



March 29th, 2021

Waiting for recovery

- Economic activity dropped less than expected in Q4 2020, yet the recovery will start only later this year.
- Inflation increased at the beginning of the year mainly due to the increase in energy prices and the normalization of German VAT and will remain rather high during 2021.
- The outlook is subject to high uncertainty. Both upside and downside risks are mainly due to pandemic evolution, speed of vaccine distribution and effectiveness of the Recovery and Resilience Facility program.

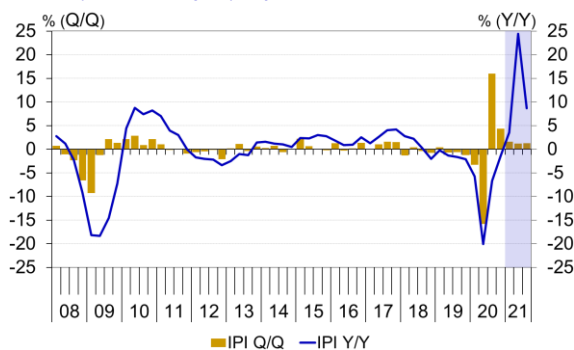
Slight GDP contraction in Q4 2020

In the fourth quarter 2020, euro area GDP dropped less than expected (-0.7%) leading to an annual decrease of economic activity for the whole 2020 of -6.6%. The second pandemic wave in Autumn induced with some heterogeneity more stringent containment measures all over the euro area affecting mainly the services sector. Foreign demand remained strong and the industrial sector was hardly affected, preventing stronger GDP contraction. In Q4, private consumption signed a remarkable drop by 3.0%, representing the main negative contributor to GDP growth. On the other hand, gross fixed capital formation (+1.6%) increased to balance a stronger decline of overall economic activity.

The development was quite heterogeneous across countries. In Italy and France GDP declined by 1.9% and 1.4% respectively, whereas in Spain (+0.4%) and Germany (+0.3%) the recovery continued although at a slower pace.

FIGURE 1 | Eurozone Industrial Production Index

Seasonally and working day adjusted



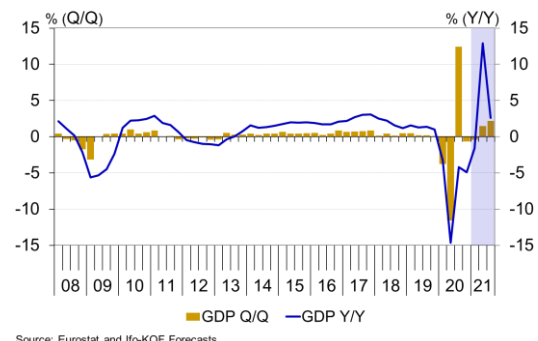
In the first months of the year, the manufacturing sector has been showing positive signals. The industrial production expanded in January (+0.8% compared to the previous month) after stagnating in December. France and Italy recorded the strongest increases, whereas in

Spain and Germany the production contracted slightly. The Economic Sentiment Indicator (ESI), increased in February mainly due to manufacturing sector, while the other sectors were moving sideways. Short term perspectives are highly uncertain, especially in the service sector. On the one hand, the start of the vaccination campaigns gives some reason for optimism. On the other hand, from the beginning of March onwards the pandemic situation has started to worsen almost everywhere with a reappraisal of the containment measures in some countries.

However, these negative effects are expected to have only a transitory effect on the economy. In 2021 industrial production will remain on a positive trend. It is expected to expand by 1.6% in Q1, compared to the previous quarter, slowing down to +1.2% in Q2. Due to the base effect of the very low second quarter in 2020, the year-on-year growth rate in Q2 2021 will be over 24%. In Q3 2021, quarter-on-quarter growth should remain robust (+1.3%).

FIGURE 2 | Eurozone GDP Growth

Seasonally and working day adjusted



The recovery of capital investment is expected to proceed at a slower pace. On one hand, the underutilization of capacity and the high uncertainty about the evolution of the pandemic will negatively affect the firms' expectation. On the other hand, international trade is projected to expand, supported by strong economic growth in China and the United

States. Therefore, gross fixed capital formation is projected to stagnate in Q1 (+0.2%). In the following quarters, a timely start of the distribution of the Next Generation EU funds and a speed-up of the vaccination campaigns will support the recovery of investment by +1.5% in Q2 accelerating to +1.9% in Q3. Private consumption is expected to decrease in Q1 (-1.5%) due to new containment measures, but it will rebound in Q2 and Q3 (+1.8% and +2.9%, respectively). Altogether, GDP is expected to contract slightly in Q1 by 0.4% and to recover from Q2 onwards by +1.5% in Q2 and +2.2% in Q3.

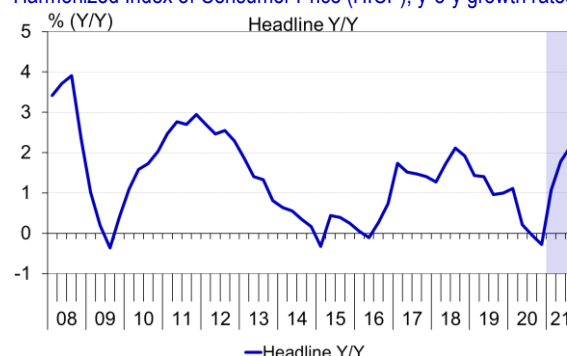
Inflation will increase

In January the annual change in the harmonized index of consumer prices (HICP) turned positive (+0.9%) and remained at same level in February. This is due to various reasons: the increase in energy prices, the normalization of German VAT rates and unusually strong changes in the category weights of inflation components. In Q1, the inflation rate is expected to amount at 1,1% compared to previous year.

Under the technical assumptions that the Brent price of oil remains at \$62 per barrel and that the dollar/euro exchange rate is stable at 1.21 over the forecast horizon, the underlying price pressure should increase slightly from the second quarter onwards due to the recovery in demand and the positive contribution from oil prices. The annual growth rate of the HICP will record at 1.8% in Q2 and will increase to 2.1% in Q3 2021.

FIGURE 3 | Eurozone Inflation

Harmonized Index of Consumer Price (HICP), y-o-y growth rates



Source: Eurostat and Ifo-KOF Forecasts

Uncertainty still high

The outlook is subject to high uncertainty, determined by the resurgence of contagions in many European countries. Both upside and downside risks are mainly due to the evolution of the pandemic. On the upside, several vaccines have already been introduced and deployed notwithstanding the fact that vaccination campaigns are proceeding slower than expected in many countries. In addition, the Next Generation EU funds should support the recovery in the EU starting from Q3 2021. Moreover, the US and Chinese economies have picked up recently representing a stimulus for global growth. The downside risks are related to the third wave of infections and the possible reintroduction of containment measures which would postpone the economic recovery.

Table 1 | Forecast Overview

	2020	Q1 21		Q2 21		Q3 21	
		q/q	y/y	q/q	y/y	q/q	y/y
Industrial Production	-8,5	1,6	3,5	1,2	24,5	1,3	8,7
Gross Domestic Product	-6,6	-0,4	-1,6	1,5	12,9	2,2	2,6
Private Consumption Expenditures	-8,0	-1,5	-4,7	1,8	11,0	2,9	0,2
Gross Fixed Capital Formation	-8,3	0,2	-2,8	1,5	17,6	1,9	5,2
Headline Inflation	0,3	0,8	1,1	1,5	1,8	-0,1	2,1

Change in %, seasonal and working day adjusted

Source: ifo-istat-KOF-Forecasts

Methodological Notes

This quarterly publication is prepared jointly by the German ifo Institute, the KOF Swiss Economic Institute, and the Italian Istat Institute. The forecast results are based on consensus estimates building on common macroeconomic forecast methods by the three institutes. They are based on time-series models using auxiliary indicators from business surveys by national institutes, Eurostat, and the European Commission. The joint three-quarter forecast covers Eurozone industrial production, GDP, consumption, investment, and inflation. Further country-specific and global economic analysis is available by:

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