Eurozone economic outlook

July 3rd, 2020

Historic collapse of Eurozone economy

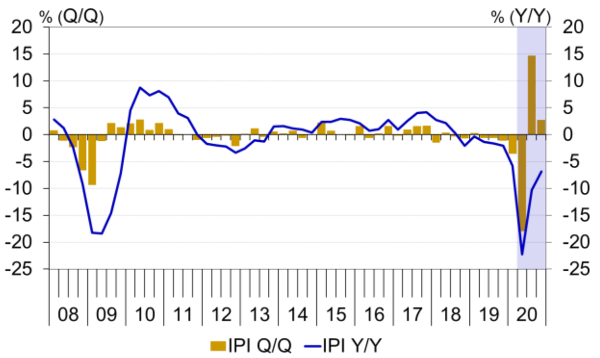
- *The lockdowns due to COVID-19 caused economic activity to fall remarkably in Q1 2020.*
- *The decline of GDP growth is expected to be even deeper in Q2 2020.*
- *Capacity underutilization is likely to cause inflation to decelerate below zero.*

Sharp fall of production

The lockdown measures in the euro area from mid-March onwards have forced many companies to slow abruptly down their activity. This caused GDP to fall remarkably in Q1 2020 by 3.6%. The greatest negative contribution came from private consumption. Households reduced their activities in response to rising COVID-19 infection numbers and following governments' orders or advices on staying at home and respecting social distancing rules. Also, numerous shops were closed and many services were not available. Further, firms hold back their investments due to liquidity issues and uncertainty on future developments. In addition, external demand was weak and caused exports to plunge. Italy, France and Spain were hit hardest by the COVID-19 pandemic and introduced strong lockdown measures. As a consequence, economic activity went down by 5.3% (Italy), 5.3% (France) and 5.2% (Spain). Germany was affected less severely with GDP contracting by 2.2%.

FIGURE 1 | Eurozone Industrial Production Index

Seasonally and working day adjusted



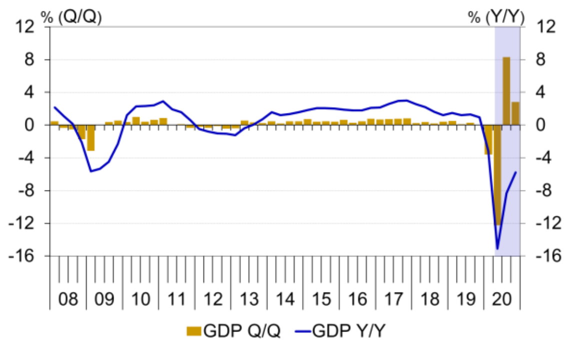
Source: Eurostat and Ifo-KOF Forecasts

Coinciding and leading indicators for the euro area continued to plunge in April and recovered somewhat in May and again in June as lockdown measures were partly eased. The European Commission's economic sentiment indicator fell from 94 points in March further to 65 points in April, rebounded somewhat in May and increased strongly in June up to almost 76 points. All sectoral indicators went down with the service sector recording the biggest drop. The IHS Markit composite purchasing manager's index reflects a similar development as it dropped from 30 points in March to as low as 14 points in April. In May it recovered to 32 and in June again up to 48 points.

Because of the measures introduced to contain the COVID-19 pandemic, industrial production dropped sharply already in March by 11.9%. In April, the decline of production was even more massive (-17.1%). Altogether, industrial production is expected to fall with an unprecedented 18% in Q2 2020. Assuming that the containment measures can be further relaxed, industrial production is likely to rebound in Q3 (+14,7%) and Q4 (+2.7%) from its currently very low level.

FIGURE 2 | Eurozone GDP Growth

Seasonally and working day adjusted



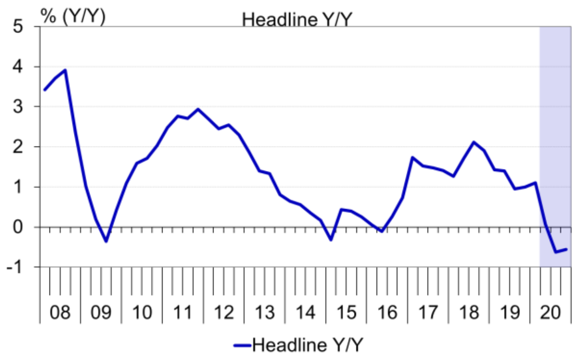
Source: Eurostat and Ifo-KOF Forecasts

In contrast to previous recessions, not only industrial production has been declining sharply, but also production in the service sectors fell massively. Overall, the eurozone economy is likely to see a sharp recession in the first half of 2020. GDP already contracted in Q1 by 3.6%. In Q2, the decline of GDP is forecast to be historic (-12.3%). On the other hand, the recovery is likely to be quick supported by massive stimuli in some eurozone countries with GDP growth reaching +8.3% in Q3 and +2.8% in Q4 2020. Yet, the GDP level at the end of last year will not be reached by the end of this year.

On the demand-side, private consumption is expected to fall further in Q2 by 11.8% and to rebound in the second half of the year. At the end of the year, the level of consumption is likely to be still clearly below the level of Q4 2019. Gross fixed capital formation is forecast to plunge also in Q2 (-15.4%). It will recover somewhat in the coming two quarters, but weak foreign demand, uncertainty about future prospects and the fragile financial situation of the firms will dampen the rebound.

FIGURE 3 | Eurozone Inflation

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



Source: Eurostat and Ifo-KOF Forecasts

Inflation is likely to turn negative

The Brent oil price has recovered slightly from its very low levels at the end of April to around 40 USD per barrel currently. Yet, as this price is still clearly below the price of one year ago, the energy price component is pulling headline inflation down currently. Because of the current capacity underutilization, core inflation is expected to fall as well. On the other hand, there might be price increases for some goods and services due to supply issues related to the containment measures, however, these are likely to have comparatively small effects on headline inflation.

Headline Inflation is likely to record at 0.1% (year-on-year) in Q2 2020. In the second half of the year, inflation will further decelerate down to -0.6% in Q3 and Q4, respectively. The inflation forecast assumes a stable oil price and a stable USD/EUR exchange rate at 1.11 over the forecast horizon.

Strong downside risks

Currently, economic projections are made in face of high epidemiologic uncertainty. Not only can the course of the pandemic change quickly, but also the governmental reactions to it. This forecast assumes that a second COVID-19 wave will be prevented. The occurrence of a second wave, with containment measures to being introduced again, is thus a downward risk for our forecast. On the positive side, many countries will be better prepared for future waves as multiple measures have been or are currently being introduced to decrease the vulnerability, such as availability of health protection equipment, testing capacities and measures to increase hygiene. Another uncertainty for this forecast is that we are still learning about consumer reactions to containment measures and it is still unclear, how quickly consumption behavior will normalize.

In addition, the liquidity situation of many companies is deteriorating rapidly. An unexpectedly high number of insolvencies might disturb the economic recovery and cause bigger than expected problems for the banking sector. Currently, in many countries new regulations for postponing insolvencies were introduced, which means that these will become evident later than usual, probably not before autumn. Also, numerous private households might run into solvency issues due to lower income and a worsening labour market situation.

Table 1 | Forecast Overview

	Q2 20		Q3 20		Q4 20		2020
	q/q	*y/y*	q/q	*y/y*	q/q	*y/y*	
Industrial Production	-18,0	*-22,3*	14,7	*-10,3*	2,7	*-6,8*	-11,3
Gross Domestic Product	-12,3	*-15,1*	8,3	*-8,3*	2,8	*-5,8*	-8,1
Private Consumption Expenditures	-11,8	*-15,4*	9,0	*-8,3*	2,7	*-5,9*	-8,4
Gross Fixed Capital Formation	-15,4	*-19,1*	11,0	*-5,6*	3,8	*-6,7*	-7,7
Headline Inflation	0,6	*0,1*	-0,9	*-0,6*	0,3	*-0,6*	0,0

Change in %, seasonal and working day adjusted

Source: ifo-KOF Forecasts

Methodological note

The Italian National Institute of Statistics Istat was not able to participate in this quarter's forecast.

The forecast results are based on consensus estimates building on common macroeconomic forecast methods by the 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:

- **ifo Institute** Pauliina Sandqvist +49 89 92 24 1239
- **KOF Swiss Economic Institute** Heiner Mikosch +41 44 632 42 33