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Eurozone: GDP contraction to rival great recession

With most eurozone countries in partial or full lockdown, GDP contraction this year is likely to rival the Great Recession. While the European Central Bank has ultimately put a big monetary package on the table, a common European fiscal approach still seems far away

Lockdown idles a large part of the economy

While the sentiment indicators for March were bad, they probably can be thrown in the bin immediately. After four months of increases, economic sentiment nosedived in March.

Although the decline was historically large, it probably still understates the actual fall in sentiment, as the survey was conducted between 26 February and 23 March and fieldwork was hindered by containment measures.

> *The OECD placed the loss of added value for most eurozone member states at around 25% per month of lockdown*

We have more faith in the French statistical office INSEE's analysis that estimated the loss of activity by sector during the first week of the lockdown, as well as the loss of demand for each sector. Both the production and expenditure approach point to an economy operating at 65% of capacity. The OECD, using a similar methodology, placed the loss of added value for most eurozone member states at around 25% per month of lockdown.

Consumer confidence crashed in May

Source: Refinitiv Datastream

A better second half won't prevent significant GDP contraction

In our base case, the lockdown will be gradually lifted by the end of April, setting the scene for a recovery in May. However, there will be some negative second-round effects from higher (temporary) unemployment and rising bankruptcies, implying a very negative second quarter.

> *We now pencil in a GDP contraction of 5% in 2020, followed by a 3.2% expansion in 2021*

While the rebound in the second half of the year is likely to be strong, it might take until the summer of 2022 before we catch up with the pre-crisis production levels. We now pencil in a GDP contraction of 5% in 2020, followed by a 3.2% expansion in 2021.

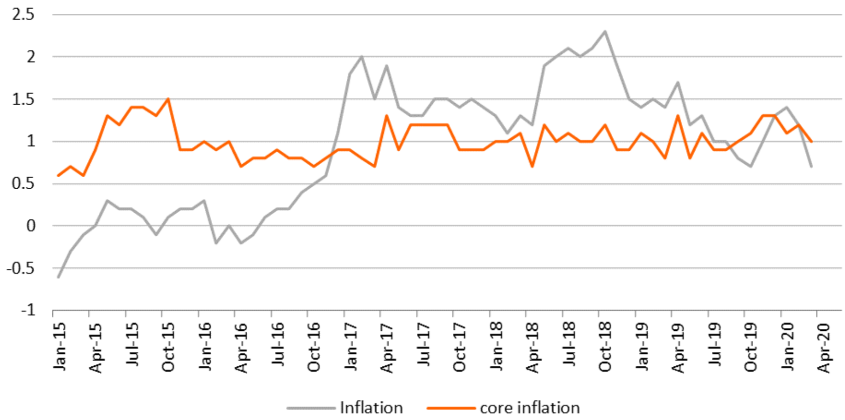
While some think that the supply shock might push inflation higher, we believe that falling demand will keep inflation at bay.

No unity on a common approach

The reaction of authorities has been rather swift. The general escape clause of the European Union's fiscal framework was activated to allow member states to disregard fiscal constraints to be able to fully respond to the economic challenges. On average about 2% of GDP stimulus has already been decided upon.

Whether this will be sufficient to compensate for the economic fallout remains doubtful, but European leaders have thus far failed to come up with a common European approach. The bone of contention remains a common debt instrument, a formal proposal by nine member states.

Inflation comes down again



Source: Refinitiv Datastream

'Crossing the Rubicon' moment

Meanwhile, the ECB has morphed back into "whatever it takes" mode.

In the first instance, the central bank came up with a thoughtful response, loosening the conditions for banks to get ultra-cheap funding (even below the deposit rate) through the TLTRO III, to avoid a credit crunch. As markets' reaction was lukewarm, the ECB decided in an emergency meeting to put in place the Pandemic Emergency Purchase Programme, allowing the bank to purchase for €750 billionworth of sovereign and corporate bonds. Greek bonds will now also be included as well as commercial paper.

> *If the ECB buys according to capital keys, it might temporarily pass the issuers limit for Germany but since the German government has decided to go big on fiscal expansion, the ECB's holdings of German debt are likely to fall below 33% again in 2021*

With the PEPP (even though it allows some flexibility), together with the existing programmes, the ECB is now likely to buy more than €100bn a month in assets for the remainder of the year. The ECB will continue to use the capital key for the ultimate distribution of the purchases, although it decided to junk the issuer's limit, something that might trigger new complaints at the constitutional court in Karlsruhe.

While some saw this as a "crossing the Rubicon" moment, the reality is more prosaic. If the ECB buys according to the capital keys, it might temporarily pass the issuers limit for Germany. However, as the German government has decided on a big fiscal expansion, the ECB's holdings of German debt are likely to fall below 33% again in 2021.

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