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Eurozone: This is big

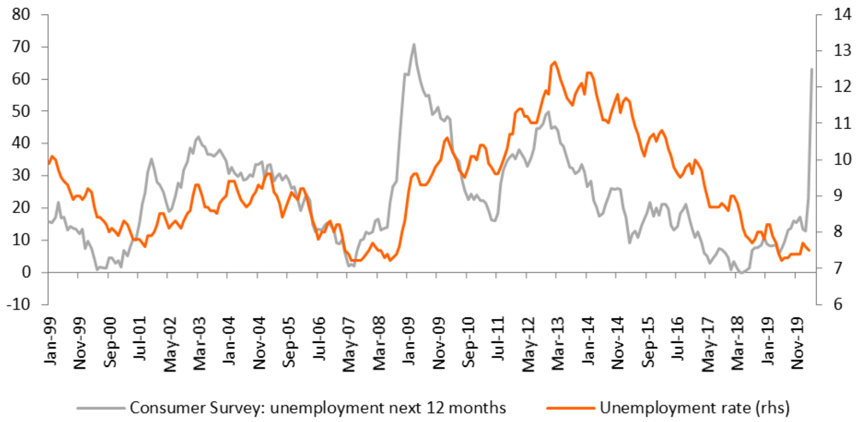
With the lockdown measures lengthened and only phased out very gradually, the eurozone economy is likely to shrink by around 8% this year. The European central bank will continue to do the heavy lifting in terms of measures to soften the blow, though the verdict of the German Constitutional Court, questioning the legality of QE, certainly doesn't help

Source: Shutterstock

The big one

It is now very clear that the economic shock caused by Covid-19 is big. Very big. In the first quarter, eurozone GDP shrank by a non-annualised 3.8% on the back of a two week lockdown in most member states. Given the fact that the confinement lasted, on average, more than a month in the second quarter and that the relaxation of the lockdown measures will only be very gradual, the contraction in the second quarter is likely to be between 10 and 15% quarter-on-quarter non-annualised. The good news is that the number of new infections is now clearly on a downward path, meaning that the epidemic is under control. However, as long as an effective cure and vaccine remain unavailable, economic and social life will not return to normal, and the need for social distancing will continue. This means that even after the most severe lockdown measures have ended, production is still going to remain below capacity for quite some time.

Unemployment likely to rise significantly



Source: Refinitiv Datastream

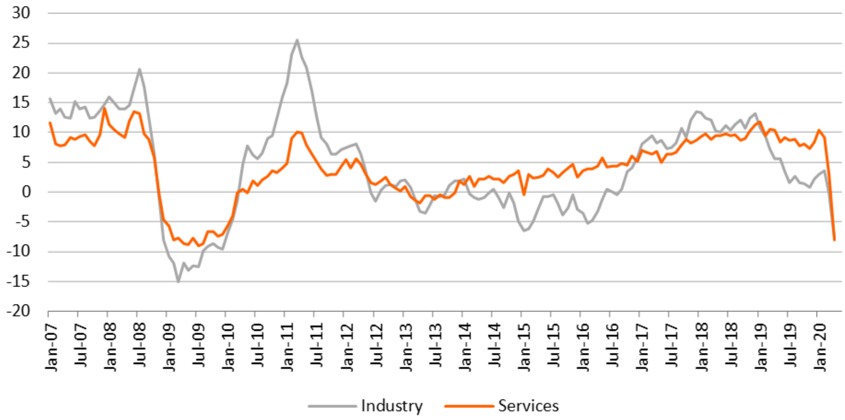
Second round effects

On top of that, we also have to pencil in some negative demand effects. Even with the temporary unemployment schemes, trying to preserve as many jobs as possible, a number of companies are likely to fail or restructure, transforming some of the temporary unemployment into permanent job losses. We also expect business investment to take a hit, as collapsing demand and balance sheet problems will lead to delays or the cancelling of investment plans. Given the longer than expected lockdown, we had to cut our growth forecast in our base case to an 8% fall in GDP this year, which places us near the middle of the possible range of outcomes that the ECB put forward (between 5% and 12% GDP contraction). For next year, we expect a rebound of 4.0%, although for this to happen, we have to assume that we don't see a repeat of the mistakes after the financial crisis and that budgetary policy remains relatively expansionary. However, we remain doubtful that much stimulus will come from a European programme, as the size of the Recovery Fund that the European Commission has been mandated to put in place, will remain limited.

Deflationary forces

With the crash in oil prices, headline inflation is going to be significantly lower this year. April already saw HICP inflation falling to a mere 0.4%. Core inflation declined to 0.9%. With the negative output gap widening rapidly, core inflation will remain under downward pressure. That said, in the course of 2021 a slightly higher core inflation rate might be observed, though more a kind of normalisation than a trend. Oil prices are expected to regain some lost ground, but even then we see headline inflation at only 0.5% this year and 1.4% next year.

Expected selling prices survey



Source: Refinitiv Datastream

The ECB versus the German Constitutional Court

The ECB keeps adding to its pandemic fighting measures, with a further easing of collateral rules (now also including 'fallen angels' corporate bonds), new liquidity lines and an even more generous pricing of the Targeted Longer-Term Refinancing Operations (TLTRO III). During the press conference after the meeting of the Governing Council, ECB President Christine Lagarde repeated several times that the ECB stands ready to use all available tools and deploy full flexibility in fighting the crisis. In a blog post, ECB Chief Economist Philip Lane added that non-fundamental volatility in spreads in government bond markets impairs the smooth transmission of monetary policy across countries and that the central bank should counter this. In that regard, we deem it likely that in the course of this year, the size of the Pandemic Emergency Purchase Programme will be substantially increased to further support the bond markets of the weaker countries. However, the verdict of the German Constitutional Court, questioning the legality of the Public Sector Purchase Programme, will force the ECB to tread carefully in this regard

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