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Economic Research:

The Eurozone Can Still Rebound In 2021 After Lighter Lockdowns

December 1, 2020

Key Takeaways

- We forecast the eurozone economy will shrink by 7.2% this year before rebounding by 4.8% in 2021; constraints on economic activity--while much less stringent than in March and April--have interrupted the recovery in place.
- The extension of support for fiscal and monetary policies, as well as their coordination, will be essential to restart the economy from 2021 onward.
- The European central bank will have no choice but to keep its interest rates lower for longer and extend its asset purchases into the end of 2021, given inflationary pressures are unlikely to build before 2023.

SENIOR ECONOMIST

Marion Amiot
London
+ 44(0)2071760128
marion.amiot
@spglobal.com

EMEA CHIEF ECONOMIST

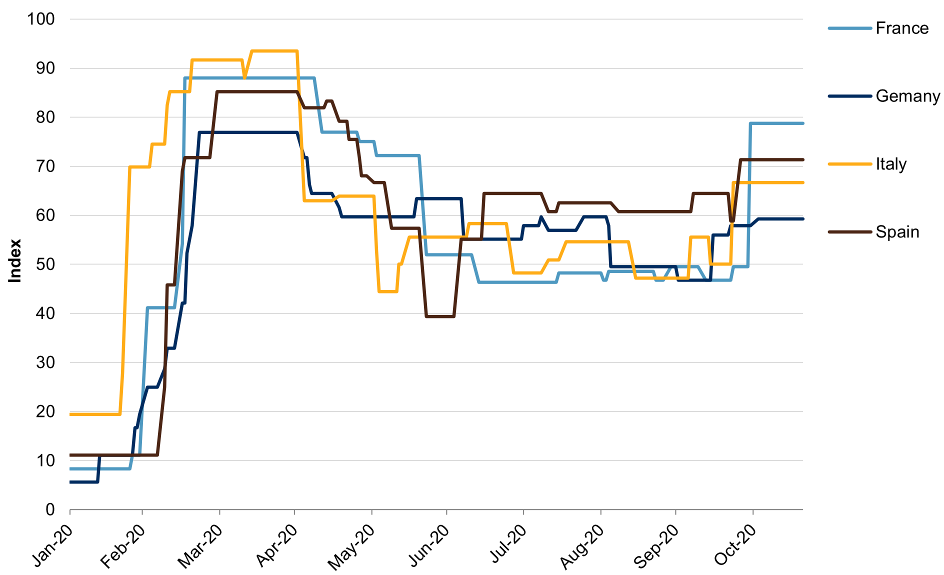
Sylvain Broyer
Frankfurt
+ 0049 69 33 999 1
sylvain.broyer
@spglobal.com

A second wave of COVID-19 is unlikely to be as disruptive to the eurozone economy as the first. Companies have learned to better operate amid the turmoil, health and safety measures are in place, and protection equipment more widely available. The latest round of lockdowns won't hit the economy at full steam this time; the containment measures haven't tightened from zero as was the case in March. Recent announcements on effective vaccines have also steadied nerves. The fatality rate is now one-tenth the level during the first outbreak, and the second wave could even have already peaked. But Christmas celebrations will be the litmus test.

S&P Global Ratings now expects the eurozone's real GDP to be 6.5% below last year's levels in the fourth quarter, compared with 14.8% below in the second quarter of 2020. This leaves our 2020 GDP forecasts broadly unchanged, given we also underestimated the strength of a rebound in the third quarter.

Chart 1

Social-Distancing Measures Tightened Moderately In November Compared With February-April
Oxford University Stringency Index

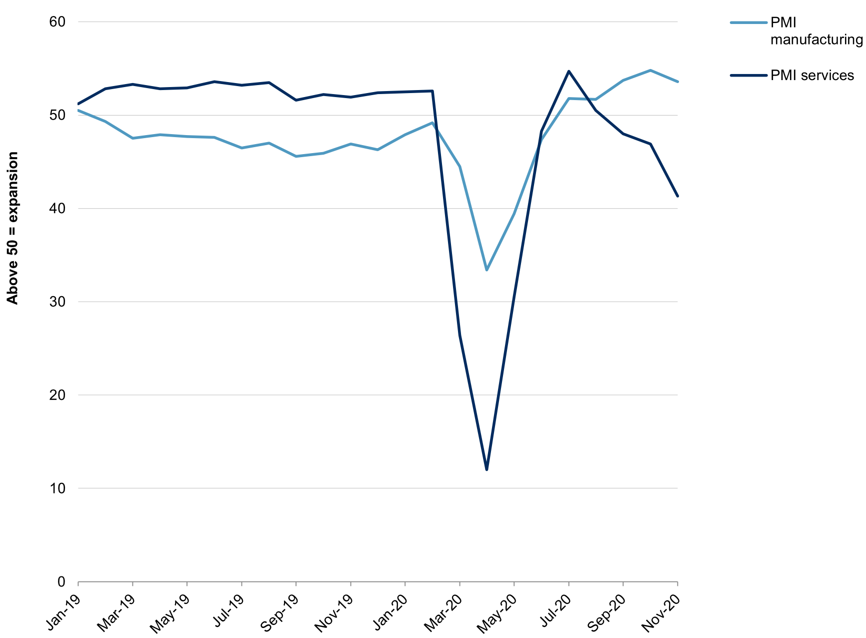


Source: Refinitiv, S&P Global Ratings.

High-frequency data up to mid-November 2020 suggest that the hit to economic activity was milder than in the second quarter (see chart 2). The services sector--especially hospitality, transport, and leisure--is again carrying the brunt of the adjustment. Yet, manufacturing is holding up quite well so far. Factories haven't been forced to close, and firms can therefore address a large backlog of work and foreign orders, especially from Asia, as global trade is still recovering. Construction is also operating as usual and many countries (for example, Germany and Spain) have kept non-essential shops open or are planning to reopen them in December (for example, France, U.K., and Italy).

Chart 2

With Softer Lockdowns, Manufacturing Is Less Affected Than Services



PMI--Purchasing managers' index. Sources: IHS Markit, S&P Global Ratings.

But the second round of lockdowns will dent our forecasts for 2021. The containment measures at the end of 2020 have interrupted the recovery, and that mechanically means that the GDP carryover for next year will be lower than we previously anticipated. Moreover, several European governments have suggested constraints on socializing are likely to remain in place until the spring of 2021.

In other words, most of the rebound from this second wave will be delayed to the second and third quarters of 2021, when the situation should start to normalize (we assume vaccines will be widely available by the end of the second quarter). This means the eurozone is likely to expand by only 4.8% in 2021, compared with our forecast of 6.1% that we made in September.

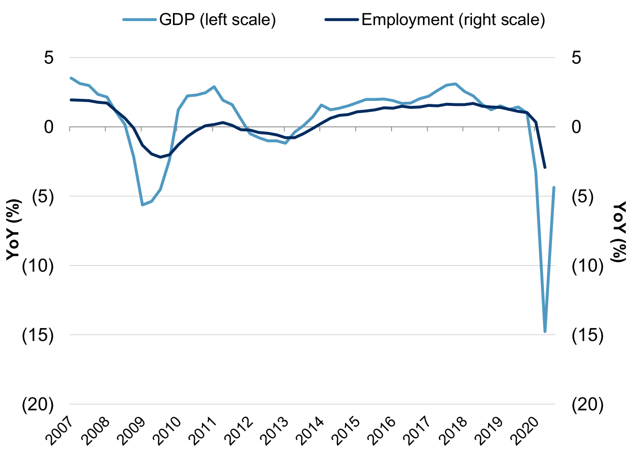
Coordinated Fiscal And Monetary Policy Will Speed Recovery

Central bank and government measures put in place in March and extended beyond the fourth quarter of 2020 helped to put the economy back on track. As such, the third quarter performance was much better than we expected.

Short-time work schemes, delayed bankruptcy filings, and credit guarantees for firms have dampened the impact of the crisis on defaults and the labor market. Compared with the global financial crisis, employment was around 60% less sensitive to the fall in GDP in 2020, even though the service sector has been hit more this time (see chart 3). Most households held on to their income and saved unprecedented amounts of money (see chart 4), paving the way for a quick rebound in demand and activity.

Chart 3

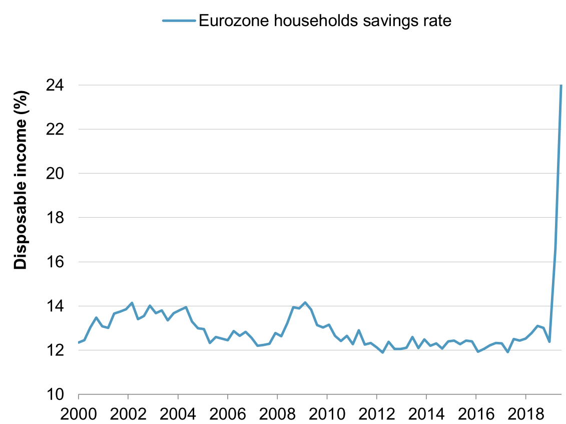
Employment Was About 60% Less Sensitive To The Fall In GDP In 2020 Than In The GFC



GFC--Great financial crisis. YoY--Year on year. Source: Eurostat, S&P Global Ratings.

Chart 4

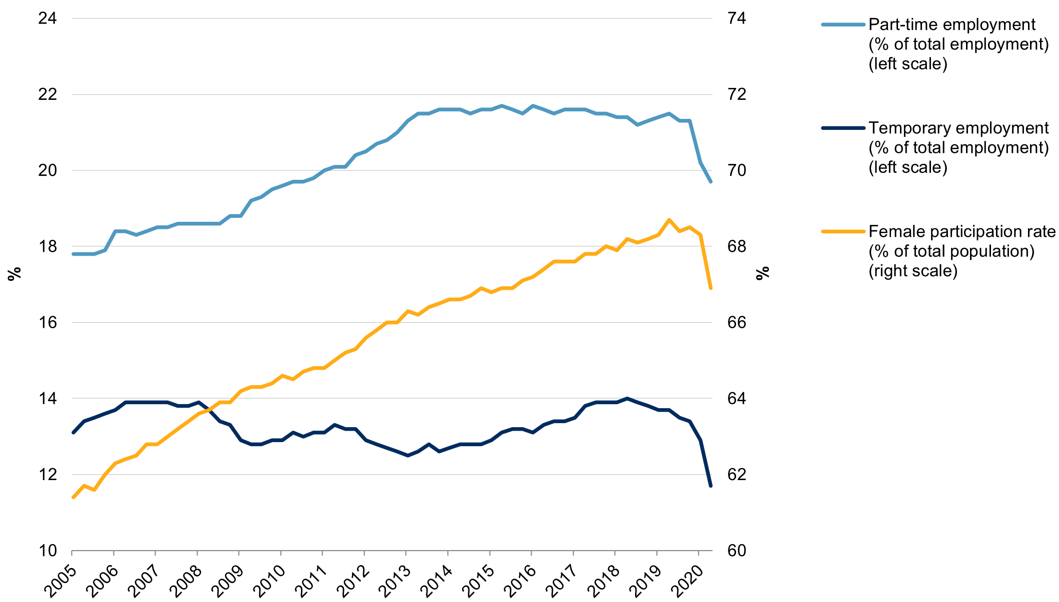
Households Saved Unprecedented Amounts Of Income During Lockdown



Sources: Eurostat, S&P Global Ratings.

Chart 5

More Precarious Forms Of Employment Have Been Less Well Protected Through This Crisis



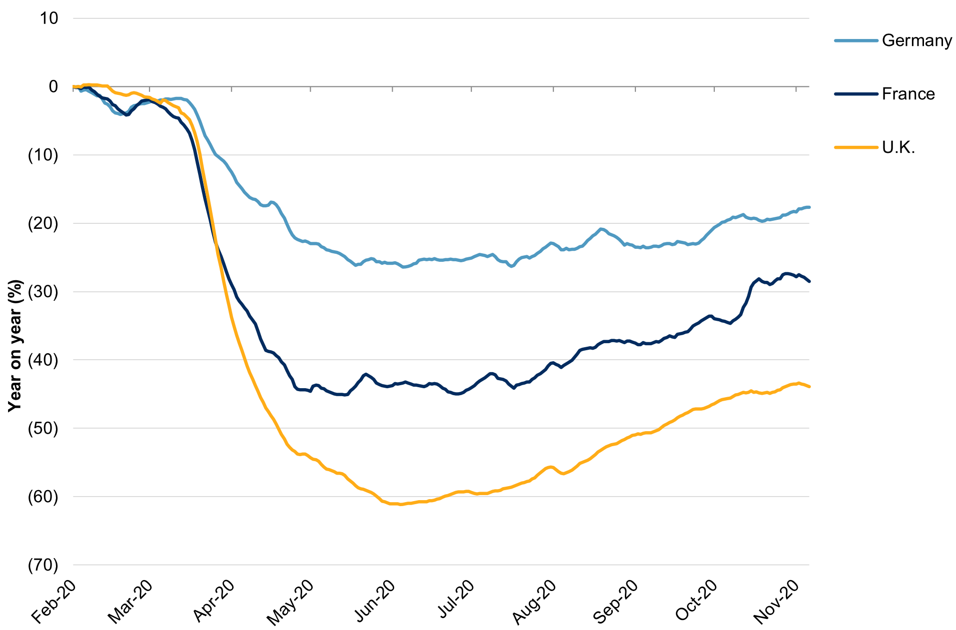
Sources: Eurostat, S&P Global Ratings.

More precarious forms of employment, such as temporary and part-time employment, have not been well shielded in this crisis. The share of temporary contracts as a proportion of total jobs has dropped by twice as much as during the financial crisis (see chart 5). This in part reflects the lower prevalence of permanent contracts in the most affected sectors (for example, hospitality, travel), but also the fact that those forms of employment are often used by firms to adjust their workforce to the economic cycle. With fewer job prospects on the horizon, unemployed workers have exited the labor market, driving a drop in long-term unemployment and the participation rate.

Against this backdrop, we expect the unemployment rate to edge up to 8.7% in 2021--much lower than the 2010-peak of 10.3%--and recover to its precrisis level of 7.6% by the end of 2023. Part of this increase in the unemployment rate will paradoxically be good news, since it suggests people will be actively searching for a job after refraining from doing so during the first round of lockdowns. This is likely to continue as the labor market gradually reopens (see chart 6).

Chart 6

Online Job Postings Suggest The Slack In European Labor Markets Is Diminishing But Still Substantial



Sources: Indeed HiringLab, S&P Global Ratings.

Beyond the immediate crisis support, governments have already committed to substantial fiscal stimulus from 2021. Amid depressed demand and negative rates, fiscal policy is the most powerful tool to boost growth. We estimate that 4% in government spending (levels to which France and Germany have committed) would boost GDP by 6% in two years and up to 8% in four years given that monetary policy has hit the effective zero lower bound (see: "The Case For Bold Fiscal Stimulus In The Eurozone," published on RatingsDirect on Nov. 17, 2020). Expenditure geared toward digitalization, greening the economy, and infrastructure are also set to boost long-term growth, especially because governments have underinvested in these areas over the past 10 years, leaving an investment gap of the magnitude of 2% of GDP.

More Stimulus Is Coming From The ECB As Inflation Pressures Remain Low

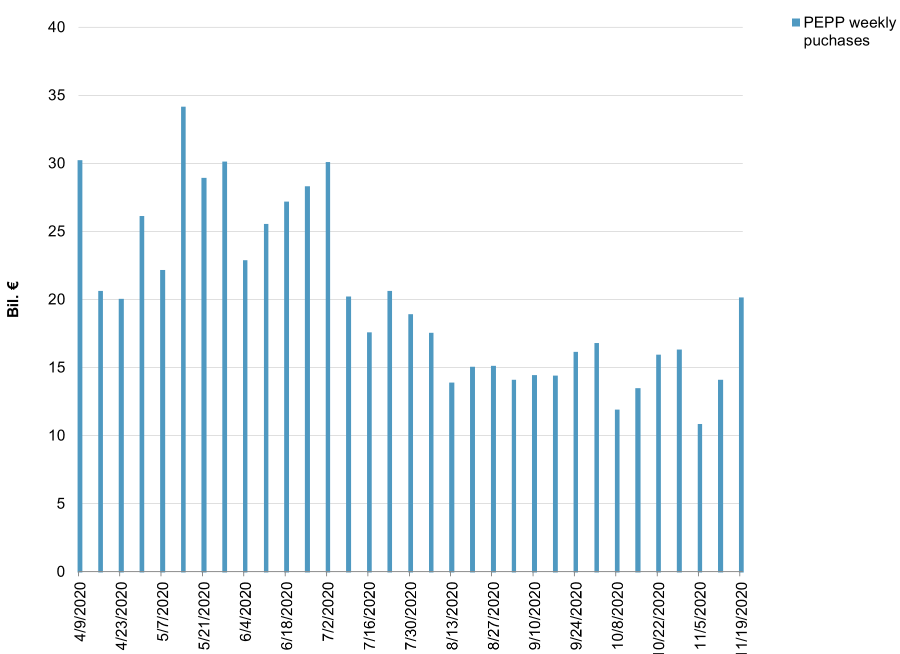
Transitory factors that weighed on prices in 2020 should dissipate in 2021. These inflationary dynamics included delayed sales, temporary VAT cuts, a drop in energy prices, and past appreciation in the euro. We now expect headline inflation to rise from to 1% in 2021 from 0.2% in 2020. Over the next few years, the significant slack in the labor market should translate into lower wage pressures, keeping labor costs low for companies. Downward pressure on prices will also come from lower inflation expectations and weak global demand, and we thus expect inflation to remain low, only reaching 1.3% in 2023.

This is below the ECB's target of close to but below 2%, meaning it will have to do more. Some measures will be announced in December to support the economy through a second lockdown. We expect the ECB to lengthen the duration of its Pandemic Emergency Purchase Program (PEPP) and targeted longer-term refinancing operations (TLTRO) to the end of 2021. As a result, the ECB will need to add around €500 billion to its PEPP €1.35 billion envelope to ease market financing for an additional six months (see chart 6).

To ensure that the tightening of credit standards reported in the last Bank Lending Survey don't derail bank lending, the ECB is likely to lower the TLTRO refinancing rate by 25 basis points. This will help banks' profitability at a time when provisioning for nonperforming loans is mounting. Longer term, the low inflation outlook suggests the ECB is set to keep its monetary policy loose until at least the end of 2023.

Chart 7

The ECB Will Need To Add €500 Bil. To Its PEPP To Extend It Until End-2021



PEPP--Pandemic Emergency Purchase Program. ECB--European central bank. Sources: European Central Bank, S&P Global Ratings.

Risks Are More Balanced

Risks to our macroeconomic outlook remain tilted to the downside but are slightly more balanced than three months ago:

- The virus could resurge after Christmas or a third wave may emerge before the vaccine is distributed sufficiently broadly among the population.

- The policy mix may desynchronize due to premature fiscal austerity or tightening of monetary policy.

Premature fiscal austerity could occur, for example, if the EU asks member states to reduce their debt-to-GDP ratios at a pace that jeopardizes the economic recovery. Premature tightening of monetary policy--a contraction of the central bank's balance sheet--could occur if we face a lasting inflationary shock. Both possibilities do not seem very likely in the current context.

The main upside risks are related to the availability of the vaccine that might come quicker than we have penciling into our baseline forecast, as well as positive effects on confidence due to the simple existence of a vaccine. Our forecasts may also not do enough justice to the EU's recovery plan, given the high multiplier effects that they might have in the current regime of slack and interest rates at the zero lower bound. We have a clear idea of how much grants EU countries will get, but it remains uncertain when the money will effectively flow and how EU member states will make use of it.

Table 1

S&P Global Ratings: European Economic Forecasts (November 2020)

(%)

GDP	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
2018	1.3	1.8	0.8	2.4	2.3	1.8	1.9	1.3	3.0
2019	0.6	1.5	0.3	2.0	1.6	1.7	1.3	1.3	1.1
2020	(5.6)	(9.0)	(8.7)	(11.3)	(4.1)	(7.3)	(7.2)	(11.0)	(3.9)
2021	3.7	6.2	5.3	6.5	3.0	4.8	4.8	6.0	3.2
2022	3.2	4.4	3.2	6.4	2.5	4.1	3.9	5.0	3.1
2023	1.9	2.5	1.7	2.6	2.2	1.7	2.2	2.4	2.0
CPI inflation									
2018	1.9	2.1	1.2	1.7	1.6	2.3	1.8	2.5	0.9
2019	1.4	1.3	0.6	0.8	2.7	1.2	1.2	1.8	0.4
2020	0.3	0.5	(0.1)	(0.3)	1.2	0.5	0.2	0.9	(0.7)
2021	1.4	0.7	0.8	0.9	1.3	1.4	1.0	1.8	0.3
2022	1.5	1.3	1.0	1.4	1.4	1.7	1.3	1.9	0.5
2023	1.4	1.2	1.1	1.5	1.6	1.8	1.3	1.9	0.5
Unemployment rate									
2018	3.4	9.0	10.6	15.3	3.8	6.0	8.2	4.1	4.7
2019	3.1	8.5	9.9	14.1	3.4	5.4	7.6	3.8	4.4
2020	4.3	8.2	9.1	15.9	4.1	5.2	7.9	4.8	4.7
2021	4.8	9.4	10.3	17.6	5.2	6.1	8.7	6.7	4.6
2022	4.3	9.2	10.1	16.4	4.3	5.8	8.1	5.2	4.5
2023	3.9	8.8	9.5	15.6	3.6	5.6	7.6	4.5	4.3
10-year government bond									
2018	0.5	0.8	2.6	1.4	0.6	0.8	1.2	1.5	0.0

Table 1

S&P Global Ratings: European Economic Forecasts (November 2020) (cont.)

2019	(0.2)	0.1	1.9	0.7	(0.1)	0.2	0.4	0.9	(0.5)
2020	(0.5)	(0.2)	1.2	0.4	(0.3)	(0.1)	0.1	0.4	(0.5)
2021	(0.6)	(0.3)	0.9	0.3	(0.4)	(0.2)	(0.1)	0.3	(0.4)
2022	(0.4)	(0.1)	1.1	0.5	(0.2)	(0.0)	0.1	0.4	(0.3)
2023	(0.2)	0.1	1.3	0.7	(0.1)	0.1	0.3	1.0	(0.1)

Exchange rates

	Eurozone	**U.K.**		**Switzerland**	
	US$ per Euro	US$ per GBP	Euro per GBP	CHF per US$	CHF per Euro
2018	1.18	1.34	1.13	0.98	1.15
2019	1.12	1.28	1.14	0.99	1.11
2020	1.14	1.28	1.12	0.94	1.07
2021	1.19	1.29	1.08	0.92	1.10
2022	1.19	1.33	1.12	0.96	1.14
2023	1.19	1.35	1.13	0.97	1.16

	Eurozone (ECB)	**U.K. (BoE)**	**Switzerland (SNB)**
	Policy rates	Deposit rate	Refi rate
2018	(0.40)	0.60	(0.75)
2019	(0.43)	0.75	(0.75)
2020	(0.50)	0.23	(0.75)
2021	(0.50)	0.10	(0.75)
2022	(0.50)	0.10	(0.75)
2023	(0.50)	0.10	(0.75)

CPI--Consumer price index. BoE--Bank of England. SNB--Swiss National Bank. Source: S&P Global Ratings.

Our COVID-19 Assumptions

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Related Research

- The Case For Bold Fiscal Stimulus In The Eurozone, Nov. 17, 2020

This report does not constitute a rating action.