst could be over. In the months ahead, there is high risk of layoffs and corporate bankruptcies. If a second wave of the pandemic were to strike, the health crisis might well have a lasting impact on the Eurozone economy.

A LASTING LOSS OF ACTIVITY?

In Q1 2020, Eurozone GDP contracted sharply, down 3.6% quarter-on-quarter (q/q). This is bigger than the contraction observed in Q1 2009, in the midst of the great economic and financial crisis. In Q2 2020, GDP is expected to plunge even further since the European countries were in lockdown for a longer period during the quarter. Eurozone GDP is expected to contract by about 13.5% in Q2 2020. Domestic demand, especially household consumption, is expected to be extremely sluggish after contracting sharply in Q1. The automatic rebound expected in H2 2020 will not erase the loss of activity reported in the first half.

All in all, we expect Eurozone GDP to contract 9.2% in full-year 2020 before rebounding by 5.8% in 2021. Economic momentum remains highly uncertain in the months ahead. Looking beyond the hypothesis of a second wave of the pandemic, the economic rebound will be all the more robust and sustainable if economic agents regain confidence. Households fear more layoffs and hiring freezes, while companies are worrying about liquidity and/or solvency risks and sluggish demand. Health and economic risks could lead them to prolong their precautionary behaviour, and to postpone or even cancel investment projects. In any case, Eurozone GDP will not return to pre-crisis levels within our forecast horizon of year-end 2021. There is even the possibility that it could remain lower in the longer term, depending on the scenario (such as a second wave of the pandemic).

The impact of the Covid-19 crisis on the region's growth potential is also an open question. In the aftermath of crises, the developed countries tend to report slowing trends, notably after major and lasting shocks on demand. This could be the case today. The Eurozone's growth potential could be weakened by the loss of production capacity: we can imagine a sharp increase in corporate bankruptcies and long-term unemployment. Sluggish investment can also place a lasting strain on productivity gains. So far, the public policies implemented by Eurozone member states have limited these negative impacts of the crisis.

INDICATORS ARE PICKING UP, BUT ECONOMIC ACTIVITY IS STILL FALTERING

For the moment, the worst seems to be over. On the whole, the leading economic indicators available to date are showing a less negative signal. These indicators provide more up-to-date statistical information on economic trends. One of the most commonly used indicators is the Purchasing Managers Index (PMI). This survey of business leaders provides a reliable image of the economic health of various sectors of activity. The PMI for the services sector has picked up strongly, after dropping to 12 in April 2020, the lowest level since the creation of the Eurozone. In June it rebounded to 47.3, which is slightly below the 50 threshold that separates economic expansion from contraction. In other words, the level of activity is still very deteriorated. The rebound in PMI does not mean that the losses reported during the previous months of lockdown have been erased. Similar observations can be made

GROWTH AND INFLATION (%)

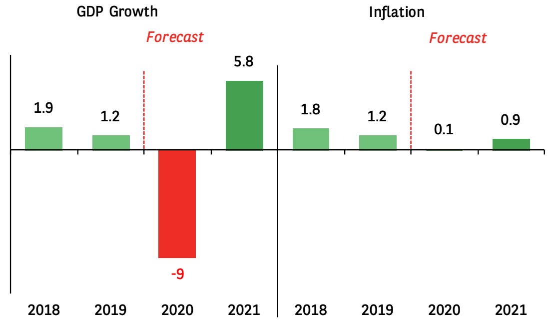

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

REAL GDP IN EUROZONE

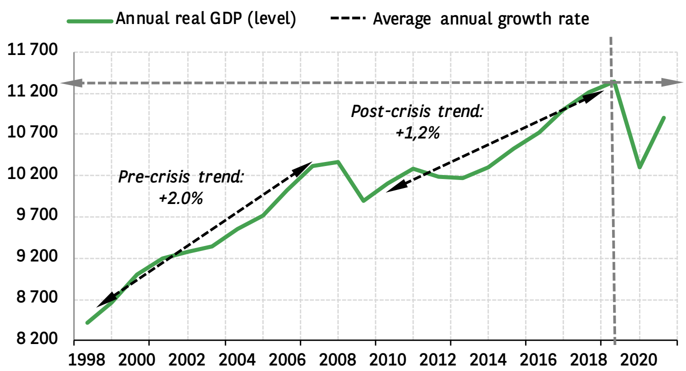

CHART 2 SOURCE: AMECO, BNP PARIBAS

about business sentiment: the index has rebounded from April's low, but is still weak compared to past levels. Lastly, household confidence – which has also picked up from April's low – will play a key role. Although some households were hit by wage losses, measures were implemented to offset these losses (notably job retention schemes). A part of household consumption was restricted during the lockdown (for non-essential goods) and might remain that way in certain sectors (leisure services), households have involuntarily built up so-called "forced" savings, which might be spent during a recovery phase (which would be beneficial for both economic growth and public finances). A vigorous rebound in household consumption will depend on whether households regain confidence in the economic situation and in the government's fiscal policy response, which should strive to prevent any precautionary behaviour. With households lacking confidence and opportunities to spend, we should see a significant increase in the household savings rate. It is expected to hit 19% of gross disposable income in the Eurozone in 2020, which is much higher than the long-term average of about 13%.

ECB: MORE, FOR LONGER

"Our reaction function should nonetheless be clear: the ECB will respond to any significant tightening in financing conditions for as long as the negative effects of the COVID-shock persist"[1]. Over the duration of this crisis, the European Central Bank (ECB) has adopted and will maintain a flexible approach. The Frankfort-based central bank has increased the amount of securities purchases as part of its Pandemic Emergency Purchase Programme (PEPP), which now has a total envelope of EUR 1350 bn. The timeframe for purchases was also extended to the end of June 2021, and the maturing principal payments of securities purchased under PEPP be reinvested at least through the end of 2022. The ECB also further eased the conditions on targeted longer-term refinancing operations (TLTRO-III) for Eurozone banks. For banks exceeding the lending thresholds, new TLTRO-III rates will not be calculated on the average interest rate of the main refinancing operations but on the deposit facility rate. Based on the current deposit facility rate (-0.5%), for example, the interest rate on new TLTRO IIIs would be -1%.

M3 money supply growth has accelerated rapidly since the beginning of 2020. This is largely due to lending to public administrations, which was buoyed by the Eurosystem's intensification of sovereign bond purchases. Short-term liquidity needs might be the sole reason for the sharp acceleration in lending to non-financial companies[2]. Despite monetary expansion, headline inflation has declined sharply (+0.1% in May, from 1.4% in January) under the impact of low energy prices, while core inflation is still mild. These inflation trends must be monitored closely.

A EUROPEAN RESPONSE: ANOTHER SMALL EFFORT

Europe now seems to be more proactive and countercyclical than in the past. The European Commission has proposed a Recovery Plan for Europe, with an envelope of EUR 750 bn. This marks a remarkable step forward that goes beyond the European budget, which does not take into account the health of the economy. To finance the Recovery Fund, the Commission will issue bonds on the financial markets on behalf of the European Union. The overall plan would comprise a large share of grants (EUR 500 bn), or about 3.5% of EU-27 GDP. These grants will be paid out in the first years of the next EU budget, between 2021 and 2024, and will not have to be paid back individually. The remaining EUR 250 bn will be distributed in the form of loans to member states. The proposed Recovery Fund, which must still be approved by all member states, will not transform Europe into a fiscal union. All the same, a rapid agreement between the 27 member states is not only expected but necessary.

EUROZONE: ECONOMIC INDICATORS

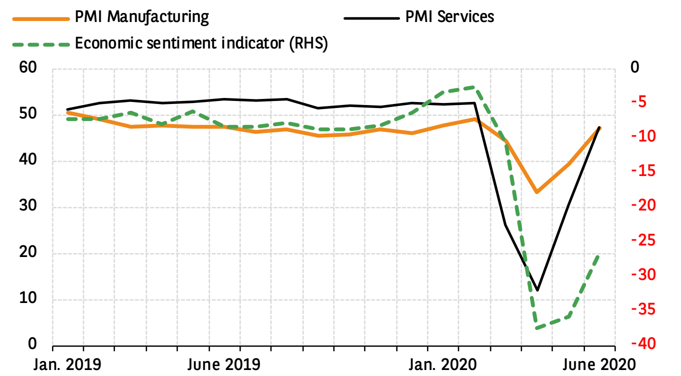

CHART 3 SOURCE: MARKIT, EUROPEAN COMMISSION

Louis Boisset
louis.boisset@bnpparibas.com

1 The price of uncertainty and uncertainty about prices: monetary policy in the post-Covid-19 economy, Speech by Fabio Panetta, 1 July 2020
2 Euro Area Bank Lending Survey, ECB, Q1 2020