Eurozone Quarterly: The gradual, but not great, re-opening

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Eurozone Quarterly: The gradual, but not great, re-opening

As ever, the EU is muddling through. The post-pandemic recovery response has been robust, but we think there will be more. The gradual re-opening of the economy provides hope, but with social distancing norms here to stay and inflation still not going anywhere, a subdued recovery is all we expect. And we seem to be inching closer to the common bond dream too

Source: Shutterstock

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Eurozone: Bottoming out

With the easing of the lockdown measures, growth is picking up in the eurozone albeit very gradually. Additional fiscal stimulus is being put in place but inflation is still going nowhere. The ECB has increased the size of its bond-buying programme, but we think it'll still be insufficient and a further increase in the second half of this year looks likely

Source: Shutterstock

Subdued recovery

The good news is that most recent data now indicates that the eurozone recession probably troughed in April.

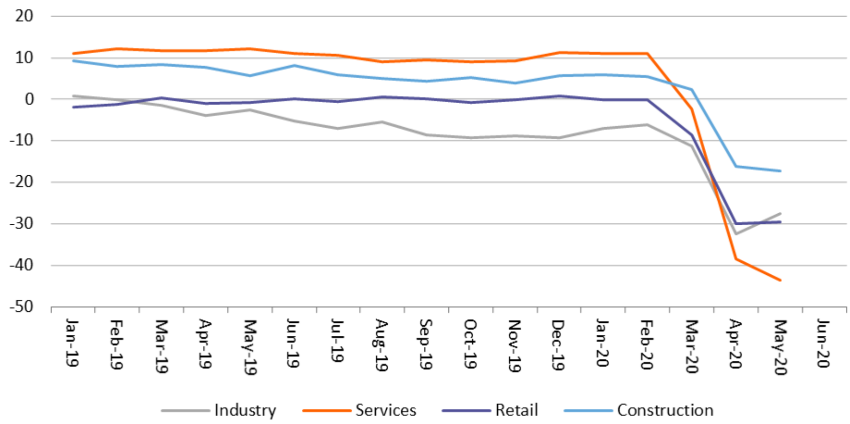
The gradual opening of shops and factories pushed sentiment indicators slightly higher in May. That said, the upturn remains very cautious, which is not really a mystery in an economy where social distancing remains the norm. The latter also explains why services, where human interaction is key, has hardly seen any improvement; they'd already taken a big hit in the first quarter, falling 6.8%, while GDP shrank 3.6%.

Our GDP growth forecast remains at -8.0% for this year and +4.5% for next year

These are labour-intensive sectors of the economy, with often low paid workers with a high propensity to consume. On top of that, the Covid-19 crisis has accelerated some structural trends, necessitating some painful short-term adjustments. As an example, the boost e-commerce received from the lockdown is likely to accelerate the loss of employment in high street shops. Such trends could weigh on the strength of the recovery. We have slightly downgraded our second-quarter GDP, now expecting a contraction of close to 13%.

Our GDP growth forecast remains at -8.0% for this year and +4.5% for next year. As a reference, in its base case, the ECB is looking at an 8.7% GDP contraction this year, followed by a 5.2% expansion in 2021.

Improvement in manufacturing economic sentiment; services lagging



Source: Refinitiv Datastream

Fiscal boost continues to increase

France recently announced a 'cash for clunkers' scheme and a lengthening of temporary unemployment measures. There was also an increased subsidy to buy electric cars in Germany, as part of a bigger stimulus plan worth almost 4% of GDP.

> *The flipside of the strong fiscal stimulus is that budget deficits in most eurozone countries are expected to hit close to 10% of GDP this year and are not going to decline very rapidly*

According to the Bundesbank, this package should add one percentage point to German GDP this year and 0.5% in 2021. The flipside of the strong fiscal stimulus is that budget deficits in most eurozone countries are expected to hit close to 10% of GDP this year and are not going to decline very rapidly. That would again bring a very delicate exercise that turned awry after the financial crisis: how to get budget deficits down without killing the recovery?

The common bond dream

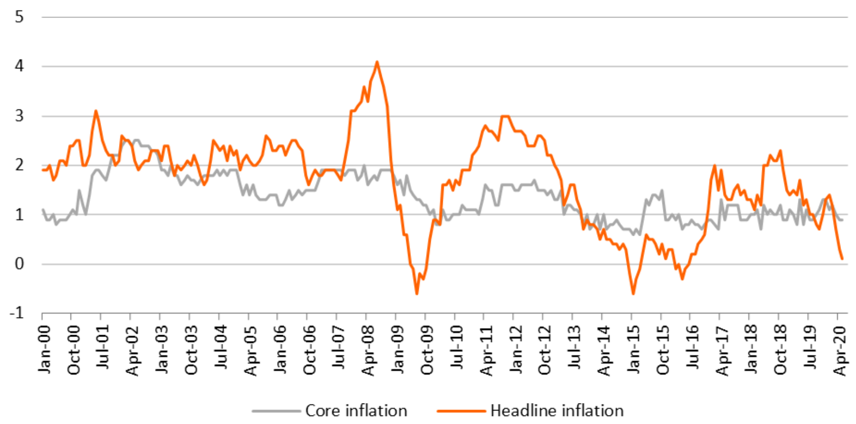
The proposal from the European Commission to put in place a €750 billion recovery fund to help the countries that are most negatively impacted by the Covid-19 crisis is an interesting development, should it be approved by the European Council although we think it will be watered down.

The fact that the EU will actually issue bonds to finance the programme comes pretty close to issuing a common bond

While it might not be a game-changer in terms of a short-term stimulus (the grants in the programme would be worth about 0.7% of GDP per year for the coming four years), it would clearly be an important symbolic step towards more integration.

The fact that the European Union will actually issue bonds to finance the programme and request additional sources of income to service the debt, comes pretty close to the issuance of common bond.

Inflation still going nowhere



Source: Refinitiv Datastream

More QE in second-half of 2020?

A temporary VAT cut in Germany will probably push eurozone inflation into negative territory in the second half of the year. The ECB itself has more or less given up hope that it will reach its objective in the medium-term because the staff forecast for 2022 is now only 1.3% for headline inflation. That explains why the ECB felt comfortable in further increasing its Pandemic Emergency Purchase Programme (PEPP) by €600 bn with an extension of purchases until at least June 2021.

We think that this will probably still be insufficient and a further increase in the second half of this year looks likely. The only potential party pooper is the German constitutional court. While its verdict didn't concern the PEPP, the Bundesbank's position in the other bond-buying programmes could be compromised.

Even though ECB President Christine Lagarde stated that the ECB is confident that a good solution will be found, the matter could create some uncertainty in the short run.

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Germany: Austerity champion turns into a big spender

Thanks to the government's U-turn on fiscal policy, Germany should be one of the first and strongest countries to emerge from the crisis

Source: Shutterstock
German Chancellor Angela Merkel takes part in virtual EU Summit, Berlin, Germany

Available hard data for the second quarter was dreadful. After declines in March, industrial production and exports continued to drop like a stone in April.

Without any changes in May and June, the economy would contract by up to 30% quarter-on-quarter. However, more experimental and real-time data suggests that the economy has experienced a sharp rebound since the lifting of the lockdown measures. Remember that Germany, together with Austria, was the first eurozone country to start easing the lockdown measures at the end of April.

Google mobility data and the German truck toll mileage index, social-economic activity had returned to some 90% of its pre-crisis level by early June. While the month of April was the worst month ever in terms of economic data, the month of May could become one of the best.

First a 'v' but then what?

Looking beyond the expected imminent rebound, the prospects for the two former growth engines of the economy do not look too promising.

Industrial production and exports - which had already been suffering from structural disruptions, the trade war, Brexit uncertainty and less demand from China - are unlikely to kick-start the recovery. During the financial crisis, Asian countries played an important role in the swift recovery of German industry. Today, there is no saviour in sight to boost external demand.

Therefore, the strength of the rebound will depend strongly on domestic demand.

Labour market under pressure

Up to now, a strong labour market had been the main argument in favour of continued strong domestic demand.

However, the tentative increase in unemployment and the sharp surge in short-term work schemes have weakened private consumption. In the current crisis, employees subject to these short-term work schemes will receive up to 85% of their last salary for up to 12 months. At the peak of the financial crisis, some 1.5 million employees were on such schemes. However back then, it was largely the manufacturing sector which was hurting the most, with some 80% of all employees in this sector working on short-term schemes. In contrast, the current crisis has hit the economy almost indiscriminately, with between 25% and 31% of all employees in the manufacturing sector, trade and services, working on these schemes. The construction sector is one of the few positive exceptions, which has been barely hit by the crisis so far.

We expect German unemployment to increase by another million in the coming 12 months

The 2008/9 crisis briefly interrupted the structural improvement in the German labour market, which had been driven by structural changes in the mid-2000s and long-lasting economic recovery. But there is a strong possibility that the Covid-19 crisis could enhance structural changes. The labour market had already started to bottom out and to show some surreptitious signs of worsening prior to the pandemic. The longer the crisis lasts, the higher the chance the German labour market could re-live memories of a long-forgotten past: hysteresis.

It is currently hard to tell how strong this effect will be, but we expect German unemployment to increase by another million in the coming 12 months.

The remarkable fiscal u-turn

With the serious risk that external demand will not kick-start a sustainable recovery and the fact that Covid-19 has not altered the structural weakness of the German economy, the need for fiscal stimulus has been high. After years of international criticism over the perceived inactivity of the government in relation to investment and its adherence to fiscal surpluses, Covid-19 has led to a full u-turn.

Since the start of the crisis, the German government has been transformed, from austerity champion to big spender. In the first phase of the crisis, the government made more than 30% of

GDP available to cushion the economic fallout of the lockdown measures. These measures mainly included guarantees and loans for companies but also compensation of income losses for small enterprises and freelancers, as well as short-term work schemes.

This change of heart on fiscal policy isn't just good news for the entire eurozone but also good news for the domestic economy

These measures were augmented by a so-called stability fund, which were mainly aimed at supporting bigger companies by eventually taking stakes. The third and final step of the fiscal response was a stimulus package, including a temporary VAT-reduction as well as income subsidies, incentives to buy electric vehicles and a large portion for investment in innovation, R&D and renewable energies. In total, the government has agreed to close to 10% GDP of cash-out fiscal stimulus and some 30% of guarantees and loans. The latest fiscal package ticks many boxes of a perfect stimulus package as it combines short-term support for the economy with investments and incentives to steer structural changes.

This change of heart on fiscal policy is remarkable. It is good news for the entire eurozone as illustrated by Germany's role in the development of a European Recovery Fund. But it's also good news for the domestic economy as it increases the chances that Germany will not only be in pole position at the start of the race but will remain a leader of the pack in what probably will be a long test of endurance.

The German economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	0.6	-5.3	4.9	1.2
Private consumption	1.5	-5.9	7.4	0.5
Investment	2.7	-4.2	4.5	3.1
Government consumption	2.1	4.6	4.8	2.6
Net trade contribution	-0.4	-2.5	0.3	0.0
Headline CPI	1.4	0.1	1.7	1.8
Unemployment rate (%)	3.2	3.8	3.8	3.6
Budget balance as % of GDP	1.8	-8.0	-4.0	-2.0
Government debt as % of GDP	58.0	75.0	74.0	70.0

Source: Thomson Reuters, all forecasts ING estimates

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The Netherlands: Cherishing the restrained shock

We think the Dutch economy will shrink by -6% to -8% in 2020 despite a sizeable public support package. As lockdowns ease, economic activity is resuming again, but a full recovery might not happen until 2022

Source: Shutterstock

Dutch Prime Minister Mark Rutte (L) visits a barbershop in The Hague, The Netherlands

Why the Netherlands stands out favourably

Dutch GDP fell by -1.7% quarter on quarter in 1Q20.

Although still large in absolute terms, this decline is mild compared to the eurozone average of -3.6%. This is because the lockdown in the Netherlands was milder and the wage subsidy scheme generous. As for almost any economy, figures for 2Q20 will be significantly worse. April figures on industrial production (from -1% MoM to -8%, adjusted for working days and seasons) and retail sales (from -2% MoM to -6%) were much worse than the March figures since the lockdown only started two weeks into March.

The very large drop in employment of 160 thousand people (-1.7% of the labour force) in April illustrates that the corona crisis had an unusually quick and large effect, but compared to peer economies the Netherlands stands out favourably.

Outlook for May better due to gradual lifting of lockdown

Industrial production and retail data of May will most likely look only a bit better than April. Sentiment figures were at similar levels in May as they were in April, but the underlying data shows that especially expectations improved, in line with the gradual reopening.

Since 15 May, contact-intensive occupations such as hairdressers and masseurs, are allowed to do business again. At 1 June, also bar, restaurants, cinemas and theatres were allowed to open again, although with capacity restrictions. School re-opened in the first weeks of June. Major restrictions for tourist from most EU countries were lifted 16 June. Fitness clubs and saunas will open on 1 July. Events with large crowds, including soccer matches and night clubs, will have to wait until at least 1 September.

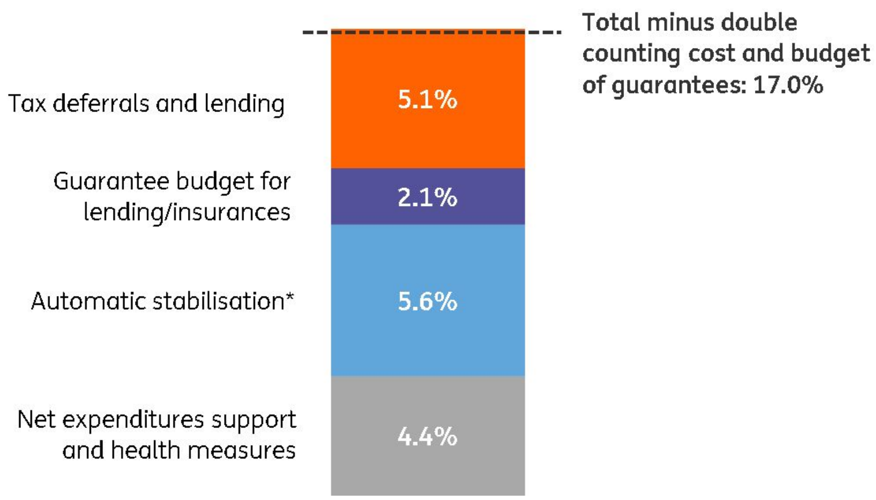
Direct public support large, but tax deferral tops

After the initial support for three months, the Dutch government decided at the end of May to extend the majority of economic support measures by four months until 1 October.

The extension, which initially was intended for three months, was expanded after deliberations with unions and employer associations. The decision meant extension of the main measures such as the wage subsidies, benefits for self-employed and deferral of taxes. Another major intervention, re-insurance of supplier credit, was already valid for the entire year 2020.

Support for 2020 is large in historical perspective, but there are countries which do more, most notably Germany. While the bulk (5.1% of GDP of 2019) of discretionary measures concerns tax deferrals, also the total direct net expenditures are sizeable amounting to about 4.4% GDP in 2020.

Largest discretionary public support in tax deferrals and lending



Source: Government estimates, calculations ING, *Lower tax revenues and higher regular social security expenditures due to lower economic activity

Some tweaks to earlier package

Some of the conditions for support have changed.

For example, firms using the wage subsidy - the main instruments of the support package shielding almost a quarter of workers - will temporarily (in 2020) be forbidden to pay out any dividends or executive bonuses or execute share buy-backs. Some new instruments were added, such as compensation for firms for fixed cost and support for public transportation.

Corona policy measures by the Dutch government substantial in size

Amount per COVID-19 measure in billion € in 2020

	Direct net expenditure	Guarantee budget	Loan /deferral	Total***
Temporary arrangement for compensation of labour costs (NOW)	22.8			
Benefit assistance scheme for the self-employed (TOZO)	3.0			
Damage compensation firms in affected sectors (TOGS €4.000)	1.7			
Public transport compensation	1.5			
Fixed cost compensation (TVL)	1.4			
Lowering of imputed wage for entrepreneurs	1.0			
Floriculture and chip potatoes industry support	0.7			
Child day-care compensation	0.3			
Cultural industry support	0.2		0.2	
Temporary income support for low income flexible labour (TOFA)	0.2			
Sport club support	0.1			
Support for continuing construction	0.1			
Expansion labour cost scheme	0.1			
Other projected extra expenditures (mostly health care and education)	1.4			
Re-insurance supplier credit	1.0	12.0		
Guarantee Corporate Finance scheme, budget expansion (GO)	0.1	1.4		
Small credit Corona guarantee scheme (KKC)	0.2	0.7		
Corona bridging loans (COL)	?	0.3		
Expansion SME credit guarantee scheme (BMKB)	0.0	0.2		
Credit guaranteefund travel (SGR)	?	0.1		
Expansion Qredits microcredit scheme	0.0	0.0		
Expansion guarantee scheme SME credit agriculture	0.0	0.0		
Air France-KLM support package	?	2.0	2.0	
Tax deferral	0.2		33.5	
Coronareserve corporate tax	?		3.4	
Capital assistance scheme for the self-employed (TOZO)	?		2.5	
Expansion SEED Capital-lending scheme	?		0.0	
Fiscal facilitation mortgage payment break	?		-0.1	
Total of selected measures	35.7			
Total of selected measures in % GDP*	4.4%			
Automatic stabiliser	45.0			
Automatic stabiliser in % GDP*	5.6%			
Total of selected measures incl. autom. stabi.***	**80.7**	**16.8**	**41.5**	**137.6**
Total of selected measures incl. autom. stabi. in % GDP***	**10.0%**	**2.1%**	**5.1%**	**17.0%**

*Due to uncertainty about gdp-developments gdp of 2019 has been used as denominator
**Total may contain some double counting if new measures limit the use of existing policy
***Total minus direct double counting of guarantee cost and guarantee budget

Source: : Government estimates, calculations ING Research, in case of ranges upperbounds used, 50/50% division in case of missing disaggregated figures and constant amounts assumed in case of extension

Better set up for recovery, but it may still take a while

The packages of interventions help maintaining employment and income and keep firms afloat. Nevertheless, a substantial fall in consumption and investment will not be avoided for 2020. The Dutch economy is forecast to shrink by -6% to -8% in 2020 in our base case scenario, keeping the Dutch on the favourable side of the eurozone average. Based on an index measuring vulnerability to a prolonged corona slump, the Dutch economy also seems better set up for a recovery than peripherical eurozone countries.

Nevertheless recovery to the pre-corona level of GDP may not be complete by the end of 2022.

The Dutch economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	1.8	-6.8	4.1	2.0
Private consumption	1.4	-5.8	4.4	1.9
Investment	5.3	-13.0	9.2	4.9
Government consumption	1.6	-2.1	0.6	1.3
Net trade contribution (%-point)	-0.3	-0.9	0.2	0.0
Headline CPI	2.6	1.2	1.4	1.5
Unemployment rate (%)	3.4	5.1	6.9	5.6
Budget balance (% of GDP)*	1.7	-9.2	-1.9	-1.7
Government debt (% of GDP)	48.6	65.4	58.2	57.6

Source: Macrobond, all forecasts ING estimates. *Budget balance projection deviate from official forecasts by the Netherlands Bureau of Economic Policy Analysis (CPB) i.a. due to differing views on the output gap.

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Spain: A terrible shock and a weak recovery

Spain has been one of the worst-hit countries by Covid-19, both in terms of health and the economic perspective. The severe lockdown measures have had a large effect on activity in the first half of the year, so the likelihood of a quick recovery is minimal compared to other eurozone countries. For now, we think GDP will contract by 11% in 2020

Source: Shutterstock

Spanish Prime Minister Pedro Sanchez

The pandemic and lockdown measures

In Spain, the first Covid-19 infection was identified on 31 January and by 13 March the virus had spread to all 50 regions.

The Spanish government declared a state of emergency and placed the country in lockdown on the weekend of 14 March. People were ordered to stay at home unless they had to buy food or medicine or go to work or hospital. All non-essential shops closed, together with restaurants and bars. As the health crisis aggravated, the lockdown measures intensified even further.

On 28 March all non-essential activity was banned and so non-essential workers had to stay home.

Government action to combat the economic fallout

The economic impact caused by the lockdowns was going to be large and that was obvious from the start.

On 17 March, the government announced a package of measures worth €200bn which is 20% of GDP. €117bn would be mobilised by the government - €100bn in guarantees and €17bn in direct stimulus - and the rest would come from private companies. The plan also allowed some mortgage and utility payments to be delayed, and some social security contributions to be suspended. The measures also made it easier to temporarily suspend employment, rather than make employees redundant and retain some benefits.

Given the severity of the crisis, the overall fiscal stimulus wasn't that large. And we think concerns regarding debt sustainability were at play.

> *Immediate fiscal stimulus in Spain now accounts for 2.3% of GDP, deferrals for 0.9% and other liquidity or guarantee schemes for 9.2%.*

For example, the minister of economy Nadia Calviño, said they need to conserve fiscal firepower in case the epidemic lasted longer than anticipated. Government officials were afraid of a change of position by the European Commission about budget rules, and bond investors punishing Spain with higher borrowing costs.

Over the course of the crisis, some emergency measures were added. According to Bruegel, a think tank, immediate fiscal stimulus now accounts for 2.3% of GDP, deferrals for 0.9% and other liquidity or guarantee schemes for 9.2%.

The government is currently discussing a recovery plan and more details are expected in the next few weeks. Given the fiscal position of Spain, with a debt to GDP ratio of above 100% in 2019, we don't expect the government to put a lot more money on the table. However, the funding could come from Europe.

The recent proposal by the European Commission, dubbed 'Next-generation EU', has an important mechanism of solidarity built-in and would provide some extra funds. Even though the plan is not yet agreed, it is expected that Spain, as one of the worst-hit countries, will get a larger share of the pie.

The immediate economic impact was severe

Given that the lockdown in Spain was quite severe in comparison to other eurozone countries, the impact on the 1Q GDP growth figures was large too.

GDP contracted by 5.2% quarter-on-quarter - one of the worst within the Eurozone. Given the fact that the lockdown measures only impacted 1Q during the two final weeks, this doesn't bode well for 2Q.

And indeed, the figures for April and May were abysmal. For example, PMIs for the service industry in April dropped to 7.1, from the record low of 23 in March. Admittedly, the figures improved somewhat in May, as the lockdown measures gradually eased, but remained terrible. The PMI for the service industry, for example, recovered to 28 in May, but this is still the third-worst reading ever recorded.

Gradually lifting lockdown measures

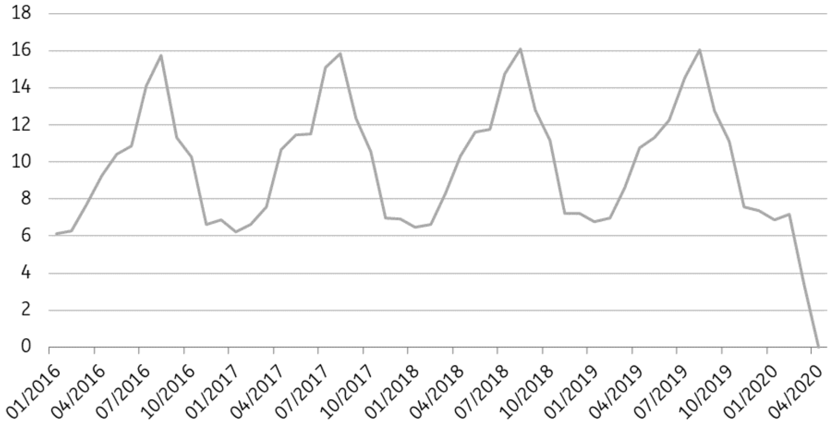
Since mid-April, some non-essential sectors, such as construction have re-opened.

The rest began to open up from the beginning of May onwards on the basis of a four-phased plan. Currently, most of the country is in the final phase, which is the least restrictive. Importantly, Spain opened its borders for European tourists on 21 June.

As the lockdown measures ease, activity should also recover. Unfortunately, the Spanish economy will probably recover slower than other eurozone countries.

We recently investigated which eurozone countries are the most vulnerable for a slow recovery. We took a number of indicators into account, such as sectoral composition and percentage of employment in small businesses, and Spain ranked as one of the countries that were most vulnerable to a slow recovery.

Zero international tourist in April (in millions)



Conclusion

Given that the lockdown was stricter in Spain and the fact that a fast recovery is less likely, we forecast a sharper downturn in 2020 and a weaker recovery compared to the eurozone average.

For now, we think GDP will contract by 11% in 2020. In 2021 and 2022 we see the economy growth by 4% and 1.8%, respectively.

The Spanish economy in a nutshell

	2019	2020F	2021F	2022F
GDP (%)	2.0	-11.0	4.0	1.8
Private consumption (%)	1.1	-12	5	2
Investment (%)	2.0	-19	4	1
Government consumption (%)	2.3	3	1	1
Net trade contribution	0.5	-0.1	-0.1	0
Headline CPI (%)	0.8	0	0.8	1.3
Unemployment rate (%)	13.7	19	17	16
Budget balance as a % of GDP	-2.8	-7.9	-3.8	-2.7
Government debt as a % of GDP	95.5	115.2	114.1	113.6

Source: Refinitiv Datastream, ING forecasts

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Article | 22 June 2020 **France**

France: Looking for a breath of fresh air

Now that French economic restrictions are easing, President Macron is looking for a second wind to take him to the next Presidential elections which are due in 2022. At first glance, the recovery announcements made up to now won't get him there

Source: Shutterstock
French President Emmanuel Macron

The French economy is currently paying the price of one of the harshest lockdowns in the Eurozone.

After a record -21.4% quarter on quarter annualised contraction of GDP in the first quarter, we expect the contraction to reach 65% in 2Q20. Indeed, activity surveys have shown that the French economy was running at only 65% and 75% of capacity in April and May, while the Google mobility data for June shows, there is plenty of catching up to do.

On average, 2Q20 GDP is likely to be 20% lower than what we saw in 4Q19, which explains why the current growth forecast for France in 2020 is one of the worst among Eurozone economies (-9.5%).

The French economy is currently paying the price of one of the harshest lockdowns in the Eurozone

If we still believe that the first part of the recovery will be V-shaped, disruptions in supply chains and the labour market should put a brake on growth in 2021. Despite an expected 6.5% rebound next year, the French economy is unlikely to catch-up to its 4Q19 GDP level before the end of 2022.

External trade is likely to weigh on the recovery

On one side, a domestic demand recovery will take place, but at a stunted pace because of widespread corporate caution about future investments and higher unemployment.

On the other side, external trade should also weigh on growth. French exports will take time to recover as we expect weak growth in the Eurozone, the potential threat of a no-deal Brexit on New Year's eve, more trade war pressures and a subdued Asian recovery, while imports will be fueled by the recovery of domestic demand.

Domestic demand will see two brakes

More than half of private-sector employees - 25 million in 4Q19 - are on the French temporary unemployment scheme, which, in terms of direct public spending, is by far the main measure taken so far to safeguard the French economy.

Despite this, the number of unemployed (on top of those nearly 13 million workers) has jumped from 3.2 to 4.3 million between February and April 2020 as interim and short-term contract workers lost their jobs.

We expect that in 4Q20, the unemployed population will have increased by more than half a million people on the year, taking the unemployment rate towards 10.5% (compared to 7.9% in 4Q19). As the weakest workers with the highest propensity to consume will be disproportionately hit (as they are overrepresented in the worst-hit sectors like tourism), we believe it will weigh on the private consumption recovery throughout 2021.

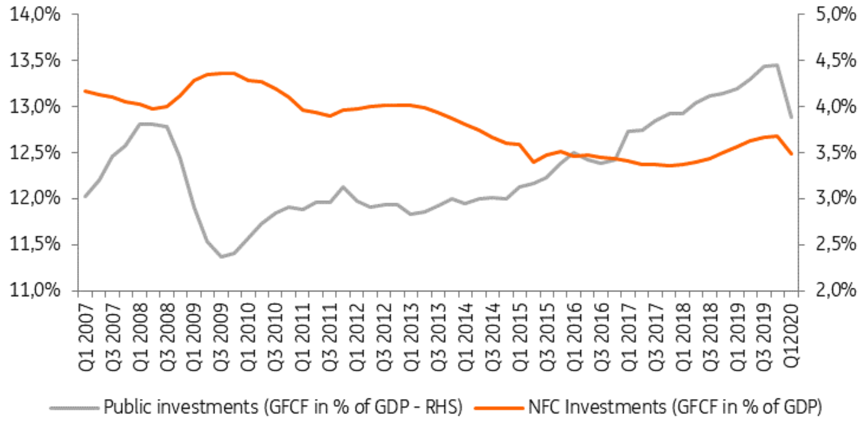
Public v Corporate investments

As far as investments are concerned, public investments will probably substitute corporate investment for a few quarters.

The figure below shows that corporate investments grew faster than GDP in the post-financial crisis recovery, thanks to a mix of supply-side policies. At the same time, public investments remained subdued until 2017. Calls for ambitious public investment plans for 2021 and beyond still have to be designed.

The EU Commission proposal for a Recovery and Resilience facility of EUR 560 bn could bring a framework to these investments together with an incentive to act. If the proposition is approved, each country would have to build an investment plan for the coming years that could potentially go well beyond EU funding intentions.

Can public investments catch-up in coming years?

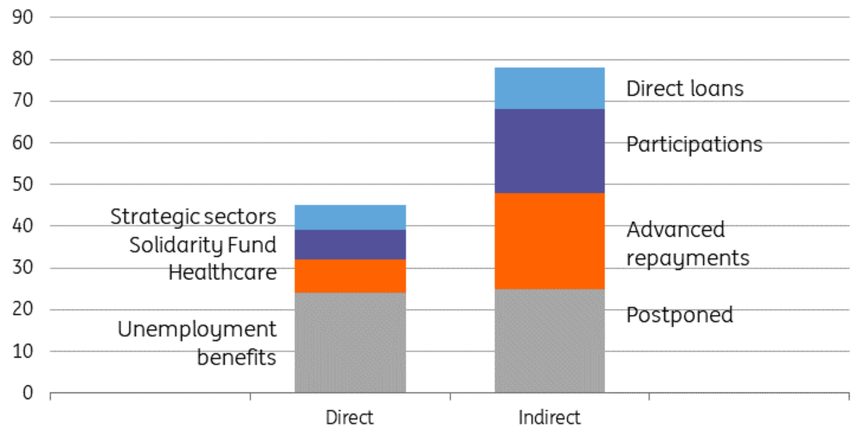


Source: INSEE, ING

Pre-announced economic safeguarding measures are now in place

It is not as if nothing has been done though. The French government has already come up with some recovery plans for three strategic sectors: aeronautics, automobile and tourism industries.

But only part of the measures contained in these plans are actually new: they rely heavily on the instruments put in place earlier in the Covid-19 crisis.
1) Direct spending (at least 2% of GDP) which include an extra healthcare budget (8 €Bn), a solidarity fund for SMEs (7 €Bn) and various adjustments (3 €Bn). The main direct spending is the temporary unemployment scheme which has a direct cost estimated at 24 €Bn in the adjusted 2020 budget. But since this estimate, the number of potential beneficiaries has increased by 50% and the program has been lengthened so that the costs could be 15 €Bn more elevated. On top of these, we estimate that around 6 €Bn will be spent directly in strategic sectors (see below).
2) Tax measures and participations (70 €Bn or 3.1% of GDP): the Treasury has advanced due payments (23 €Bn) and postponed taxes it should have received (25 €Bn). It is likely that part of this amount will end up in the direct spending category, but it is too soon to say in which proportion. The French State will also take participations in "strategic" industries, for an amount that is currently 20 €Bn. "Strategic loans" are also scheduled for 3 specific sectors (see below), so far for around 10 Bn€.
3) Guarantees (315 €Bn or 13.9% of GDP) for various corporate loans issued through the banking sector.



Source: ING

But the last plans for strategic sectors do not go much further

On top of these, specific plans have been decided for three strategic sectors, which largely (for around 90%) rely on the above mentioned measures.

1) Tourism (18 €Bn): tax rebates (for 2 €Bn, part of the 25 €Bn mentioned above that could ultimately end up in direct spending) and higher limits for meal cheques (given by employers as part of a salary package). The headline figure (18 €Bn) is actually relying much on the above mentioned instruments: tourism will specifically use 6.2 €Bn of guarantees for SMEs, 3 €Bn of temporary unemployment benefits, a share of the Solidarity fund and of the participation plan (1.3 €Bn for an investment fund that is supposed to drive a total of 5.4 €Bn investments from the private sector on top of the 1.3 €Bn capital).

2) Aeronautics (15 €Bn): the national airline AirFrance will benefit from a 7 €Bn plan (4€ Bn of credit guarantees and 3 €Bn of direct loans). These are part of previously announced instruments. Apart from military orders for the aeronautic industry (which should reach 0.6 €Bn) and direct R&D investments (1.7 €Bn), the rest of the plan is made of temporary unemployment benefits and guarantees for corporate credits.

3) Car industry (8 Bn€): around 1 €Bn for cleaner car purchases by the general public (up to 200k units) and 0.75 €Bn of investments in the sector together with Renault and PSA (which will add 100 € million each). The rest of the plan (around 6 €Bn) is essentially made of credit guarantees and temporary unemployment benefits.

The lack of fiscal room for maneuver will shadow the two last years of Macron's presidency

The impact on public finances will be sizeable as the deficit is likely to reach 12% of GDP this year (with a hypothesis of 65 €Bn of direct spending, which is 20 €Bn more - than in the April budget estimate).

Public debt should therefore temporarily reach 118% of GDP before coming down to 115% in 2021. This is likely to weigh on President Macron's ability to deliver in the last two years of his mandate which therefore will have to focus on structural reforms, in particular ending the pre-Covid debates on pension reforms. He may need a second breath to achieve this, which is why a government reshuffling is not unlikely this summer.

However, despite the current rumours, we still find it hard to see a replacement for Mr Philippe as the prime minister at the current juncture.

The French economy in a nutshell

	2019	2020F	2021F	2022F
GDP (%YoY)	1.3	-9.5	6.5	2.4
Headline CPI (%)	1.1	0.4	1.3	1.7
Unemployment rate (eop, %)	7.9	10.5	9.2	8.5
Budget balance as % of GDP	-3.0	-12.0	-4.0	-2.0
Government debt as % of GDP	98.1	118	115	111

Source: ING forecasts

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Italy: Still in emergency mode

Unfavourable lockdown accounting has been calling for compensating temporary measures so far. Looming use of EU facilities should help mark a change in shift towards a forward-looking approach

Source: Shutterstock

Italian Prime Minister Giuseppe Conte

First hit first to lock down

Italy was hit first among European countries by the Covid-19 pandemic. Early local lockdowns turned into a nationwide lockdown on 8 March.

Google Covid-19 local mobility data shows that the Italian implementation of social distancing measures was relatively strict from the very beginning and this was reflected in the 5.3% QoQ (-5.4% YoY) contraction of GDP in 1Q20, unsurprisingly driven by private consumption and investment components.

A trio of fiscal packages

The strict social distancing rules imposed mandated closures of many economic activities, called for a set of measures meant to mitigate their social and economic impact.

The Italian government put in place three fiscal packages between 15 March and 20 May, combining direct fiscal impulse with sizeable tax and loan deferrals, liquidity-enhancing measures and loan guarantees.

The May decree, dubbed Relaunch decree, was aimed at refinancing many measures introduced before while widening their scope to businesses formerly left-out and simplifying their rules to let the money reach more eligible parties.

Keeping people on the books

On the household front, a lot of effort was put in to keeping people in jobs by freezing layoffs until the end of August and reinforcing and extending an existing unemployment insurance plan (CIG), now funded until October 2020. Self-employed and autonomous workers and working parents were compensated with monthly monetary bonuses.

Businesses were directly helped through tax payment deferrals and debt moratoria, and indirectly with the possibility to tap state-guaranteed funding from banks and other state-owned vehicles. In the May Relaunch decree, some tax cancellations were introduced along with measures to rescue the battered tourism sector.

EU funding to enter the scene

The three fiscal packages, amounting to a total of €80 bn (excluding guarantees) were apparently compensatory in nature and deliberately aimed at tackling the emergency while lacking any emphasis on the planning of a post-pandemic future.

The forward-looking angle has recently gained centre stage in the political debate after it has become clear that the future availability of the EU recovery funds will be conditional on a sound portfolio of projects. So long as economic and epidemic uncertainties aren't dispelled, medium-term strategic reform plans and short-term emergency measures will have to proceed in tandem.

> *We believe labour protection will remain a priority but whether Italy requests access to the ESM pandemic credit line remains an open question*

We believe that labour protection will remain a priority and that the relevant funding could likely come from the SURE EU vehicle. Whether Italy will also request access to the ESM pandemic credit line remains an open question. The government coalition is still in disagreement: the PD, Italia Viva, and Liberi e Uguali are in favour, and the 5SM is still against. PM Conte, after some ambiguity, is trying to mediate.

Before taking the final decision, the prime minister will likely wait to see what the ongoing discussion on the EU recovery fund will be. If available resources prove smaller than hoped and the economic rebound is weak, he could have a hard time giving up the opportunity to get some €36 bn of non-marketable, long tenor, almost unconditional cheap funding from the ESM.

Beware of the upcoming round of delayed regional elections now expected late in September. They also might impact the timing of the decision on the ESM.

As lockdowns ease, re-opening isn't easy

In the meantime, positive developments on the epidemic front have allowed PM Conte to progressively loosen the strictness of the lockdown, upon respect of precautionary distancing rules.

Manufacturing and construction activities were re-opened on 4 May, retail activities a week later and bars and restaurants on 18 May. Inter-regional personal mobility and inbound flows of EU citizens, key ingredients for tourism activities, were allowed since 2 June. The easing of the lockdown has been timely reflected by Google Covid-19 mobility data: the gap versus pre-Covid times is shrinking, but it is far from filled. This is hardly surprising, as for many firms, particularly the smallest ones, obeying to the new precautionary sanitary rules is proving very difficult.

For many firms operating in the sector of hospitality and restaurants, strict obeyance might prove incompatible with their low margin, high volume business models.

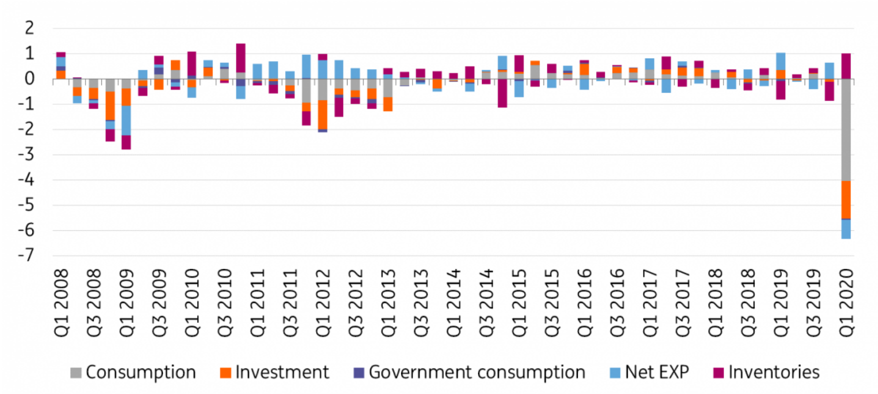
Too early to make any calls on the tourism sector

After just a few days of the re-opening of borders it is too soon to make any calls on how the tourism season will unfold.

Given that international tourist flows will hardly compare with the past, domestic business operators are overtly inviting Italian tourists to remain within the national borders. Given the dominance of domestic over international spending in the tourism and travel sector, this might prove a reasonable defensive strategy.

Proximity might be the keyword this Summer.

Similar pattern, bigger scale for 2Q20 GDP QoQ contraction



Source: Refinitiv Datastream, ING

Expect an even steeper GDP contraction in 2Q20

Based on lockdown-time accounting, it seems inevitable that in 2Q20, Italian growth will post a steeper QoQ decline than the -5.3% recorded in 1Q20.

PMI data has signaled a turnaround in May, clearly more marked in manufacturing than in services, but the order component confirmed disappointingly soft. A gradual recovery in May and June would hardly be enough to compensate for the April full-month lockdown.

While anticipating a decent rebound over 3Q20, for the time being we stick to our call for a 9.8% average GDP contraction in 2020.

The Italian economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	0.3	-9.8	3.5	1.5
Private consumption	0.4	-10.5	4.4	1.3
Investment	1.4	-15.6	4.1	3.6
Government consumption	-0.4	-0.3	0.9	1.0
Net trade contribution	0.5	-0.9	0.2	0.1
Headline CPI	0.6	-0.1	0.8	1.1
Unemployment rate (%)	9.5	8.7	10.5	10.4
Budget balance as a % of GDP	-1.7	-10.7	-6.4	-3.1
Government debt as a % of GDP	134.8	159.5	159	158.1

Source: Refinitiv Datastream, all forecasts ING estimates

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Article | 22 June 2020 Greece

Greece: Tourism is the major casualty

A mildly negative 1Q20 reflects smaller contagion but 2Q20 will look much worse and the strength of the 3Q rebound will crucially hinge on international tourists coming back to Greece

Source: Shutterstock

Greek Prime Minister Mitsotakis visits a hospital in Athens, Greece

Quick preventive reaction...

Despite fewer Covid-19 cases in comparison to its neighbours, the Greek government reacted quickly by implementing strict containment measures, including a nationwide lockdown, school closures, local mobility restrictions and selective travel bans on international travellers.

...and standard mix of “keep afloat” fiscal measures

According to the IMF, a series of fiscal measures were introduced by Greece amounting to a cumulative €24 bn which include a mix of direct expenditures, moratoria and state guarantees aimed at mitigating the social impact of forced suspension of economic activities.

On the business front, compensating measures have been ranging from the allowance of refundable advance payments to a moratorium of tax and social security obligations and cash provisions, the latter being accorded to those who will keep workers in employment through contract suspension. Among the last measures introduced was a temporary reduction of VAT rates for the June-October period on transport services, coffee and non-alcoholic beverages, and on other selected goods.

As far as households are concerned, the measures introduced were clearly aimed at keeping people in employment and at compensating both employees and freelancers for missed revenues through temporary handouts.

Obvious focus on tourism

Unsurprisingly, over the last few weeks, the government's initiatives have increasingly focused on the tourism sector, by nature more vulnerable than others to the mobility and distancing consequences of the pandemic and dimensionally critical for the Greek economy (according to WTTC, in 2019 the enlarged travel and tourism sector contributed 20.8% of total GDP).

The latest easing decisions have been mostly devoted to tourism-related activities. Yachting and restaurants has re-opened and recently holiday and seasonal accommodation, museums, historic sites, thermal springs have re-opened too.

The reopening schedule will be completed on 1 July, when fairs, concerts and artistic events will also be allowed. Only large scale public events have been reportedly left out, for the time being. According to the Greek government, after 1 July, 97% of the employees and 95% of companies who had been mandatorily suspended will be allowed to re-open.

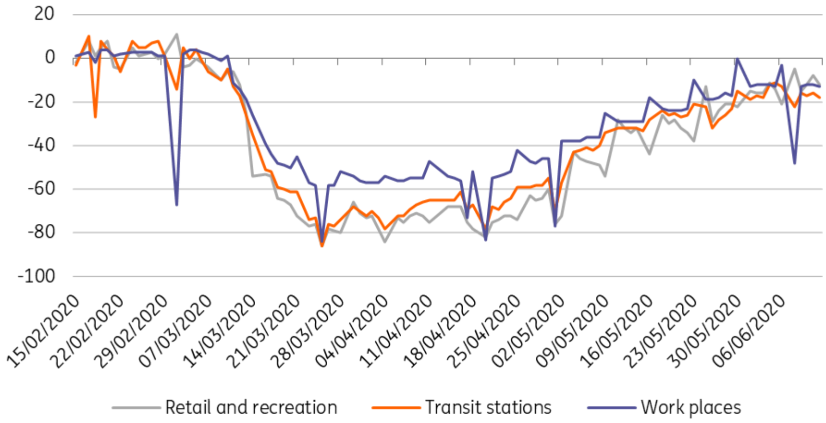
Mild 1Q20 contraction will not be confirmed in 2Q20

The Covid-19 shock caught Greece as it was engaged in a long-awaited recovery, which had for once set the country as a growth overperformer in the eurozone.

To be sure, it was not immune to the deterioration which had set in major eurozone countries over 2H19 but could still take advantage of ongoing improvements in employment which in turn were supporting domestic demand. GDP data for 1Q20 confirmed Greece as a comparatively good performer: the 1.6% QoQ (0.9% YoY) contraction was surprisingly soft and clearly less than what straightforward lockdown arithmetic would have suggested. Business confidence had held up well until March and fell markedly only in May, showing a one-month delay in reaction with respect to other eurozone countries.

We believe that the domestic demand drag will play catch-up over 2Q20 when the full impact of the lockdown is expected to emerge.

The impact of the strict lockdown will show up in 2Q GDP data



Source: Google Covid-19 Mobility Report, ING

ex Sundays

3Q rebound to be likely capped by heavy reliance on tourism

Developments over 3Q will heavily depend on how the tourism season plays out.

The Greek government tried hard to prepare for an orderly opening of the Summer season, leveraging on the low local diffusion of the epidemics and stressing that health related facilities will be in place in tourist sites.

The response of international tourists, whose spending is estimated at two thirds of total tourism and leisure spending in Greece, might not be as prompt as hoped for. The ranking of arrivals by country of origin in 2019 sees the Brits and Italians (both heavily hit by the pandemic) in the second and fourth place, respectively.

For many potential tourists, budget constraints, battered spirits and epidemic concerns might turn out to be powerful reasons to choose to stay at home.

The Greek economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	1.9	-9.5	3.8	2.1
Private consumption	0.7	-5.7	2.1	1.7
Investment	4.5	-24.7	3.7	11.6
Government consumption	2.2	2.6	2.7	1.2
Headline CPI	0.5	-0.5	0.5	1.0

Source: Refinitiv Datastream, all forecasts ING estimates

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Article | 22 June 2020 Portugal

Portugal: Swift response, but a sharp shock anyway

Portugal reacted swiftly after the first Covid-19 infection was detected around mid-March. But the subsequent lockdown has had a huge impact, even if they come soon in a pandemic. Therefore, we expect the economy to contract by 9% in 2020

Source: Shutterstock

Portuguese Prime Minister Antonio Costa

Delayed entry

Covid-19 entered Portugal later than other European countries.

For example, in Spain and Italy, Covid-19 infections were detected towards the end of January, while in Portugal it was in early March. This enabled the Portuguese government to take swift action early, as it announced the state of emergency 16 days after the outbreak began (on 18 March), while in Spain, for example, it took six weeks after the detection of the first infection.

The number of infections and deaths is therefore relatively low in Portugal. The lockdown measures, however, still had a sharp impact on economic activity. Before the official state of emergency, there were already disruption for some activities and a drop of demand for some products, such as accommodation and food service activities.

The state of emergency ended early May and the country continues to gradually reopen. The country lifted the restrictions on a sector-by-sector basis.

Since 3 May small retail shops have reopened and metro systems in Lisbon and Porto resumed at a reduced capacity. During the second phase that started on 18 May, restaurants, larger shops, and schools for some year groups reopened. In the third and final phase that started on 1 June shopping malls and cultural venues reopened, but with capacity restrictions.

Short term economic impact was still severe

GDP contracted by 3.9% in the first quarter of 2020 compared to the previous quarter, which is comparable to the worst quarters during the financial and eurozone crisis.

The growth impact in the first quarter was as severe as for the eurozone as a whole and less severe compared to neighbouring Spain. April was obviously also bad. Retail sales, excluding motor vehicles, for example, dropped by a whopping 24% compared to a year earlier. As the lockdown eased in early May, activity will also gradually resume.

To limit the economic fallout, the government announced a number of measures to combat the negative effect on the economy. According to Bruegel, a European think tank, Portugal decided on an immediate fiscal impulse of 2.5% of GDP, deferrals of about 11% and 5.5% for other liquidity and guarantees.

We expect the economy to contract by 9% in 2020. This is a bit more compared to the eurozone average, mainly due to the high dependence of Portugal on tourism.

However, it is less than the 11% contraction forecasted in Spain. In 2021 and 2022, we expect Portugal to grow by 4.5% and 1.6%, respectively.

The Portuguese economy in a nutshell

	2019	2020F	2021F	2022F
GDP	2.2	-9	4.5	1.6
Private consumption	2.3	-8.2	6.0	1.5
Investment	6.5	-11	8.0	1.5
Government consumption	1.1	2.5	2.0	1.0
Net trade contribution	-0.7	-0.5	0.0	0.2
Headline CPI	0.3	0.1	0.4	0.8
Unemployment rate (%)	6.5	11	8.5	7.5
Budget balance as a % of GDP	0.2	-6.7	-3.5	-2.3
Government debt as a % of GDP	117.7	135.8	133.0	132.2

Source: Refinitv Datastream, ING forecasts

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Belgium: Multiple challenges ahead

Like most economies, Belgium is experiencing an unprecedented health and economic shock. Despite the accurate assessment of the losses incurred during the lockdown period, the recovery trajectory is still very uncertain. Yet it is in this economic context that a new government will have to be found

Source: Shutterstock

Belgian Prime Minister Sophie Wilmes for the reopening of the Atomium touristic attraction in Brussels

The illusion of a recovery

In the first quarter, Belgium's central bank forecasted that the country's GDP contracted by 3.6% compared to the previous quarter.

Given the activity losses during the lockdown, obviously the second quarter of the year will be marked by a much sharper contraction of activity. Moreover, the central bank's weekly surveys show that, despite the widespread easing of lockdowns, activity in the private sector is still more than 20% below normal. As a consequence, we expect a contraction of more than 10% in activity compared to the first quarter. If we consider the level of activity in the last quarter of 2019 at level 100, the second quarter would then be marked by a level of activity of only 83.

At the end of 2020, we think economic activity would still only be *at 96% of what it was at the end of 2019*

Assuming we don't see a second wave of the pandemic, we should see a recovery in the second half of the year, but it is likely to be just as unprecedented like the initial shock.

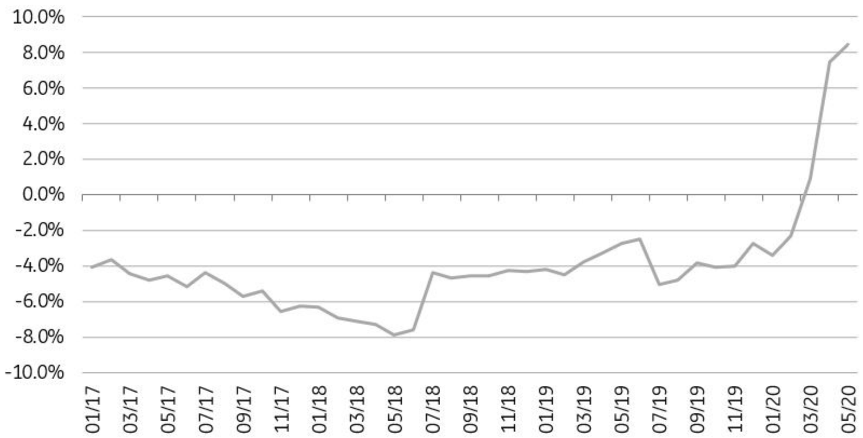
First of all, the drop in activity was very sharp, most of the variables that normally move in parallel with the activity did not have time to adapt. This applies to the number of bankruptcies or the labour market for example. However, the loss of activity will have consequences: while a very short lockdown would have gone unnoticed in most other economic variables, it is highly likely that this prolonged containment will strongly influence them in the coming months. In the labour market, we are already seeing a sharp increase in unemployment (+9% YoY in May), but this is probably the beginning of a long adjustment process. Indeed, we expect nearly 120,000 net job losses this year, which would raise the unemployment rate from 5.4% in 2019 to 7.5%. Belgium will, therefore, is in a paradoxical situation, where activity will increase, but at the same time, other variables will reveal the true face of the economy.

In addition, we shouldn't forget that prolonged lockdown has profoundly modified the behaviour of economic agents. One-third of households have reported a loss of income.

As a consequence, durable goods consumption can, therefore, be expected to be postponed. The same is likely to be true for households that have not suffered any loss of income: fears of a return of the pandemic may change their consumption behaviour. At the corporate level, two-thirds of companies say they have postponed their investment projects, which will also influence activity. Finally, supply constraints due to supply chain disruptions are not going to be quickly resolved.

For all these reasons, we fear that while the recovery will be strong in the second half of the year, it will not allow a return to pre-crisis levels of activity. At the end of 2020, we think economic activity would still only be at 96% of what it was at the end of 2019.

Number of jobseekers is already increasing (year-on-year growth, %)

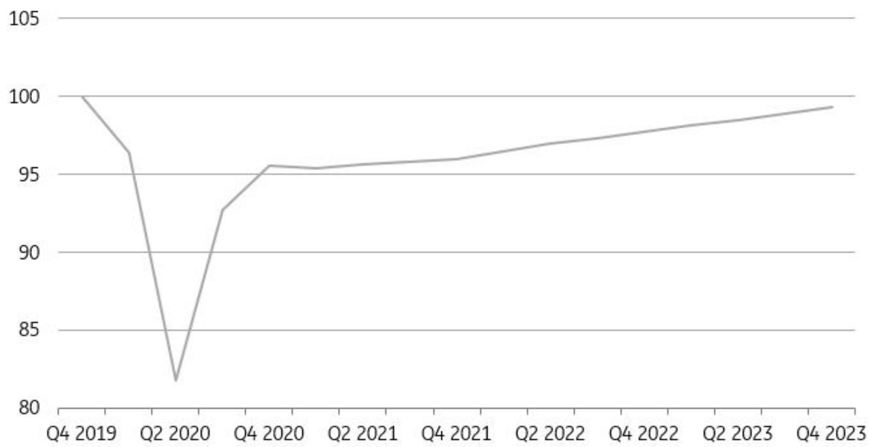


Source: Refinitiv Datastream

Going back to normal takes time

Thereafter (in 2021), the economic recovery will continue, but the process is likely to remain slow. Of course, the recovery plans in Europe and neighbouring countries will help the economy to recover. A possible Belgian recovery plan could also help. This being said, (i) the damage caused by the coronavirus crisis to the economy, (ii) the limited room for maneuver in terms of public finances and (iii) too slow a recovery of international trade in a context of growing protectionism will slow down activity on a lasting basis. The recovery will therefore be fundamentally slow, and it is only in the course of 2023 that the Belgian economy will return to its pre-crisis level of activity.

The shape of the recovery (Real GDP, Q4 2019 = 100)



Source: ING

A challenge for public finances

Of course, this crisis is leaving its mark on public finances, which are suffering a double blow. On the one hand, expenditure is exploding as a result of the management of the crisis and its social consequences. On the other hand, as activity is reduced, tax revenues also fall. In the case of Belgium, this is expected to result in a deficit of more than €42 billion in 2020, or 9.5% of GDP. Next year, this deficit should be reduced thanks to the economic recovery, but we are still expecting a deficit of well over 4% of GDP in 2021. It therefore goes without saying that public finances will be at the heart of the economic and political debate in the coming years. Nevertheless, Belgium's sovereign rating remains strong.

Political crisis ensues

After the fall of the government in December 2018, a caretaker government took over until the elections in May. However, these elections have so far failed to produce a new parliamentary majority and the entire year of 2019 was spent under a caretaker government. This government is composed of only three parties (the French-speaking and Dutch-speaking Liberals and the Dutch-speaking Christian Democrats) which together have only 38 seats in parliament out of 150.

As the caretaker government's powers in terms of taxation and spending are limited, efforts to consolidate public finances were not pursued. This handicapped the budget deficit and debt dynamics, but paradoxically, it also helped to stimulate the economy in 2019.

At the beginning of 2020, given the coronavirus health crisis, Belgian political parties showed pragmatism in the face of this emergency and a large proportion of the political parties agreed to give parliamentary support to the caretaker government and granted special powers to manage the crisis, which will be in place until the end of June and can be extended until September if the situation requires.

That said, it is clear that this situation cannot last. New discussions are currently starting to form a new government with a majority in parliament. If these discussions fail, elections would have to be held, with the likelihood to see extreme right (in Flanders) and extreme left (in Wallonia and Brussels) parties gaining seats, making the formation of a stable majority government even more difficult.

The Belgian economy in a nutshell

	2018	2019	2020F	2021F
GDP	1.5	1.4	-7.8	4.5
Private consumption	1.5	1.1	-9.8	4.3
Investment	4	3.2	-12.5	3.5
Government consumption	0.9	1.6	-1.1	0.8
Net trade contribution	-0.7	-0.1	0.4	0.8
Headline CPI (HICP)	2.1	1.4	0.5	1.6
House prices (%YoY)	3.6	4.4	-2	0
Unemployment rate	6	5.4	7	7.8
Budget balance as % of GDP	-0.8	-1.9	-9.5	-4.5
Government debt as % of GDP	99.8	98.6	115	113.2

Source: Refinitiv Datastream, National Bank of Belgium. All forecasts ING estimates

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Article | 22 June 2020 Ireland

Ireland: Defying gravity?

While GDP increased by 1.2% in the first quarter, it is set to plunge in the second quarter as the Irish domestic economy struggles with Covid-19 like every other eurozone country

Source: Shutterstock

Irish PM Varadkar (L) with Health minister at coronavirus briefing, Dublin, Ireland

Bucking the trend

GDP plunged in pretty much every advanced economy in the first quarter of 2020. Every advanced economy? No, one (relatively) small country has managed to resist the enormous drag of the global lockdown.

The Irish economy grew by 1.2% QoQ in the first quarter of 2020. Growth of 1.2% was dominated by net export growth, also helped by shrinking imports as the domestic economy suffered like everywhere else. Especially pharma and IT kept Irish exports growth positive, which wiped out the large decline of -4.7% in personal consumption. GNP, which excludes multinational profit flows, increased by 0.1% on the quarter, a smaller but still positive growth figure.

The Irish economy grew by 1.2% in the first quarter of 2020, but this doesn't mean Ireland has manged to avoid the crisis altogether

However, this does not mean that Ireland managed to avoid this crisis altogether. The lockdowns have had such a huge impact on the economy that the second quarter will no doubt show a large contraction. To counter this, the Irish government has come up with a sizable emergency support package amounting to about 4% of GDP at the moment, which is among the larger fiscal injections for the eurozone.

An initial 2% of GDP was mainly focused on the labour market, with a short-time work scheme and income support for households that have become unemployed as a result of the crisis. The unemployment rate has so far increased from 4.8% in February to 5.6% in May, but the Statistics Office also tracks an alternative unemployment rate which includes everyone on the pandemic unemployment payment scheme. This rate stood at a massive 26.1% in May but was already down from 28.2% in April. It is hard to say what accurately tracks unemployment at the moment. The CSO considers the official rate to be the lower bound and the alternative measure to be the upper bound.

The other 2% of GDP in terms of fiscal stimulus has been allocated to business support, which includes a 2 billion euro recovery fund for medium-and large enterprises, 2 billion euros worth of guarantees for small-medium-enterprises measures and a 10 thousand euro restart grant for the smallest businesses. This package is more focused on the restart of the economy once lockdown measures have been lifted, which is happening somewhat more slowly in Ireland than in other eurozone economies.

The Irish economy has been relatively slow to restart compared to other countries and has had a relatively strict lockdown with “stay-at-home” order in place, making the second-quarter contraction quite likely to be deep.

The economy started to re-open on 18 May only, when outdoor workers were allowed to get back to work. Retailers were allowed to reopen on 8 June, larger shopping malls on 15 June and hotels, cafes and restaurants on 29 June.

Further easing of measures will take place towards the end of July under the current plan, which has already been faster than initially anticipated as containment of the virus was better than initially expected by PM Varadkar.

The Irish economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP (%)	5.5	-6.2	4	2.3
Private consumption (%)	2.8	-7.3	4.1	2
Investment (%)	94.2	-40	12	3.8
Government consumption (%)	5.1	7.7	-3	1.8
Net trade contribution (%)	-18.2	9	0.4	0.3
Headline CPI (%)	0.9	0.3	1.3	1.5

Source: Macrobond, ING Research

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Article | 22 June 2020 Austria

Austria: Crucial summer for recovery

Even though Austria has managed to come out of the lockdown faster than most other eurozone countries, the upcoming vacation period will be key for the pace of the recovery

Source: Shutterstock
Austrian Chancellor Sebastian Kurz

Austria was among the first European countries hit by Covid-19.

According to some experts, one of the famous ski resorts was considered as a super-spreader event in February. In reaction to the Covid-19 outbreak, the government took strict lockdown measures, not only closing borders but also shutting down economic and social life.

> *The economy contracted by some 2.5% QoQ in the first quarter, we currently expect another contraction by more than 10% QoQ in the second quarter*

While the downturn in the first quarter was still relatively muted, the high dependency on tourism and industrial production should not only lead to a severe economic slump in the second quarter but could also place a cap on the pace of the rebound in the second half of the year. While the economy contracted by some 2.5% quarter on quarter in 1Q20, we currently expect another contraction by more than 10% QoQ in the second quarter. For the entire year, the economy could shrink by more than 8% before rebounding by some 6% in 2021. The fact that Austria was the very first eurozone country lifting the lockdown measures, with shops, restaurants and schools all being open again, should support the rebound.

The unemployment rate has almost tripled from some 4% at the start of the year to currently more than 12%

Despite short-term work schemes, unemployment has surged. Prior to the crisis, Austria had one of the lowest unemployment rates of all eurozone countries but as the crisis hit the service and tourism industry significantly, with a high share of freelancers or small enterprises, the unemployment rate almost tripled from some 4% at the start of the year to currently more than 12%, at least according to national measures. The Eurostat unemployment rate could double in the course of the year.

Initially, fiscal stimulus mainly focused on stabilising the economy, with some 38bn euro (10% of GDP). In mid-June, the government decided on an additional package of around 12bn euro. While the initial package consisted of guarantees, loans, reduced VAT rates for restaurants and hotels as well as short-term work schemes, the new package consists of measures aimed at supporting the recovery. The most significant elements are a one-off top-up payment to unemployment benefits of 450 euros spread over three months, cutting the lowest income tax bracket to 20% from 25%, and a tax break for company investments of up to 14%.

While Austria managed to come out of the lockdown faster than most other eurozone countries, the return to normality will not be without hurdles. The dependency on global supply chains and tourism are clear hurdles to the recovery. Particularly, the upcoming summer vacation period will be key for recovery. Even though borders within the EU are open again, the crucial question is whether social distancing and the risk or fears of a second virus wave play a substantial role in the recovery.

The Austrian economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	1.5	-8.2	5.8	2.8
Private consumption	1.3	-6.5	6.8	2.7
Investment	2.8	-7.2	5.2	3.1
Government consumption	0.7	1.5	1.9	0.7
Net trade contribution	0.1	-2.3	0.8	0.7
Headline CPI	1.5	0.7	1.5	1.7
Unemployment rate (%)	4.4	7.5	6.5	5.8
Budget balance as % of GDP	0.7	-9.5	-4.2	-2.0
Government debt as % of GDP	70.4	84.4	84	81

Source: Thomson Reuters, all forecasts ING estimates

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Finland: Milder than the rest

The Finnish economy shrank by -0.9% in 1Q, but will be harder hit in the second quarter. Still, the impact will likely be smaller than in most of the eurozone

Source: Shutterstock

Finnish Prime Minister Sanna Marin speaks during a press conference on the ongoing COVID-19 pandemic in Helsinki, Finland

The Finnish economy was among the least hit from the Covid-19 pandemic in comparison to other eurozone countries in the first quarter, but among the first to slide into recession.

Given the economy contracted in the fourth quarter of 2019, the drop of -0.9% in 1Q confirmed the recession. The decline for the first quarter was modest and the lockdown had a much milder impact on the economy than in most eurozone economies. Household consumption and investment declined by just -0.6% and -0.5% respectively, while the largest hit actually came from exports. Gross exports dropped by -7.4%, which indicates that the global recession will significantly hurt countries with milder lockdowns.

Our lockdown index based on Google mobility data suggests, the lockdown in Finland has been mild, mainly because the virus didn't spread as rapidly as it did in other countries. The fatality rate in Finland was much lower too than the average in the eurozone and also lower than in Denmark and Sweden. The impact of the lockdown was mild too and has since then been more or less on track with Germany towards normalcy. At the start of June, our index-tracking daily visits to workplaces, retail and grocery stores ranked between 0 and 20%, lower than it was in January and

February.

The Finnish economy was among the least hit in the eurozone in the first quarter, but among the first to slide into recession

To counter the negative impact of the crisis on the economy, the Finnish government has announced a spending and tax package amounting to about 3% of GDP, which is complemented by a tax deferral scheme that is also worth about 2% of GDP. This includes grants to SMEs and self-employed for 650 million euros and expanded parental allowance, social assistance and unemployment insurance for 3 billion euros. The latest announcements for additional spending happened in early June and include 1.2 billion euros in support for households and businesses and 1 billion euro in public spending, clearly focusing on kickstarting the economy in the recovery phase.

The reopening of the economy has been relatively quick as domestic movement restrictions were already lifted on 14 April. The reopening of schools and restaurants has happened now and events with over 500 people will be allowed again at the end of July, which is earlier than most European countries. With that, the overall impact of the lockdown on the Finnish economy in the second quarter is expected to be relatively mild as well.

According to Statistics Finland, the decline in activity in April was 2.1% compared to March, which was, in fact, smaller than the drop in March at 5%. An uptick can be expected for May and June as restrictive measures on the economy gradually get lifted, which would mean that the overall lockdown impact would remain relatively mild. One has to be careful with the extrapolation of the monthly output index on GDP though as the March decline would have caused a much larger 1Q decline than just 0.9%.

Still, compared to many countries with stricter lockdowns, Finland is expected to recover more quickly. In a note comparing vulnerability to a weak recovery from this specific crisis, we find that Finland has a very low chance of recovering poorly compared to the eurozone average. The mild lockdown, strong automatic stabilizers, an economic structure that has smaller sectors that are impacted more and a lower number of employees that work for small businesses and relatively strong support in terms of emergency spending will are just a few factors that position Finland well for a milder contraction and quicker recovery to pre-crisis levels.

While the crisis will definitely be deep, it is likely to be less deep than in most of Europe.

The Finnish economy in a nutshell

	2019	2020F	2021F	2022F
GDP (%)	1	-4.8	4	1.9
Private consumption (%)	1	-5.3	4.8	2.3
Investment (%)	-0.8	-7.6	7.1	2.5
Government consumption (%)	0.9	6	-2.4	1
Net trade contribution (%)	1.9	-0.7	-0.2	0
Headline CPI (%)	1.1	0.4	1.5	1.9

Source: Macrobond, ING Research

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EU Summit: A bit united in still a lot of diversity

No white smoke so far on the EU Recovery Fund, but that was not to be expected today. Some encouraging signs point to the fact that the fund will be going live, even if this still seems to require several weeks of tough negotiations

Source: Shutterstock

Any references to Alexander Hamilton can be stored safely until at least July. And we would even argue that as much as we like the idea of European solidarity to prevent increasing economic divergence, whether the birth of the European Recovery Fund can become a Hamiltonian moment remains questionable. In any case, today's videoconference of European leaders was more of a stock-taking moment than a tipping point in the ongoing discussion around the European Commission proposal for an EU Recovery Fund. German Chancellor Merkel concluded after the meeting that the leaders were now at the point where negotiations can properly start, which means that the coming weeks will bring yet another hot European summer full of debate about a possibly historic fund that will boost growth in the recovery phase.

If indeed an historic agreement can be reached next month remains to be seen. There is still a lot to overcome, with the 'Frugal Four' and Finland still the starkest opponents of the Commission proposal. The list of issues that leaders have not found agreement on is long, think of the size of the recovery fund, the division between grants and loans, what exactly determines the allocation of the fund, conditionality, repayment, but also rebates from the EU budget.

The German government is pushing for a decision in July

Also, while the German government is pushing for a decision already in July, other government leaders sounded less optimistic and also less convinced by the urgency. Even though this list may cause skepticism about the chances of a deal, Commissioner Gentiloni was already happy that no outright rejection of the EC proposal was uttered.

Perhaps most important ahead of a possible agreement is what no longer seem to be controversial issues. The fact that the details of the fund are discussed means that there seems to be general consensus about the fact that the eurozone economy is best served by a Recovery Fund to begin with and that the pan-Eurozone fiscal response needs to be strengthened. Merkel indicated that the legal framework for the Recovery Fund, and maybe even more important the legal feasibility to issue common bonds at least in these crisis circumstances, was not challenged. As the discussion is now about the numbers, this indicates that the pushback on the EU borrowing from the market is mainly focused on the details and less on the fact itself. Remember that a year ago, a very symbolic and very small eurozone budget was highly controversial. Against this background, Europe has made enormous progress towards more integration.

A lot needs to happen in the coming weeks, but chances that the European Recovery Fund will see the light are high. On 1 July, Germany will take over the rotating EU Council presidency. It will probably be Angela Merkel's final stint at the European level. She and her government seem to be determined to push for more integration and solidarity.

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Eurozone: Debt monetisation by stealth

While the ECB is not allowed to monetise debt formally in the wake of the Covid-19 crisis, there seems to be some scope to do so, without fear of galloping inflation. It might even be needed to hit the inflation target

Source: Shutterstock

Monetary financing of government debt

I never thought one day I would actually be discussing something a "serious economist" (an oxymoron?) would turn away from in horror.

Mention Weimar Germany and Zimbabwe in the same sentence and you know what I am talking about: monetary financing of government debt.

For people not familiar with the concept this is when a central bank prints new money and basically hands it over to the government to spend, without the obligation to pay it back one day. Plenty of proposals have been floating around over the past few years and not all of them are actually feasible or permitted by the European Treaties.

Nevertheless, it is still worth looking at some of the alternatives and discussing the pros and cons in the wake of the Covid-19 health crisis that has hit the eurozone. With debt levels already very high in most member states lack the fiscal capacity to tackle this new deflationary shock. So why not create the means through the printing press?

Perpetuating debt holdings

The easiest proposals focus on the part of sovereign bonds currently held by the European Central Bank (for simplicity we will use the terms ECB and Eurosystem as substitutes).

Why not just eliminate this debt by replacing these bonds with a zero-coupon perpetual? This would give member states some breathing space and the capacity to spend more. But not so fast. The central bank is actually owned by the government (though there are a few cases where the ownership is mixed). And within the Monetary Union, governments receive dividends from their national banks, who in turn receive their share of the ECB's profits.

A central bank's profit derives from the difference in interest income on the assets it holds and the interest it pays on its liabilities. Banknotes by nature don't carry an interest rate. The profit the central bank makes on this is called seigniorage. In normal times, a positive interest rate is paid on commercial bank reserves, which are a large part of the central bank's liabilities. But now the ECB actually charges a negative interest rate on a big chunk of bank reserves. Therefore, they also contribute to net interest income. If the ECB exchanges interest-bearing debt on the asset side of its balance sheet with a zero-coupon perpetual, then, of course, bank profits will decline, which will result in lower dividends for the governments in the future. For most central banks in the Eurosystem, the dividends and taxes paid to the state are now around 0.1% to 0.3% of GDP.

> *What most people don't realise is that there is already some mild form of debt monetisation.*

As a matter of fact, in the current public sector purchase programme, bonds on the ECB's balance sheet that come to maturity are replaced with new bonds. As in practice, the ECB will buy the new bonds that the governments are raising to reimburse the central bank, it is pretty much as if the central bank is holding the debt permanently on its balance sheet. What's more, the interest they pay to the central bank is, at the end of the day, partially given back as a dividend. This is, of course, the case as long as the interest paid on central bank liabilities is zero or lower.

So, in a nutshell, as long as the central bank rolls over its stock of sovereign bonds, there is nearly no difference with the situation where it replaces these bonds with a zero-coupon perpetual: this part of the debt is not reimbursed and comes at close to no interest cost.

Admittedly, for the time being, there is no commitment to keep them indefinitely on its balance sheet.

Further expand the balance sheet

Of course, the ECB could continue to expand its balance sheet by further buying sovereign bonds and refinancing these bond holdings forever. Actually, that is pretty much what happened during and after the Second World War. Major central banks substantially increased their balance sheets by purchasing government debt and while the balance sheets were mostly reduced afterwards in terms of GDP, they hardly ever did in nominal terms, as is explained here. In that way, it is believed that the Federal Reserve's printing press financed about 15% of the war expenditures.

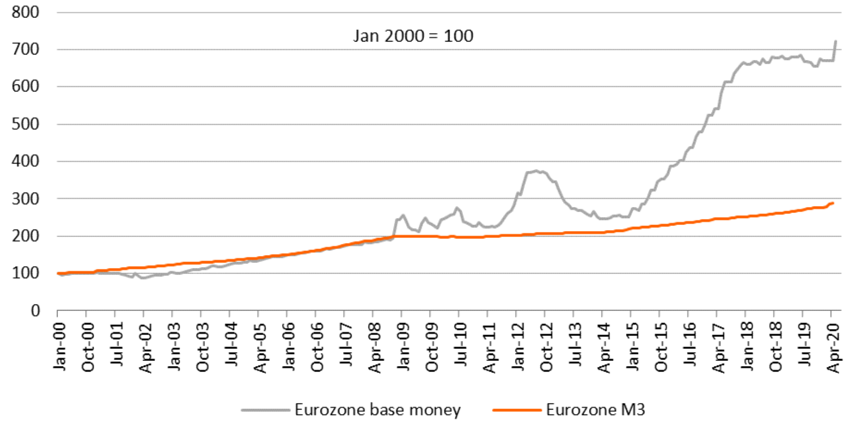
It is important that debt financing by the ECB is believed to be genuine in practice, but non-existent in theory

As the French President Emmanuel Macron compared the current Covid-19 crisis to a war-like situation, a case could be made for a permanent increase in the ECB's balance sheet. The trouble is that monetary financing isn't actually allowed under the EU treaties. Therefore, the ECB can use its balance sheet for monetary purposes, but can never commit to keeping government debt on its books indefinitely. The recent ruling of the German constitutional court is likely to draw even more scrutiny to the central bank's policy in this regard. Of course, the ECB could do this by stealth. It doesn't have to say overtly that it will continue to refinance government debt, but in practice, it could do so.

The only trouble here, a problem signalled by Adair Turner, is that the central bank might be too credible in its denial of monetary financing. In other words, the general public could believe that the debt in the hands of the ECB will have to be repaid someday, implying higher taxes in the future. That could lead to higher savings, and consequently less growth now (a phenomenon called Ricardian equivalence, if you want to impress your friends). So it is important that debt financing by the ECB is believed to be genuine in practice but non-existent in theory.

Central bank balance sheets: Expansion and Reduction since 1990

The money multiplier collapsed



Source: Refinitiv Datastream

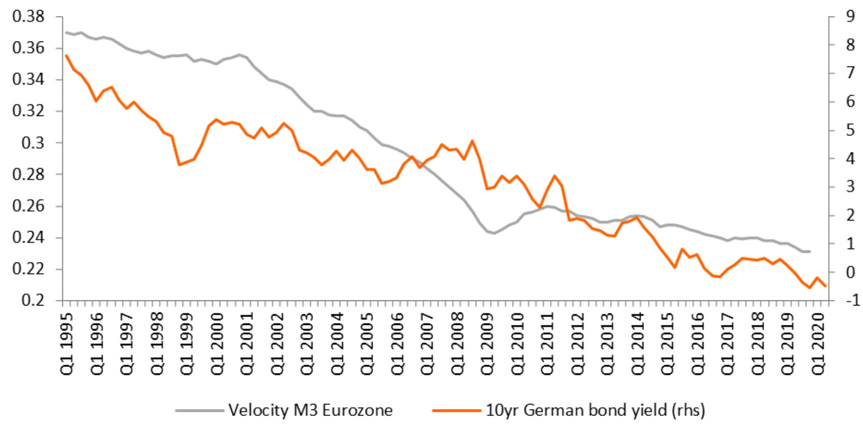
The hyperinflation sirens

But wouldn't this further increase in the size of the balance sheet lead to more inflation?

We already had a strong increase in the size of the balance sheet in previous years, not only in Europe but also in the US and Japan. The argument goes that more of this would push inflation through the roof. The reasoning behind this is to be found in the quantitative theory of money: the more money in circulation, the more inflation. What is lost in this reasoning, is that there is a difference between the money created by the central bank (base money, which equals notes in circulation and bank reserves) and broad money in the hands of the general public.

The money multiplier, which is the ratio of broad money to base money has actually collapsed. This is because quantitative easing directly creates broad money and bank reserves in similar amounts, but there is no extra money creation involved through bank credits in the process (see here for a detailed explanation). On top of that, the velocity of money, which measures the number of times the stock of money is used to do purchases during a certain time period, has also strongly declined. The latter is logical. As interest rates on alternative assets are very low, people hold a larger chunk of their wealth in the form of money, without actually using it to do transactions. To illustrate these points you only have to look at what happened in Japan over the last few decades. Since 1997, base money has increased by a whopping 970%, while consumer prices over the same period have basically remained unchanged. In other words, the increase in the ECB's balance sheet through the purchase of additional government bonds doesn't need to lead to significantly higher inflation, though of course the amount of government bond purchases without causing higher inflation, is not limitless either.

Declining velocity



Source: Refinitiv Datastream

Too low an inflation rate

You could even wonder if, at the end of the day, a little bit more inflation is not what the eurozone needs. Over the last 10 years, average inflation has been 1.3%, while average core inflation and the average GDP deflator came out at 1.1%. Nominal GDP growth, therefore, averaged a mere 2.5%. That is a worrying phenomenon since the real burden of large debt levels remains high, further depressing growth. With the current downturn creating a huge negative GDP output gap, some extra stimulus seems warranted, without immediately having to fear galloping inflation. And with short term interest rates already negative, the only tool the central bank has left to boost the economy further is balance sheet expansion. Since it is not obvious how to determine the exact amount of permanent balance sheet expansion, the central bank could announce a price level target in the future (see e.g. Bernanke), ideally one that allows for some correction of the inflation undershoot that we experienced over the last decade. The establishment and extension of the Pandemic Emergency Purchase Programme is already an important step in this regard, though at this moment the programme is still labelled as temporary.

Monetary dominance

The final question is whether the ECB, by monetising part of the fiscal expansion, would become hostage to the fiscal authorities.

Fiscal authorities might want to prevent an interest rate increase because this would implicitly increase the cost on the debt held by the central bank (it would reduce the central bank's interest income and thereby the dividends paid out to the governments), while at the same time, new debt would also have to be issued at a higher interest rate. And if the fiscal expansion to fight Covid-19 is now accommodated by the central bank, why couldn't the same thing be done to finance the green agenda?

> *Past experiences of the central bank's monetary policy being subordinated to fiscal policy did not end well*

In that way, fiscal policy would become dominant, a thesis advanced by the proponents of Modern Monetary Theory: governments can spend newly created money as long as there is no full employment. Only when the situation of full employment is reached do governments have to hit the (tax) brakes to avoid inflation. However, past experiences of the central bank's monetary policy being subordinated to fiscal policy did not end well.

A politician who needs to get re-elected is generally not the one who will "take away the punch bowl just as the party gets going". That is basically the reason why most industrial countries have opted for an independent central bank that has to maintain the purchasing power of money in the longer run. But even when maintaining the dominance of monetary policy over fiscal policy, we believe that today, there is some scope to accommodate fiscal expansion by a further increase in the ECB's balance sheet, without having to fear inflation going through the roof. At the end of the day, it might even be needed to bring inflation back to close to, but below 2%.

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