

Eurozone Watch

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Growth and inflation outlook will spur the ECB to do more

- ▶ **The eurozone economy has tumbled into a deep recession due to the spreading of the Covid-19 virus**
- ▶ **The lockdowns throughout the region are resulting in dramatic drops in consumer spending and production in large parts of the economy**
- ▶ **The abrupt (and unique) nature of the disruptions in economic activity implies that every extra week of lockdown reduces annual GDP growth in 2020 by roughly 0.75 percentage points**
- ▶ **... and also implies that growth will sharply rebound after the end of the lockdown**
- ▶ **However, we think that the negative side effects via unemployment, defaults, tightening financial conditions and supply-side disruptions will push the eurozone economy back into recession after this initial rebound**
- ▶ **Moreover, these negative second round effects are non-linear and become stronger, the longer the lockdown lasts**
- ▶ **We expect the ongoing weakness in activity to reduce underlying inflationary pressures and result in a further decline in (core) inflation, which has already been undershooting the ECB target for a number of years**
- ▶ **Government finances will deteriorate dramatically due to discretionary policy stimulus and the cyclical economic deterioration, leading to additional funding needs of EUR 690bn**
- ▶ **We expect the ECB to step up the PEPP by EUR 500bn to 1250bn soon**

Extending the lockdowns

By mid-March, all eurozone countries had imposed economic lockdowns aimed at preventing the spread of the Covid-19 virus. Some countries a bit earlier than others and some countries more strict than others, but in general a large part of economic activity abruptly came to an end around that time. Since then, the original lockdown phase (of around four to five weeks) has been extended in most countries. France's lockdown is now scheduled to continue until at least 11 May, which is roughly four weeks longer than the original end date of 15 April. Germany's and Italy's lockdown phases are scheduled to end on 3 May and Spain will probably extend its current lockdown end date of 25 April by one or two weeks. Having said that, some countries have announced that they have planned to lift some of the most stringent lockdown measures (such as school closures and the closure of 'non-essential' shops) already within the next few weeks.

Tumbling into recession

When assessing the immediate economic impact of the COVID-19 virus on the expenditure side of the economy, private consumption initially is hit the hardest during lockdown. Non-essential consumption excluding e-commerce has a share of around 30% in total consumption. We assume this part of consumption will drop by around 90% in lock-down periods. On the production side of the economy, construction and large parts of services (for instance tourism, culture and leisure) and industry collapse. Various studies by central banks and international organisations, as well as statistical evidence have suggested that during an average period of lockdown, production falls by roughly a third in the eurozone. A report by the Banque de France showed the parts of the economy that were hit the most during the first two weeks of lockdown were construction (-75%) and services that fall within the broad category wholesale, retail trade, transportation, accommodation and food services (-65%). Within manufacturing (which fell by 48% in total), the companies that suffered the most were in the automotive industry and in the sectors metal and machinery and equipment.

Services hit the hardest



Source: Thomson Reuters Datastream

New passenger car registrations plummeted in March



Source: Thomson Reuters Datastream

Besides the one-off initial damage to the economy, second round effects will prolong the economic weakness. These are due to a rise in unemployment, corporate defaults, the tightening of financial conditions and supply-side disruptions. These will continue to weigh on private consumption as well as fixed investment for a prolonged period after the end of the lockdowns. The size of these second round effects depends on the length of the lockdowns, so there is likely to be a non-linear relationship between the duration of the restrictions and the size and duration of the economic shock. In addition, the second round damage to the economy will depend on the efficiency and degree of macro stimulus.

Growth scenarios for 2020-21 critically depend on assumed lockdown period

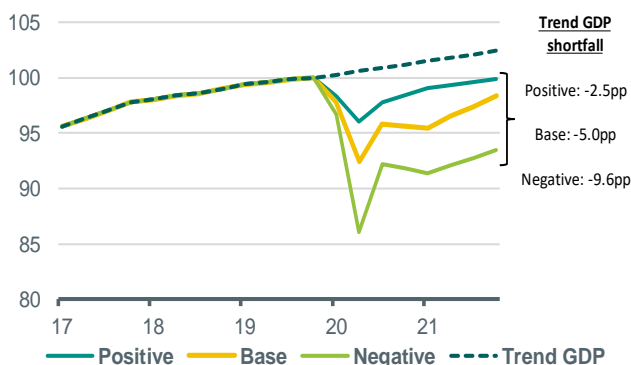
We have constructed three scenarios for the eurozone economy (see the graph below). In our base case we have assumed that the lockdowns continue until end-April, which seems to be in line with the extension until Sunday 3 May in a number of countries, but is already too optimistic for, for instance, France (lockdown will last a week longer).

In our base case, GDP will contract by around 4.5% in 2020 and grow by 1.6% in 2021. There will be significant second round effects from the lockdown and a durable and strong recovery will not take off before Q2 2021. Alternatively, our negative scenario assumes that the lockdown period is extended until the end of May. In that case, GDP would contract by around 8% in 2020 and grow by only around 1% in 2021, as second round effects are a much more powerful drag despite even more aggressive macro stimulus. Finally, the positive scenario assumes the same lockdown period as in base case but activity returns to normal more quickly as measures are wound down rapidly and consumer behaviour normalises. In that

case, the real economy and market confidence recovers sharply, although growth in H2 2021 will probably be lower as fiscal and monetary stimulus will be less aggressive.

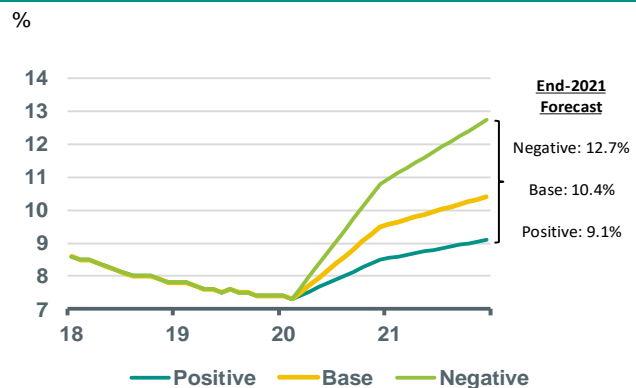
Eurozone GDP (levels) in different scenarios

Q4 2019 = 100



Source: ABN AMRO Group Economics

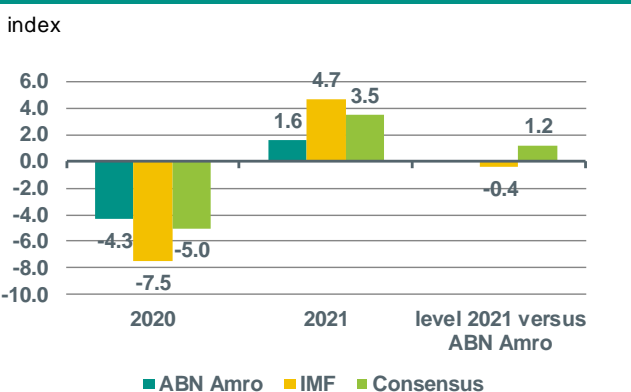
Unemployment in different scenarios



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

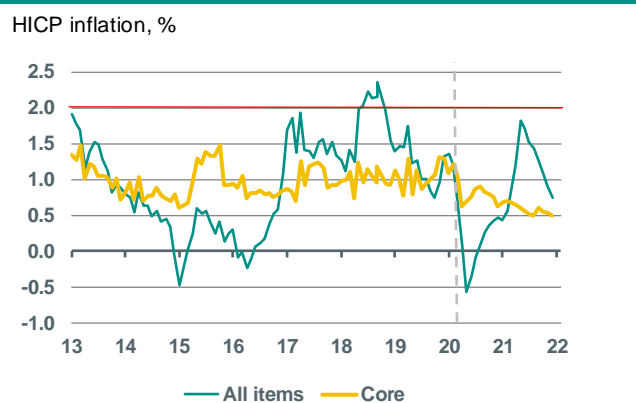
We have compared our own forecasts to those of the IMF and consensus. It turns out that our forecasts for 2020 are less negative, but our forecasts for 2021 are significantly less positive than the IMF and the consensus.

ABN Amro forecasts versus IMF and consensus



Source: IMF, Bloomberg, ABN Amro Group Economics

Core inflation to decline



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Unemployment to rise rapidly

We expect the eurozone labour market to be hit hard by the economic downturn (see graph above), despite the introduction of government-subsidised temporary unemployment schemes. Around 15% of eurozone employment consist of people that are self-employed and around 13% of total employees work under a temporary contract. A significant part of this flexible part of the labour market is expected to become unemployed quickly. Indeed, data from Spain and Germany have already given some indication about the impact of the lockdowns. Germany reported that the number of requests for temporary unemployment schemes jumped to 470,000 in March, up from 1,900 in February. This number of requests is equal to around 1% of Germany's labour force. To compare, at the peak of the GFC around 1.4million applications for this scheme had been made, which was equal to around 3% of the labour force at that time. The majority of the requests in March came from companies in the trade and the hotel and restaurant sectors. Spain's Ministry for Labour and Social Security reported a

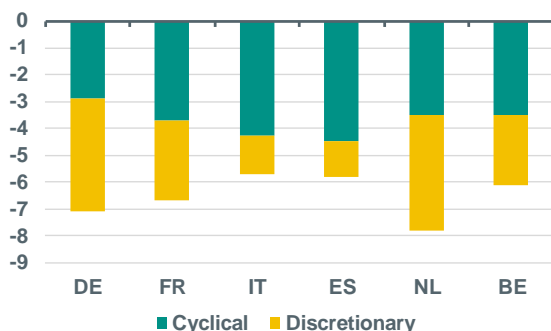
rise in the number of jobless claims by 302,000 in March (equal to around 1.3% of the labour force) and a drop in employment by almost 834,000 during that month (equal to more than 4% of total employment), with the tourism and construction sectors hit the hardest. According to the ministry, the monthly rise in jobless claims was about 1.5 times higher than the largest monthly rise during the GFC. All in all, we expect the unemployment rate to rise to levels above 10% by the end of 2021 in our base case (from 7.3% now).

Core inflation to gradually decline

The hit to the global economy during the Covid-19 crises, looks to reflect a combination of demand (lower output and prices) and supply shock (lower output but higher prices). However, it seems likely to us that the demand shock is actually dwarfing the supply shock. The key driver of the downward revisions to our growth forecasts has been the sharp falls in consumer spending. In addition, there will be a second round demand shock from tightening financial conditions, rising unemployment and corporate defaults, and we judge that spare capacity will build in coming quarters, which will bear down on underlying inflationary pressures. As well as these more medium-term downward pressures, the collapse in oil prices will put immediate downward pressure on inflation. Consequently, HICP inflation will drop in the coming months and will probably register a couple of negative numbers on a year-over-year basis during Q2 of this year. Assuming some recovery in oil prices later in the year, headline inflation should bounce back sharply towards 2% by mid-2021. However, before that, headline inflation will fall again to converge towards core inflation. Core inflation is likely to slow significantly in coming quarters. Given the weakness in demand, we expect core inflation to drop to around 0.5% by the end of next year from around 1% now. As a comparison, core inflation fell by around a percentage point following the global financial crisis. In our negative scenario, core inflation drops to around zero.

Change in 2020 budget balance main countries

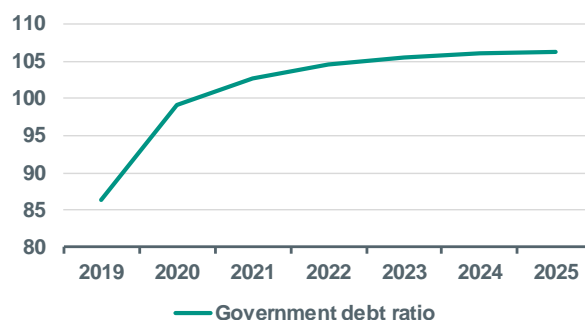
Pps GDP



Source: IMF, Bloomberg, ABN Amro Group Economics

EZ government debt to jump higher

% GDP



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Fiscal policy stimulus to lift budget deficits and government debt

Since mid-March, there has been a flurry of announcements by governments of measures to support the eurozone economy in the face of the Covid-19 shock. The measures can be broken down into discretionary fiscal measures, deterioration in the public finances due to the cycle (often known as the automatic stabilisers) and liquidity support measures (defined as bank loan guarantees as well as lending schemes). Taking all the measures together, for the eurozone as a whole the fiscal and liquidity measures total around EUR 2 trillion (around 18% GDP). Most of this comes from liquidity measures, though the fiscal support is also substantial. Discretionary fiscal stimulus at the eurozone level is around 3% GDP, with Germany and the Netherlands leading the way (see the graph above). The automatic stabilisers are also greater than, for instance, in the US because of a bigger welfare state. Due to the deterioration in the budget balance as well as the expected contraction in GDP, the government debt ratio will probably jump higher in 2020 and 2021 (see graph above). When calculating the longer-

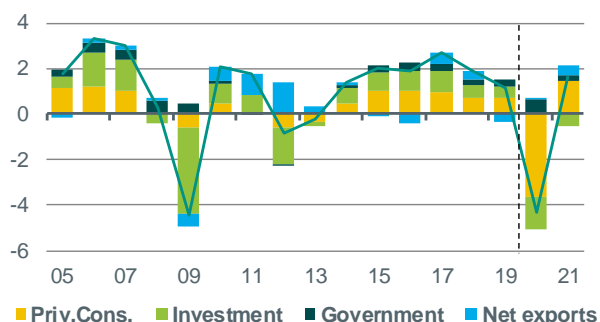
term trajectory of government debt, it is crucial whether governments will implement austerity to compensate for the current discretionary fiscal stimulus. In the graph above we have assumed that around half of the current discretionary stimulus will become structural and that half will be compensated by austerity measures in the years after the crisis. Moreover we have assumed that (largely thanks to ECB policy) government bond yields will remain at levels below nominal GDP growth in the longer-term in the eurozone as a whole, which will have a favourable impact on government debt and largely compensates for the upward impact of the structural deterioration in the budget balance. Having said that, there will be wide differences between individual countries, with trends much more unfavourable in Italy, and to a lesser extent France.

ECB to step up the PEPP

On 18 March, the ECB announced a new EUR 750bn asset purchase programme of private and public sector securities (the so-called Pandemic Emergency Purchase Programme - PEPP). We expect the ECB to announce a further increase in the PEPP. We think that a step up of around EUR 500bn for this year will be announced – likely in April – on top of the EUR 750bn already announced. There are a number of factors behind this view. To begin with, the sharp economic contraction in the near term, but also our view that a strong and durable rebound takes shape only in the second half of 2021. Second, the expected slowdown in inflation (see above). Third, the likely additional government bond supply due to the deterioration in public finances (see above). We think the ECB is engaged in yield curve and yield spread control as it attempts to mitigate the tightening of financial conditions throughout the eurozone. As such, we think it will step up purchases in order to absorb the additional issuance by sovereigns. Recent comments by ECB officials have also signalled that the central bank is ready to ease monetary policy further.

GDP growth and contribution main component

% yoy, pps yoy



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Key forecasts for the Eurozone

	2018	2019	2020e	2021e
Economic outlook				
GDP (% yoy)	1.9	1.2	-4.3	1.6
- Priv. consumption (pp contribution)	0.7	0.7	-3.6	1.4
- Fixed Investment (pp contribution)	0.5	0.9	-1.6	-0.7
- Net exports (pp contribution)	0.4	-0.3	0.1	0.5
Inflation (CPI)	1.8	1.2	0.3	1.1
- Core inflation (CPI)	1.0	1.0	0.8	0.6
Interest and exchange rates (eop)				
ECB deposit rate	-0.4	-0.5	-0.5	-0.5
3m Euribor rate	-0.31	-0.38	-0.44	-0.44
DE 10yr yield	0.25	-0.19	-0.55	-0.50
EUR/USD	1.15	1.12	1.12	1.20
WTI oil (USD/barrel, pa)	65.8	61.1	35.0	44.0

Source: ABN AMRO Group Economics

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