# A STRONGER THAN EXPECTED ECONOMIC RECOVERY?

**The pandemic continues to spread rapidly within the Eurozone member states, and many uncertainties remain. Yet the most recent economic data are encouraging. Far from claiming victory, these signals nonetheless raise expectations of an accelerated economic recovery as of H2 2021. The greatest hope lies in the successful rollout of vaccination campaigns among national populations. The authorities will remain at the bedside of an ailing Eurozone economy, ready to help through public policies while trying to avoid any tightening moves that might hamper the recovery process. In terms of monetary policy, for example, Christine Lagarde announced that the ECB would step up the pace of securities purchases, which means that financing conditions are being closely monitored.**

Although the virus is still spreading actively in most of the Eurozone member countries, the economic horizon has brightened with the rollout of vaccination campaigns. Yet the Covid-19 pandemic will have to come under full control and economic agents will have to regain confidence before the economy returns to more normal levels of sustainable growth.

## SOME ENCOURAGING SIGNALS, DESPITE THE REST

Even as new health restrictions and lockdown measures are straining the momentum of the Eurozone recovery, some recent economic news is nonetheless providing grounds for optimism.

As a highlight the big increase in the March 2021 purchasing managers index (PMI), which is closely monitored by economic experts. After virtually stagnating since year-end 2020, the composite PMI rose above 50 to 52.5 in March (flash estimate), for the first time since October 2020. In other words, private sector activity in the Eurozone expanded for the first time in six months. This performance, which was much better than the consensus forecast, can be attributed to cyclical improvements in the manufacturing sector as well as in market services. Although the services PMI remained below 50, it nonetheless rose in March to 48.8, beating expectations. The manufacturing PMI reached a record high of 62.4 in March, up from 57.9 in February. Without jumping to conclusions, this strong performance reflects the turnaround in the "jobs" component, which rose to 54.7 in March, from 51.5 the previous month, as well as the upturn in the "new export orders" component (62.4).

Economic players seem to be adapting better to social distancing and other restrictive measures, but an ongoing improvement in Eurozone economic growth will depend on the success of the vaccination campaigns. This is the key to restoring the confidence of economic agents over the long term. Here too, the latest statistics are rather favourable: the European Commission's economic sentiment and consumer confidence indices rose to the highest levels in the past year. Even so, the consumer confidence index is still fragile, and far below pre-pandemic levels.

On the whole, we expect to see a notable acceleration in the Eurozone's economic recovery as of H2 2021. Three key factors will drive this movement: an increase in the pace of vaccinations, the release of pent-up demand once restrictive measures are lifted, and support from the policy mix within the Eurozone and from the American Rescue Plan. This rescue plan should have a positive impact on Eurozone growth in the quarters ahead. We expect to see a net rebound in Eurozone GDP growth over the full year (with average annual growth of 4.2%), followed by another acceleration to 5% in 2022. Under this scenario, Eurozone GDP could return to pre-crisis levels by H1 2022.

GROWTH AND INFLATION (%)

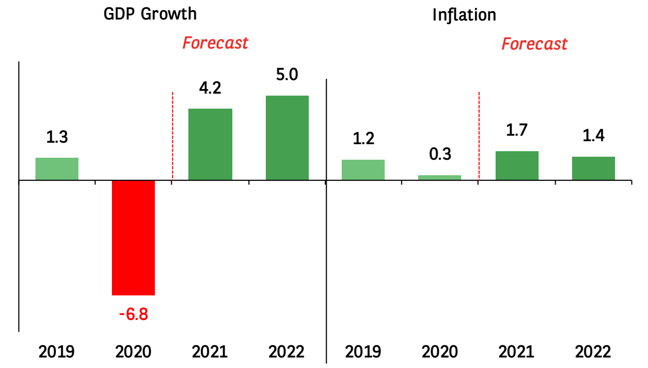


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PMI

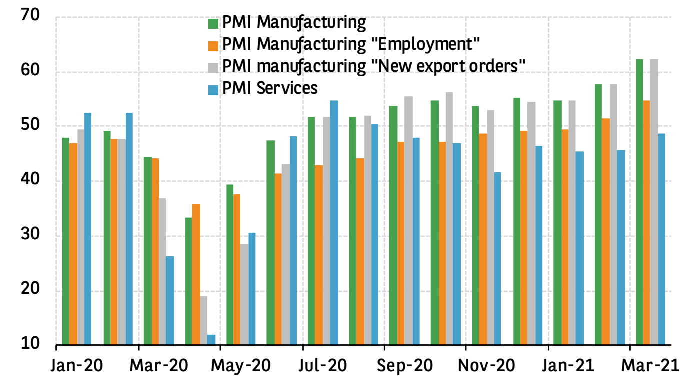


CHART 2 SOURCE: REFINITIV

## ECB: FINANCING CONDITIONS AS AN INTERMEDIATE TARGET

A vigorous economic recovery coupled with rising input prices and longer turnaround times have raised fears that prices could accelerate sharply in the months ahead. These fears are particularly strong in the United States. In the Eurozone, where year-on-year inflation rose to 1.4% in January, before easing to 1.1% in February (see chart 3), the inflationary pressures observed since early 2021 are likely to be short-lived, making the risk of strong price increases less of an issue. From an economic perspective, the recovery phases in the United States and the Eurozone are following different dynamics. First, vaccination campaigns are rolling out much more rapidly in the US than in the member tates. Second, the American Rescue Plan, which is largely geared towards stimulating short-term demand, is much bigger in scope and thus more likely to create bottlenecks. Lastly, the contraction of US GDP in 2020 was only about half the size of that in the Eurozone (-3.5% vs. -6.8%) and the US output gap (i.e., the gap between effective and potential production) did not swell as much according to IMF estimates. Note that the current situation makes it very difficult to interpret pricing trends. From a statistical perspective, the pandemic and lockdown measures have made it impossible to report certain prices, and the average consumer basket has been modified significantly. Tax changes in 2020, like the temporary VAT cut in Germany, also create major base effects.

The rise in inflation expectations in the United States is putting upside pressure on US long-term rates, and through a knock-on effect, on Eurozone rates. For member states, the upturn in interest rates was nonetheless limited (see chart 3), which is reassuring given the Eurozone's more timid and differentiated recovery. The European Central Bank (ECB) insisted that the real danger lies in an upturn in interest rates without an improvement in the macroeconomic environment. According to the ECB, inflation is unlikely to rise in a lasting manner in the Eurozone. Despite an upward tendency, inflation is expected to rise to only 1.4% in 2023: which is still low compared to the central bank's medium-term target of 2%. Consequently, we should not expect any monetary tightening from the ECB.

At a meeting in March, ECB president Christine Lagarde took the financial markets by surprise when she announced that the central bank would significantly increase the pace of securities purchases as part of the Pandemic Emergency Purchase Programme (PEPP). Without changing the amount, Ms. Lagarde nonetheless indicated that volumes would be increased if necessary to maintain favourable financing conditions in the Eurozone. Even if the PEPP funds were used in full by March 2022 (when the programme is set to expire), the ECB would maintain its approach to avoid any tightening of monetary conditions. If the PEPP is not renewed, based on the assumption that the worst of the Covid-19 crisis is behind us, then the ECB might envision greater flexibility in securities purchases through the Assets Purchases Programme (APP). Fabio Panetta, an ECB Executive Board member, recently pointed out that monetary support would be necessary as long as inflation does not hold sustainably at the target level, which probably will not occur until well after the pandemic ends.

## WHAT CAN WE EXPECT IN TERMS OF A FISCAL STIMULUS?

With so much uncertainty over the pandemic situation, it is difficult to discern how the Eurozone member states will orient their fiscal policy. The health crisis is getting worse in most countries, which suggests that fiscal support will be extended and increased at the national level. At the European level, even before the first subsidies from the Next Generation EU plan can be paid out -probably not until summer 2021- the programme is already being challenged. Germany's Constitutional Court has suspended the ratification process for the European Recovery

SOVEREIGN 10-YEAR INTEREST RATES (%)

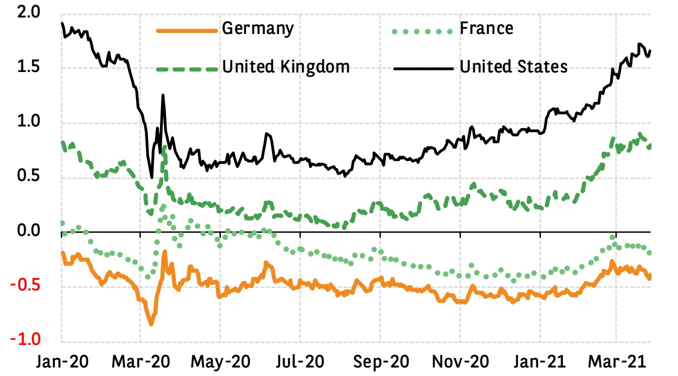


CHART 3 SOURCE: REFINITIV

INFLATION (%)

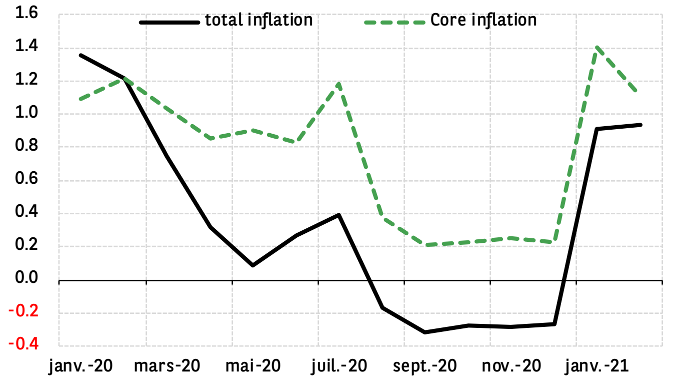


CHART 4 SOURCE: REFINITIV

Fund after an appeal was filed contesting the funding mechanism based on issuing European debt. Unfortunately, this major step towards European construction, initiated during the debt crisis, is still struggling to take shape.

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