

Eurozone

A new, massive shock

The Covid-19 pandemic has triggered a recession in the Eurozone that looks likely to be deep but short-lived. After a difficult year and a half on the economic front, the Eurozone was showing some resilience and was even beginning to show signs of stabilisation. The current shock – in demand, supply and uncertainty simultaneously – has completely changed the outlook. The health measures taken – which have been necessary to protect the population from the virus – have created the conditions for a recession. Monetary and fiscal policymakers have reacted swiftly and, so far, proportionately. However, the profile of the economic recovery remains unclear and will be crucial in assessing the damage ultimately caused by the pandemic.

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Just three months ago we, along with many other observers, were expecting the beginning of an economic stabilisation. Both the global and Eurozone economies had managed to come through many challenges and imbalances, such as the significant rise in tensions in international trade, the marked slowdown in China and the difficulties of the manufacturing sector and stretched valuations in certain markets. However none of these factors had proved sufficient to send the global economy into recession. Clearly, the picture today is different. The Covid-19 pandemic has created a massive shock, which will push the Eurozone economy into recession this year.

■ A three-pronged shock: supply, demand, uncertainty

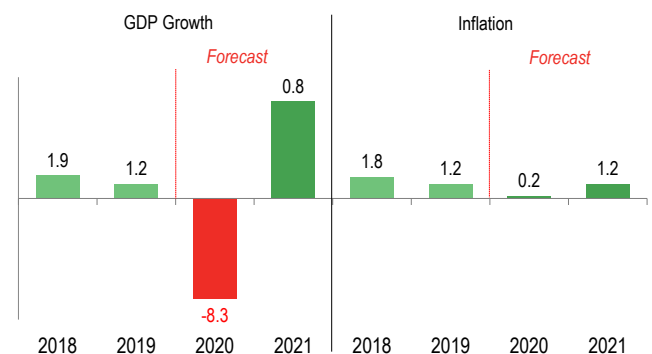
Until recently, the available economic indicators that we usually monitor only partially reflected the shock. At that stage, the Covid-19 was seen as a uniquely Chinese – and thus fairly distant-phenomenon. The expectations of economic agents in the Eurozone did not deteriorate immediately, and the same was true in the US economy, where the standard deviations of forecasts is still high, reflecting the considerable uncertainty surrounding possible economic scenarios¹. The publication of the Purchasing Managers Index (PMI) figures for March has changed the picture. The composite PMI fell from 51.6 in February to 31.4 in March. This collapse was largely due to the abrupt fall in the service sector PMI, which hit a record low of 28.4. The previous low point, dating back to February 2009, saw the service sector PMI drop to 39.2, highlighting the scale of the current shock. These figures confirm the real-time data².

The Covid-19 is a triple shock for the economy. First there is a supply shock, seen in the forced closure of factories and a shortage of workers, who no longer go to their workplaces. Other production facilities are hit by the shortage of intermediate goods flowing from upstream, and scale back business volumes in response. Then there is a demand shock, coming from consumers. The confinement measures taken in various European countries and the closure of many shops automatically hit consumer spending. Finally, there are still many uncertainties, notably regarding the duration of confinement measures, the strength of pent-up demand and the

¹ A. Dietrich et al., *News and uncertainty about the economic fallout of COVID-19: Survey evidence and implications for monetary policy*, VOX CEPR, 24 March 2020

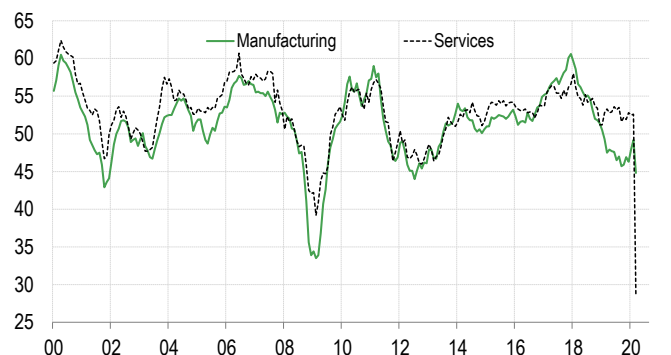
² *Real-time data show virus hit to global economic activity*, Financial Times, 22 March 2020

1- GDP Growth and inflation (YY, %)



Source: BNP Paribas Global Markets

2- PMI index in Eurozone



Source: Markit

effectiveness of economic stimulus policies (see below). These uncertainties will hold back company investment and lead to a build-up in precautionary savings.

According to the OECD's initial evaluation³, the impact on Eurozone countries is likely to be temporary but strong. The initial shock of the health measures will lead to an overall loss of economic activity, in real terms, of between 25% and 30% in the largest European economies (relative to a normal situation). Given the nature of the composition of the different economies the impact will be greater in the transport sector in Germany than in France for example.

³ *Evaluating the initial impact of Covid containment measures on activity*, OECD, March 2020



Considerable uncertainty remains, however, and several factors could accentuate or attenuate the initial effect. This will depend on the duration of confinement measures and the possible tightening of the lockdown in the short term, and the extent to which the lost ground can be regained in the medium term. For example, lost spending in “restaurants and hotels” and “leisure services”, which together account for 12% of total consumer spending in the Eurozone, cannot be regained. It would therefore be a dead loss. Conversely, spending on “clothes and shoes” is at least partially redeemable, either through the substitution of online purchases or increased spending once shops re-open. This sector accounts for nearly 5% of total consumer spending. In addition, the ‘forced’ savings built up by consumers during confinement could provide a strong base for a vigorous recovery (particularly as oil prices have fallen significantly, thus helping boost purchasing power). However, the return to normal patterns of consumer spending will depend on consumer confidence in the Eurozone. If the deterioration in confidence seen in March (The European Commission consumer confidence index fell to -11.6, the lowest figure since the end of 2014) continues, then precautionary behaviours could limit the recovery.

■ The key challenge for public policy: ensuring the best conditions for a robust recovery

The health measures taken in the Eurozone have an inevitable and immediate effect on growth. Economic policy will then have a role to play to ensure the conditions for a vigorous recovery. Short-term measures to avoid a shortage of liquidity will need to be backed up with measures to limit the threat to the solvency of many companies. The measures taken so far look logical given the experience of previous crises. The introduction of short-time working facilities and cash flow support for companies (through government guarantees on loans or deferred-payment deadlines for tax and social security costs) would therefore look like sensible moves⁴, and indeed have been adopted in several countries. These actions should mitigate the impact of the crisis on employment and productive capacities. That said, the scale of the Covid-19 shock and the extent of health measures taken vary from one country to another, as do the fiscal responses. Thus the discretionary fiscal stimulus (excluding loan guarantees and payment deferrals) is currently much greater in Germany than in France, Italy or Spain⁵. At the European level, some decisions have been taken, although this remains relatively limited and no consensus has emerged on a common fiscal tool (such as *Coronabonds*). Most notably, the Commission has triggered the “*general escape clause*” due to the shock being both exceptional in nature and out of the control of governments⁶. This clause allows member states derogation from public finance targets, through a suspension of the rules. In other terms, countries are now

allowed to deviate from the nominal deficit target of 3% or from imposed structural adjustments.

Fiscal support has once again been facilitated by the monetary policy adopted by the European Central Bank (ECB). The ECB has announced massive and flexible measures to respond to the economic effects of the Covid-19 pandemic. At the monetary policy meeting on 12 March, Christine Lagarde had already introduced several support measures, and in particular the creation of an additional budget of EUR 120 bn between now and the end of 2020 (in addition to the existing asset purchase programme). A further emergency programme was announced on 18 March. Worth a total of EUR 750 bn, the temporary Pandemic Emergency Purchases Programme (PEPP) is likely to last until the end of 2020 and will limit the risk of a tightening of financial conditions and of fragmentation within the Eurozone. In a new development, the existing asset purchase limits in the initial asset purchase programme will not apply to the emergency programme, giving it much greater flexibility⁷. In addition, the PEPP will target short-dated assets, thus increasing the response to liquidity issues. Assuming net monthly purchases of EUR20 billion, a total of EUR 1000 bn in assets will be purchased by the ECB in 2020, or nearly 10% of Eurozone GDP.

In the medium term, the effects of the Covid-19 pandemic will have a lasting downward effect on the real natural interest rate in the Eurozone⁸, which is already close to zero, if not negative. Investment will be reduced. Conversely, discretionary savings will be increased, either due to a more cautious approach or simply because people will seek to rebuild the capital lost during the epidemic phase.

In summary, this crisis poses many questions. It has forced monetary policy to go further in the use of non-conventional tools. What might the next step be? The possibility of a direct distribution of cash to economic agents is already being discussed, but raises significant questions, particularly from a democratic point of view. For governments, the support made necessary by the crisis, and the expected collapse in economic activity, will increase government deficits and debt. Will this be followed by fiscal consolidation? Will the crisis accelerate the Japanisation of the Eurozone? We will return to all these questions once the health and the economic emergencies have been dealt with.

Louis Boisset

louis.boisset@bnpparibas.com

⁴ G. Gopinath, *Limiting the economic fallout of the Coronavirus with large targeted policies*, IMF Blog 9 March 2020

⁵ J. Anderson et al., *The fiscal response to the economic fallout from the coronavirus*, Bruegel, 27 March 2020

⁶ *Coronavirus: Commission proposes to activate fiscal framework’s general escape clause*, European Commission, 20 March 2020

⁷ *Decision (EU) 2020/440 of the European Central Bank of 24 March 2020 on the temporary PEPP (ECB/2020/17)*

⁸ O. Jordà et al., *Longer-run economic consequences of pandemics*, Federal Reserve Bank of San Francisco, March 2020

