

EUROZONE

EUROZONE RECOVERY: RUNNING OUT OF BREATH

After a more vigorous than expected recovery following the end of lockdown, the trend now seems less energetic. There is still lost ground to make up and the end of the year, beset by uncertainty on the health and economic fronts, is likely to see a marked decline of growth. In our central scenario, there is no return to pre-crisis GDP level before the forecast horizon at the end of 2021. Coupled with this, deflationary pressures are building, and the strengthening of the euro intensifies this dynamic. So far the European Central Bank has been patient, but has indicated its willingness to take new measures. If the current situation persists, an extension of emergency monetary measures, in terms of both size and duration, looks likely.

The economic recovery in the eurozone appears to be running out of breath. After an historic contraction in Q2 2020, and a mechanical rebound in Q3, economic activity is likely to slow significantly over the next few quarters. Recent inflation movements are a source of concern for monetary policy makers.

THE GAP HAS NOT YET CLOSED

The recent stabilisation of economic indicators sends a mixed signal. Following the lifting of lockdown measures, economic activity bounced back strongly but has since stabilised. The composite Purchasing Managers Index (PMI)¹ for the eurozone slipped back from 54.9 in July to 51.9 in August. Activity keeps growing continues at a slower pace than in previous months. A similar picture emerges in services, where the PMI fell from 54 in July to 50.5 in August. In manufacturing, the PMI stabilised at 51.7 in August. The services sector continues to suffer from cautious consumer behaviour. Services, which account for a majority of household expenditure (more than 50% of the total in the eurozone)², have suffered in particular from a lack of consumer confidence in the region. The consumer confidence index has seen no further improvement since June and remains below its levels in the months leading up to lockdown (-14.7 in August, from -11.6 in March and -6.6 in February). This observation can be observed in retail sales dynamic. Although retail sales figures are an incomplete record of final household consumption, they suffered a sharp fall since when they have posted only a timid recovery. They grew by only 1.3% in June (year-on-year), and then slowed to +0.4% in July.

In all, we expect eurozone GDP growth to bounce back to 9.0% q/q in Q3 2020, having fallen by 12.1% in Q2 2020, before slowing markedly, to 1.5%, in Q4. Growth is likely to average -8.0% over the whole year 2020, before rebounding to 5.2% in 2021. These trends will not allow the economy to return to pre-crisis levels within our forecast horizon (Figure 2). Significant differences exist between individual eurozone countries. The differences in speed of recovery weigh on the performance of each country given the zone's integration, notably in terms of trade. High level of uncertainty surrounds the macroeconomic scenario, in particular caused by the resurgence of the epidemic in some eurozone countries. According to ECB estimates, under a pessimistic scenario (a big second wave of the epidemic and enhanced protective health measures), real eurozone GDP at the end of 2022 would still be nearly 6% below its pre-crisis level.

INFLATION HEADACHES

In this macroeconomic situation that remains depressed and uncertain, deflationary pressures are mounting. In August, total eurozone inflation fell into negative territory, at -0.2% y/y, for the first time since

GROWTH AND INFLATION (%)

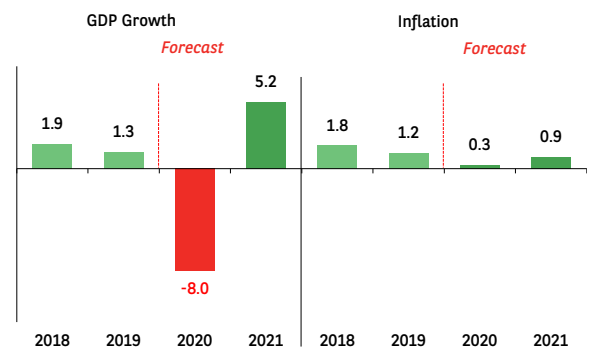


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

REAL GDP GROWTH

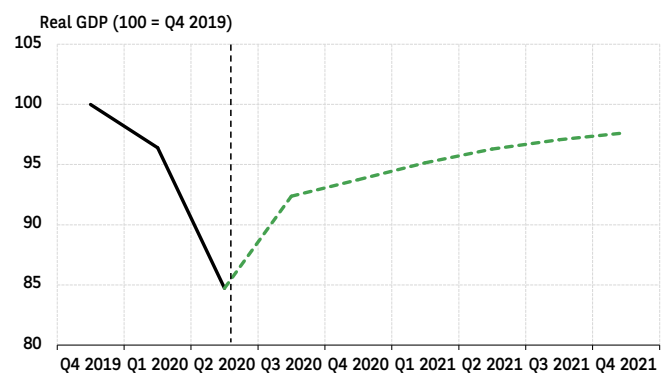


CHART 2

SOURCE: AMECO, BNP PARIBAS

mid-2016. Underlying inflation³ fell back considerably, hitting a record low of +0.4%. In more detail, the sharpest decline in prices since the beginning of 2020 has come in the transport sector, which is hardly affected by the abrupt fall-off in tourist numbers since the beginning of the pandemic. Inflation figures for recent months should be treated with some caution. Some of the slowing of prices comes in shifts in

¹ The PMI is based on data from a survey of business leaders. The survey offers a reliable picture of the economic health of various sectors of the economy (manufacturing, services, construction). Phases of contraction and expansion lie either side of the 50 point threshold.

² B. Coeuré, "The rise of services and the transmission of monetary policy", Speech at the Conference on the World Economy, May 2019

³ Underlying inflation is corrected for volatile components (energy and food) as well as alcohol and tobacco.



timing of the sales season in certain eurozone countries (France for instance), as well as the VAT cut in Germany as part of its economic stimulus package. Although it is probably still too early to talk about deflation⁴, these are nevertheless striking figures that put the ECB in a tricky position.

The negative demand shock triggered by the Covid-19 crisis has hit price trends. This movement has been amplified by the strengthening of the euro against the dollar and also against a trade-weighted basket of currencies for the eurozone (nominal effective exchange rate). This stronger currency reduces imported inflation which, ultimately, reduces domestic inflation. Although the effect of currency movements, particularly when on a small scale, is less pronounced than in the past, the situation is nevertheless being followed closely by the monetary authorities. In addition, recent moves by the US Federal Reserve (Fed) could result in changes at other central banks. The Fed has modified its inflation target, and is now aiming at an average figure of 2%. As a result, no increase in US rates is expected in the near future. The Fed has introduced a fairly accommodating bias into its policy, creating structural support for the euro against the dollar. The ECB, which has itself launched a strategic review, will need to take this into account.

At its quarterly meeting in September 2020, the ECB, through its President, Christine Lagarde, indicated that the currency issue is important, but did not make any immediate changes to its monetary policy. The current high level of uncertainty, the increasingly anaemic-looking recovery and a tightening of financial conditions as a result of the euro's continued appreciation could lead the ECB to extend its Pandemic Emergency Purchase Programme (PEPP) beyond June 2021 and to increase its total envelope, currently set at EUR 1.350 billion. It seems clear from the ECB's blog that the monetary institution is ready to do more. A recent post from its Chief Economist, Philip Lane, said: "It should be abundantly clear that there is no room for complacency. Inflation remains far below the aim and there has been only partial progress in combating the negative impact of the pandemic on projected inflation dynamics".

National stimulus programmes will form another key pillar in the recovery. The risk of defaults and rising unemployment over the coming months is particularly high. On a European scale, the agreement reached regarding the "Next Generation EU" stimulus plan is a key stage and the thorny question of its financing is as urgent as ever. In their votes on 16 September 2020, MEPs recognised the need to introduce new sources of revenue into the EU's budget (own resources). These new taxes, targeting digital businesses for example, could, however, be a new source of conflict between member states.

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PURCHASE MANAGERS INDEXES

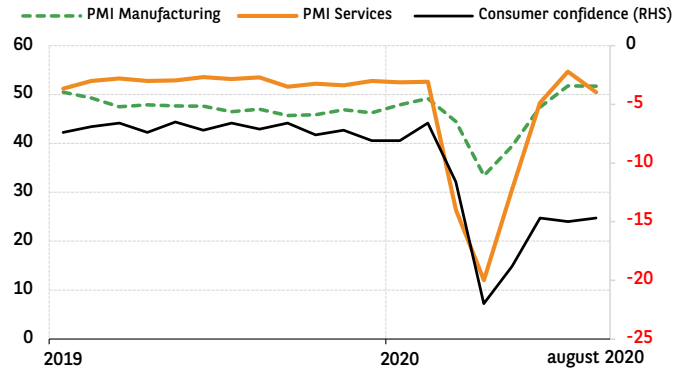


CHART 3

SOURCE: MARKIT, EUROPEAN COMMISSION

INFLATION

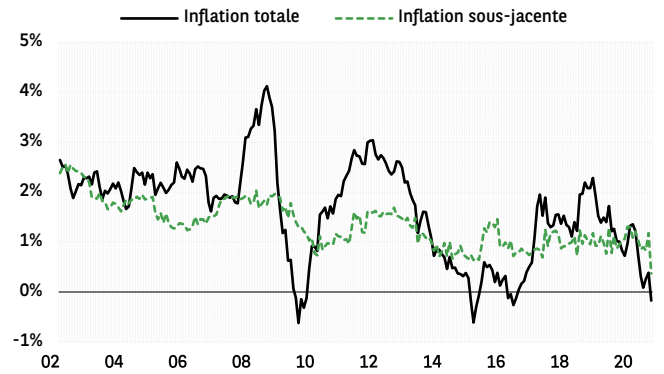


CHART 4

SOURCE: MARKIT, BNP PARIBAS

⁴ Deflation is defined as a permanent and widespread process of falling prices. A situation where only certain prices fall is not considered to be deflation.

