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Eurozone: A deceptive ‘V’

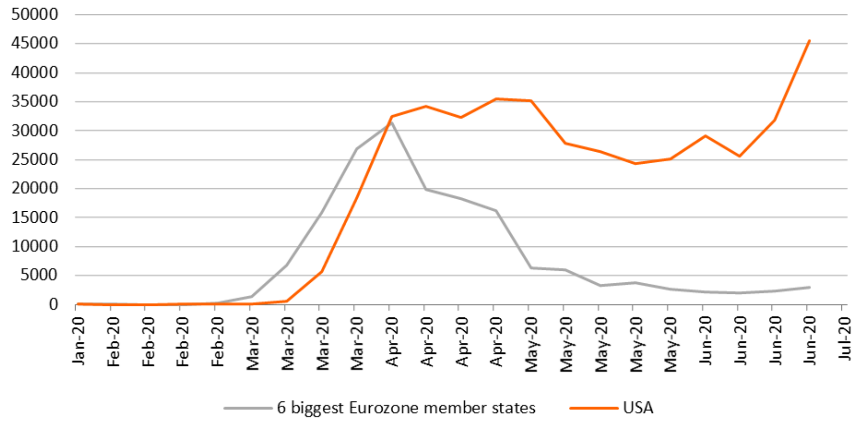
Recent indicators point to a V-shaped recovery, but that won’t last very long. With the European Central Bank trying to appease the German Constitutional Court further rate cuts look unlikely, though an increase in the Pandemic Emergency Purchase Programme is still in the cards

Source: Shutterstock

Living in hope

We now have increasing evidence that the trough of the recession is behind us. That said, let’s not get carried away with data that signals a V-shaped recovery. The flash IHS Markit Eurozone Composite PMI rose from an all-time low of 13.6 in April to 31.9 in May, increasing further to 47.5 in June. Pretty V-shaped, but bear in mind that the gradual lifting of lockdown measures had to have some impact on sentiment. That said, orders remained quite weak while on balance, jobs were cut for the fourth consecutive month. Same story with the Ifo-indicator in Germany. The healthy increase in June was largely attributable to the jump in the expectations component, while the present conditions component showed only a marginal improvement and remains far below the normal level. The eurocoin indicator, a proxy for the underlying growth pace in the eurozone, actually continued to fall in June.

Number of daily new Covid-19 infections

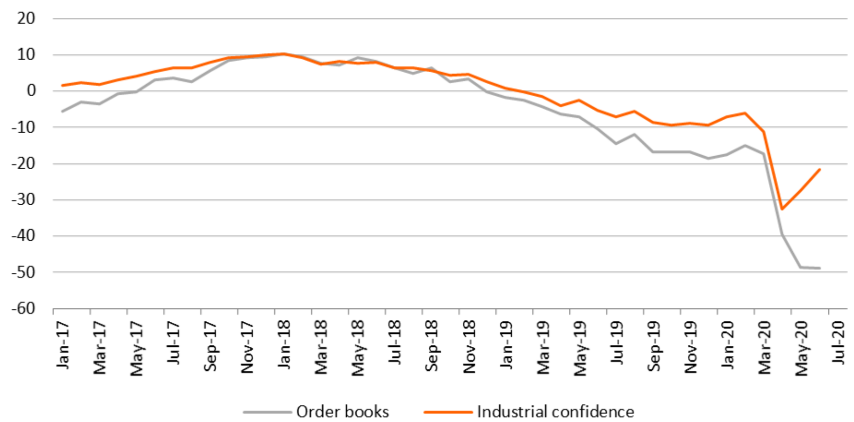


Source: Refinitiv Datastream

Covid-19 is still there

Meanwhile the pandemic is still not under control, with worldwide new infections continuing to rise. While Europe is doing better than the US on that count, new infections are not falling anymore and one could expect a flare up after the holiday season. Fortunately, authorities have now developed tools to take more targeted measures without having to lock down the whole economy. But still, as long as there is no effective vaccine, it will be difficult to return to normal. To be sure, the massive monetary and fiscal stimulus will have some effect (both in France and Spain, temporary unemployment schemes have been lengthened recently). But after a very strong third quarter and a good fourth quarter, we expect the growth pace to level off quite rapidly. We stand with our -8.0% GDP growth for this year (with risks skewed to the downside) and +4.5% for 2021, meaning that it will take until the end of 2023 before the economy returns to the pre-corona level. Would you call that a V-shaped recovery?

Not everything goes up



Source: Refinitiv Datastream

Strong money growth

Inflation remains low and the German VAT cut will contribute to a further decline in core inflation in the second half of this year. Even if the pass-through to consumer prices is only partial, it could still shave off close to 0.5 percentage points from core inflation in the coming quarters. Since the VAT cut is temporary, this effect will be reversed in the course of 2021. Meanwhile, inflation hawks are getting excited by the strong increase in money growth. Indeed, M3 rose 8.9% year-on-year in May, with credit growth equally strong. However, much of this increase reflects liquidity hoarding by companies drawing on their credit lines, while precautionary household savings in more liquid assets also contributed to the strong increase in M3. But make no mistake, this is a sign of distress and no harbinger of significantly higher inflation.

Constitutional truce

The conflict between the German Constitutional Court has been gradually defused. The Bundesbank has decided to give quarterly briefings to the German parliament, while the ECB went out its way in its communication to demonstrate that it's taking the proportionality of its decisions very seriously. Significantly, Isabel Schnabel demonstrated in a speech in Frankfurt that the ECB had decided to put in place the PEPP because in order to obtain a similar inflation effect, it would have to cut the deposit rate to -1.7%, something that would adversely impact European (read German) savers. That is basically the reason that we don't think the ECB will lower the deposit rate any further. That said, we continue to believe that the bank will announce a further extension of the PEPP of approximately €400 billion in the second half of the year. However, as a complaint against the PEPP is now also being prepared in Germany, the ECB might feel a bit more constrained in the coming years. But that is not a near term worry, for sure.

Author

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com