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EZ Outlook 2021

Aline Schuiling, Senior Economist
aline.schuiling@nl.abnamro.com

Recovery but no reflation

- **The COVID-19 health crisis will continue to dominate the eurozone economy in 2021**
- **Lockdown and social distancing measures during the second wave of the pandemic will push the economy in another recession in the final quarter of 2020 and first quarter of 2021**
- **We expect a strong upswing in the second half of 2021, when lockdown measures are expected to be lifted and economic growth will bounce back**
- **Nevertheless – unlike in the US – the boost from fiscal policy will be moderate over the next two years and spare capacity and labour market slack will remain large**
- **Against this background, underlying inflationary forces are expected to be subdued for a considerable time …**
- **… nevertheless inflation will temporarily jump higher in 2021 on the back of several one-off factors**
- **Monetary policy is expected to stay accommodative throughout 2021 and core government bond yields should remain anchored close to the deposit rate**
- **Government debt will rise to unprecedentedly high levels, but the governments' interest payment capacity will remain healthy**

Double dip to be followed by strong upswing

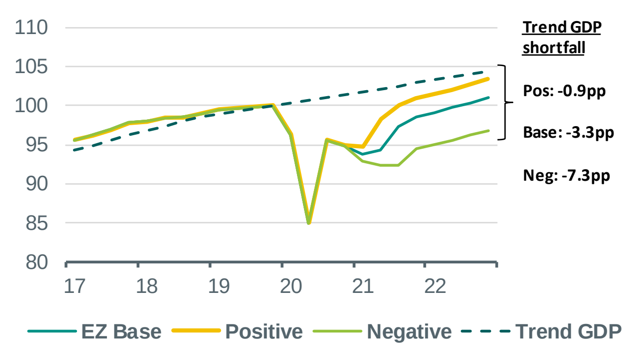
The COVID-19 health crisis has dominated economic developments in the eurozone in 2020 and will continue to do so in 2021. According to the preliminary estimate, GDP contracted by 0.7% qoq in 2020Q4, as governments throughout the eurozone have announced new (partial) lockdown measures as from the middle of October 2020 onwards. We expect another contraction in GDP in 2021Q1, as most eurozone countries have kept lockdown measures largely unchanged since October, while a number of countries has stepped up measures in the final weeks of 2020 (such as Germany and the Netherlands). We have assumed that, on aggregate, lockdowns will not be eased seriously before around the middle of the year, although there might be some tweaking of measures before then. Still, we think that vaccination programmes should have made significant enough progress to allow a significant lifting of restrictions around the start of Q3. As a result, large parts of the services sector, including tourism, will continue to be weighed down until around the middle of the year.

The good news is that the economic contraction during the second wave of the pandemic is much more limited than the collapse in activity during the first wave in 2020H1, and that growth should bounce back sharply in 2021H2. An important difference between the economic impact of the first wave of the pandemic and the second is that global trade and the global industrial sector have continued to recover since the spring of 2020, making up for the losses during 2020H1. Although growth in industry probably slowed down during the second wave of the pandemic, activity in industry still is expected to expand. A second important reason why the drop in GDP is more limited this time around, is that large parts of the services sector still were depressed by social distancing measures when the second wave of the pandemic hit, meaning that the starting point was already less favourable.

Although the components of GDP in Q4 have not yet been published, we expect fixed investment excluding investment in construction to have declined the most, followed by private consumption. This pattern would be roughly the same as during the first wave of the pandemic in 2020Q1-Q2. In contrast to changes during the first wave of the pandemic, net exports, probably contributed positively to growth in the final quarter of 2020, as imports were depressed do to falling domestic demand, while exports grew on the back of the ongoing recovery in global trade and global industrial production. We expect changes in the components of GDP to be roughly reversed during the growth rebound in the second half of 2021. Final domestic demand should rebound sharply (with the exception of investment in construction, which has remained relatively strong during the pandemic), while net exports should reduce overall GDP growth.

EZ GDP: double dip to be followed by sharp rebound

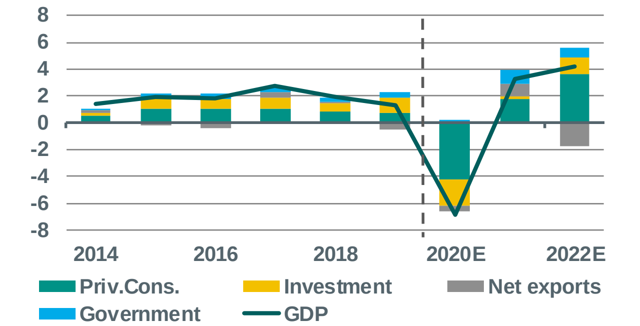
Index, Q4 2019 = 100



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

EZ GDP growth and contribution of main components

% / pps



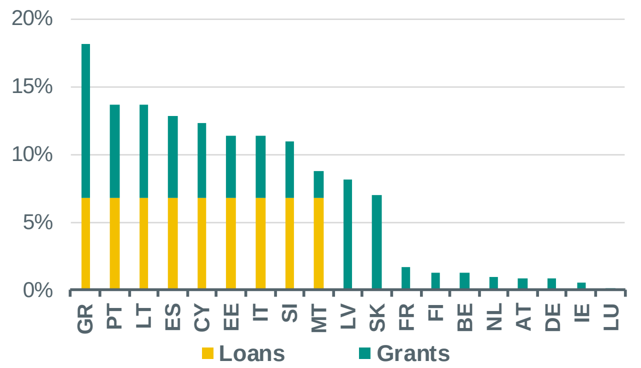
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

As from the middle of this year onwards, GDP growth is expected to jump higher, as lockdown measures should be unwound, while monetary and fiscal policy is expected to remain supportive (see below). In this respect, extra support will also come from the EUR 750bn Next Generation EU (NGEU) instrument, which consists mainly of the European Recovery and Resilience Facility (RRF). The RRF consist of EUR 312.5bn in grants and EUR 360bn in loans, which will be directly distributed to European sovereigns. The remaining EUR 77.5bn of the NGEU funds will be distributed via EU-programmes. The funds will be allocated within the next few years. Member states need to submit national reform plans on 30 April 2021 the latest, and financial support will be disbursed upon completion of the set targets and milestones.

Our estimates are that the periphery (e.g. Greece, Portugal, Spain, Italy) will be supported most by the RRF (see graph below). For instance, as a percentage of GDP, Greece will receive 18%. However, there are several reasons to be cautious on economic growth impact of the RRF. For example, loans will probably be used only by countries that have financial benefit from borrowing via the RRF instead of borrowing in the capital market on their own account. In addition, a significant part of the allocation of the RRF will be used to finance existing plans for government expenditure. We expect the impact of the RRF on economic growth to be around 0.3-0.4% additional annual growth in 2021 and 2022. Taking together both government plans and the stimulus from the recovery fund, the change in the aggregate eurozone fiscal stance points to modest stimulus over our forecast horizon, following last year’s exceptional fiscal expansion. This is in sharp contrast to the US where the fiscal stance looks set to remain incredibly expansionary. For this reason, the output gap remains deeply negative through to the end of 2022 in the eurozone, while it actually closes in the US during the course of next year. As such the US reflation narrative does not really translate well to the eurozone.

RRF: gross grant and loan allocations for EZ countries

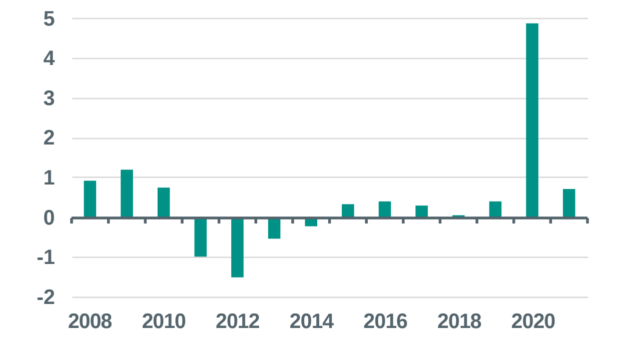
% GDP



Source: ABN AMRO Group Economics, European Commission

Change in the eurozone fiscal policy stance

Change in discretionary fiscal policy, % GDP (+ = stimulus)



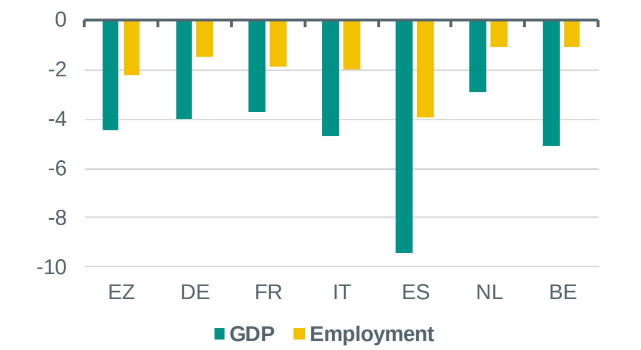
Source: EC, ABN AMRO Group Economics

A large amount of slack has built up in the labour market

One place that slack will become increasingly noticeable is the labour market. The eurozone labour market has deteriorated rapidly during the pandemic, despite the wide use of government subsidised short-time work schemes (STW). STW is designed to allow companies to temporarily reduce the number of working hours of employees (often to zero) while keeping them on the payroll. The government reimburses the companies what they have paid to these employees, which often is around 70-80% of their normal hourly pay. According to the methodology used by national statistics offices, all persons that are in STW are recorded as being employed, even when working zero hours. Despite the use of STW, employment dropped by 2.2% (equal to 3.6 million jobs) during the period 2019Q4-2020Q3.

Change in GDP and employment since end-2019

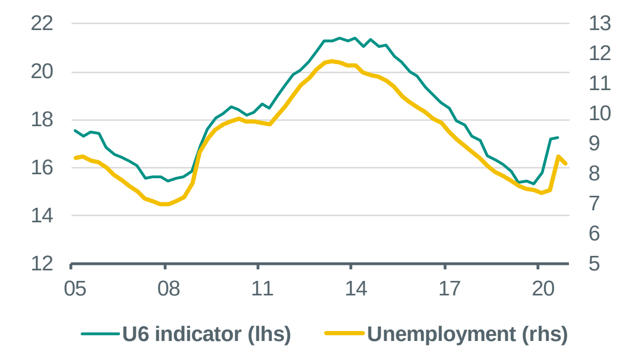
2020Q3 versus 2019Q4, %



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Labour market slack has built up

% of labour force



Source: Eurostat, Thomson Reuters Datastream, ABN Group Economics

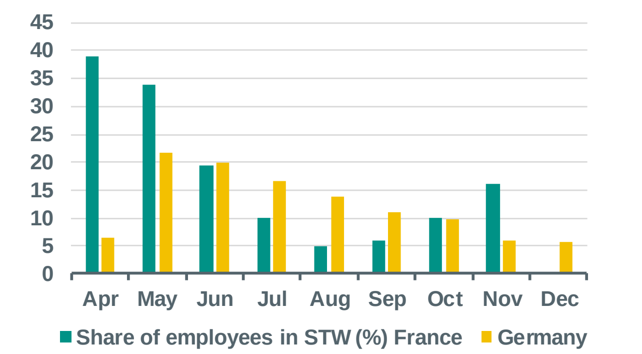
Compared to the drop in employment, the rise in unemployment (by around 1.8 million people) was relatively limited during the first wave of the pandemic. The gap between job losses and the number of unemployed can largely be explained by a 1.1 million rise in the people that have become marginally attached to the labour market during the first three quarters of 2020. These people do not meet the strict criteria for unemployment that is used by the national statistics offices in the eurozone and by Eurostat (people that are without work, *and* are available to start working withing the next two weeks *and* have also actively searched for work in the last four weeks), but are very close to officially being registered as unemployed. Including these marginally attached to the official eurozone unemployment rate would lift the unemployment rate by around 1 percentage point. Finally, slack in the labour market has built up due to the fact that a large number of people have become inactive, meaning that they have withdrawn from the labour market (around 1.7 million people, which is equal to around 1% of the active population). They are a source of future labour supply, which will prevent the labour market from becoming tight when employment growth is picking up.

Unemployment expected to move higher

We expect another drop in employment during the second wave of the pandemic in 2020Q4-2021Q1, when GDP is expected to contract. The unemployment rate will probably rise again during this second wave and extra labour market slack is expected to build up. On top of that, a proportion of the people that are in a STW are at risk of losing their jobs when the government withdraws support as lockdown measures are eased in the second half of 2021. The graphs below show that in Germany and France a significant part of employees still was in STW by the end of 2020. It seems that some part of this reflects hidden unemployment, which will result in a rise in actual unemployment when government subsidy is withdrawn. For instance, industrial production in France and Germany has rebounded sharply after April 2020 and has not been hindered by new lockdown measures since then. In France, manufacturing output was merely 3% below pre-pandemic levels in November and in Germany around 3.5%. Still, in France 19% of all employees in the transportation industry and 15% of employees in other industrial companies still were in STW in November. In Germany 8.5% of all employees in manufacturing still were in STW (see graph below on the right). In Germany's metal industry more than 15% of all employees were in STW in December and in mechanical engineering 15% as well. The fact that STW schemes were still widely used in these parts of Germany's manufacturing sector, suggests that the use of the STW represents some hidden unemployment. All in all, we expect the unemployment rate to rise to around 10% by the end of 2021.

Share of employees in STW

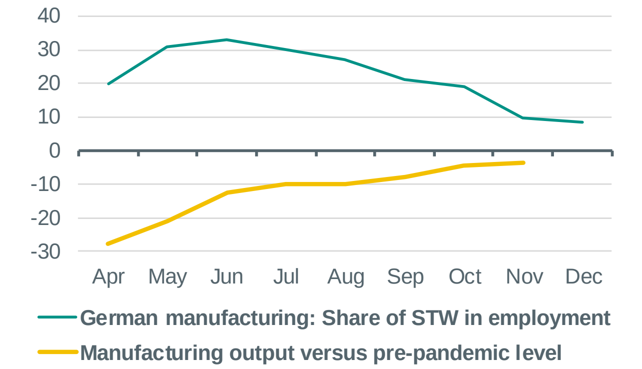
%



Source: Ifo Institute, DARES

Germany: STW in manufacturing and production

% of employees / % change



Source: Thomson Reuters Datastream, Ifo Institute

As reductions in labour market slack tend to be sluggish compared to recoveries in economic activity due to hysteresis effects, it will take a while before slack in the labour market diminishes. This will probably keep wage growth subdued in the next few years.

Inflation to jump higher in 2021 but remain subdued in the medium term

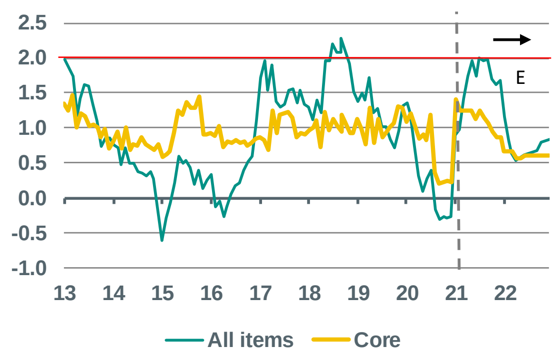
The inflation rate in the eurozone moved into negative territory in the second half of 2020. Some temporary factors have had a downward impact on inflation, such as a reduction in VAT rates in a number of countries. Most importantly, Germany's VAT rate was cut between 1 July and 31 December, which has temporarily lowered inflation in Germany by 1.2 percentage points according to estimates by the Bundesbank. But other countries, such as Austria, Belgium and Greece also have temporarily cut VAT rates. All in all, Eurostat has estimated that reductions in indirect taxes have depressed inflation by 0.6 pps in the second half of 2020.

Inflation jumped higher in January 2021. The unwinding of the VAT rate cuts mentioned above has contributed to this jump, but other factors were at play as well. For instance, in Germany a national carbon pricing system for sectors not covered by the EU ETS was introduced. Moreover, inflation may have been pushed higher by the methodology that statistics agencies are using to estimate prices that could not be collected due to lockdown measures. This might have been a particular issue for non-energy goods (their inflation rate jumped to 1.4% in January from -0.5% in December), where the share of imputed prices rose to 18% in January from 5% in December. Finally, inflation could have been lifted because new (preliminary) weights were used in January, to reflect the effect that the pandemic has had on household consumption patterns. This means that items that have seen sharp falls in demand and hence prices have been given a lower weight in the basket of the inflation index, and hence the impact of any given price fall on inflation is less from January onwards. During the remainder of 2021, the acceleration of inflation seems to be far from over. Importantly, energy inflation will shoot higher in the next couple of months due to base effects in oil prices. In addition, we are likely to see further upward pressure from the VAT changes, especially in the summer, due to base effects. Still, working against these upward pressures, will likely be the fading of statistical upward pressures on inflation once lockdowns end and more accurate price collection can resume. All in all, 2021 looks likely to be a year of relatively elevated inflation.

Looking beyond 2021, we think that inflation will decline noticeably again in 2022 as disinflation will re-assert itself as the dominant trend over the 2-3 year horizon. The disinflationary impact of an economic shock usually works with a lag and these effects are probably largely still in the pipeline. More importantly, there remains large amounts of spare capacity in the eurozone economy. Even assuming a strong economic recovery in the second half of the year, the output gap will likely be in the 3% area by the end of 2022. As noted earlier, slack is also building in the eurozone labour market. Our sense is that the ECB is still facing a very significant undershoot of its inflation goal over 2022 and 2023.

Inflation to jump higher in 2021 due to one-off factors

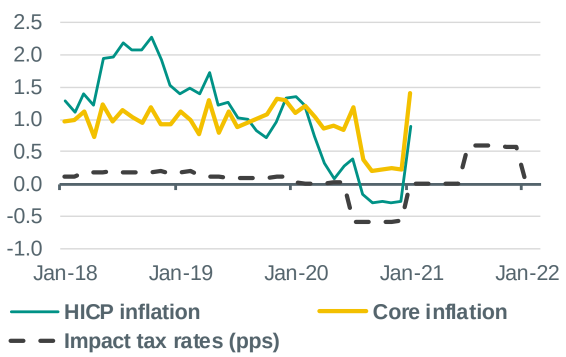
%



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Impact of VAT cuts on inflation to be reversed in 2021

%



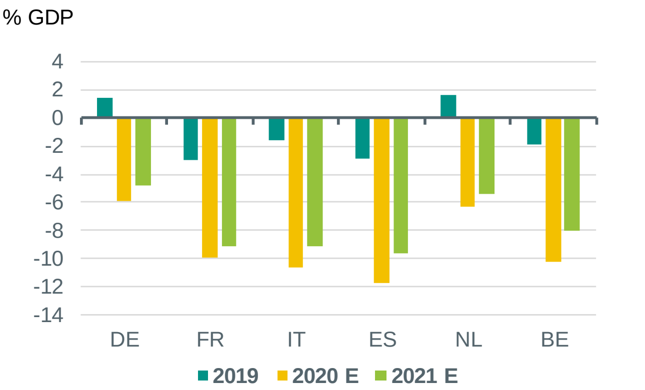
Source: Thomson Reuters Datastream, ABN Amro Group Economics

Government debt to jump higher and remain elevated

The pandemic has had a dramatic impact on the government finances of all eurozone member states. In order to cushion the economic damage from the lockdown measures during the pandemic, all eurozone governments eased fiscal policy dramatically in 2020. Fiscal stimulus has reached to the unprecedented amount of around EUR 750bn in the eurozone Big-6 countries in total. This is equal to more than 8% of aggregated GDP for this group of countries (including discretionary measures as well as the impact of automatic stabilisers). Our estimate for the eurozone aggregate is a deterioration in the government budget balance from -0.6% GDP in 2019 to around -8.7% in 2020.

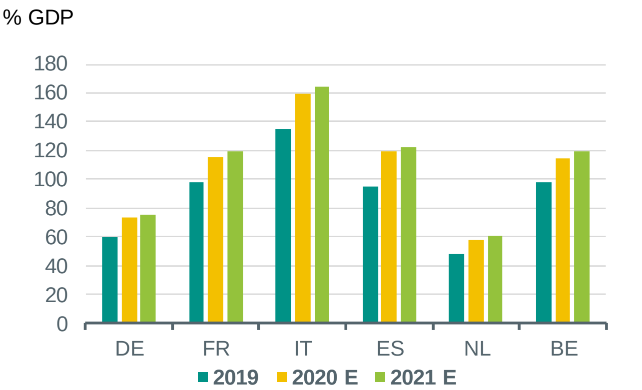
The deterioration in the government budget balance is partly due to cyclical factors. This reflects the working of automatic stabilisers during the economic crisis (lower tax income and higher government spending on social security). The cyclical deterioration of the budget balances is estimated to be around 3.5%. This part will gradually become smaller in the coming years when the economy recovers. The other element of the deterioration in the budget balance in 2020 is more permanent in nature. This part consists of discretionary policy measures (extra spending on health care, income support and tax cuts for households and companies). This part of stimulus will have to be compensated by austerity measures, which will weigh on future economic growth. Besides the fiscal stimulus, a large amount of temporary liquidity support measures, such as tax deferrals, have been granted, as well as bridge loans and government guarantees. These measures should not have a longer lasting impact on government finances. There is a risk though that part of these temporary measures will become more permanent in nature, at which point they will have a longer lasting impact on government debt. Therefore, the risks to the government debt ratios are tilted to the upside.

Government budget balances deteriorating sharply



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Government debt ratios to jump higher



Source: Thomson Reuters Datastream, ABN Amro Group Economics

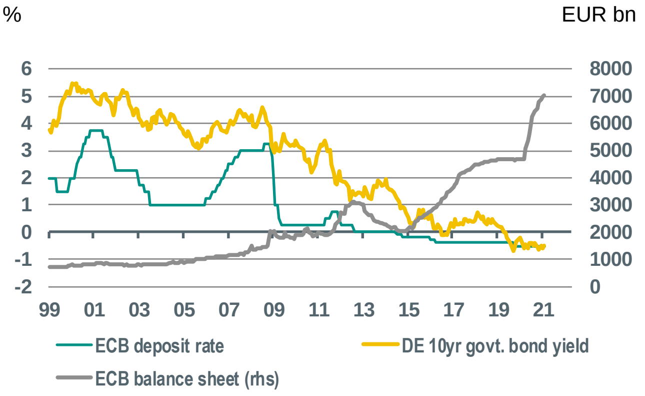
As a result of the rise in the governments' borrowing requirement government debt will jump higher in 2020. On top of that, nominal GDP will have contracted sharply in 2020, implying that government debt as a percentage of GDP will rise even more. We expect the debt ratio of the eurozone aggregate to jump from 86% in 2029 to around 104% in 2020. We expect government debt to remain elevated in the coming years. There will be wide differences in the debt ratios of the individual eurozone member states. The situation in peripheral countries (Greece, Spain, Portugal, Italy) will be the worst for two quite different reasons. In the first place the debt ratios of these countries already were relatively high in 2019, which makes the non-linear longer-term debt dynamics less favourable. Secondly, the economies of these countries were hit relatively hard by the pandemic due to the high dependency on income from tourism. Greece's debt ratio is expected to jump to around 205% in 2020. Italy's will rise to close to 160%, Spain's to 120% and Portugal's debt ratio to around 135%.

ECB policy measures support debt sustainability

The European Commission has loosened its rules for government finances, allowing countries to have higher budget deficits and government debt ratios. Therefore, the vicious circle that emerged during the eurozone crisis of 2011-2012 between the economy and government finances (high government debt, rising bond yields and government interest payments, austerity measures, economic recession, rising government budget deficits, more austerity, deeper recession and so on) have diminished. This makes the current debt situation more sustainable than during the eurozone crisis.

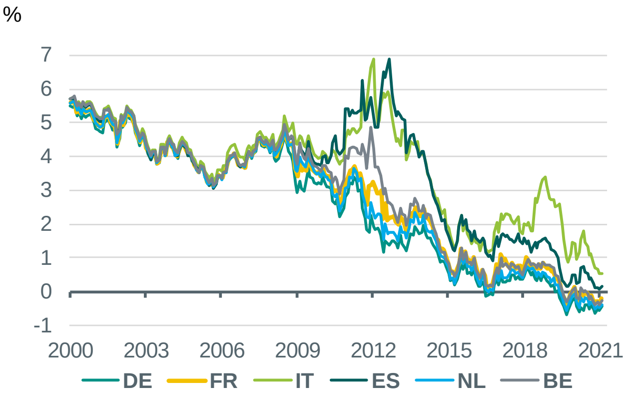
Another, more important, reason why the current debt situation is more sustainable than during the eurozone crisis, is ECB policy. Thanks to the ECB's policy measures the government's interest payments have dropped sharply during the past few years. In the first place by cutting its official policy rates (refi rate to 0.0% and deposit rate to -0.50%). Moreover, government bond yields have been pushed down by the ECB's extensive bond purchase programmes. The APP asset purchase programme was introduced in March 2015 and at the moment amounts to purchases of EUR 20bn per month. On top of that, during the first wave of the pandemic in March 2020, the ECB stepped up its bond purchases and introduced the PEPP (Pandemic Emergency Purchase Programme), which has been raised twice since then (to a total amount of EUR 1.850bn). The PEPP purchases are more flexible than the regular APP purchases and has allowed the central bank to actually target the bond yield levels of specific countries, particularly the bond yield levels of peripheral countries, which have dropped sharply. 10Y government bond yields of peripheral countries have reached record-low levels (Greece 0.8%, Italy 0.5%, Spain and Portugal each close to 0.1%). Finally, debt ratios excluding securities held by the ECB have risen much more moderately than the headline figures. Although debt held by the ECB cannot be ignored permanently, with asset purchases to continue for some time and reinvestments even longer, this is not an issue for the foreseeable future.

ECB policy very accommodative



Source: Thomson Reuters Datastream, ABN Amro Group Economics

10Y Government bond yields at historical lows



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Bond yields are expected to remain subdued for a considerable time. We have calculated that the ECB will be able to buy around EUR 1.1 trillion of net assets under PEPP up to March 2022. On top of this, EUR 240bn will be bought under APP-II in 2021. Moreover, inflation is expected to remain below the ECB's target in 2021-2023, implying that official policy rates will not be hiked. As interest rates are expected to remain low, combined with an expected increase in government tax revenues on the back of the economic recovery, we expect that interest payments as percentage of tax revenues will decline further in the coming years. Therefore, we judge that peripheral debt remains sustainable, despite sharply increasing peripheral debt stock on the back of the pandemic as long as the ECB is in town.

Key forecasts for the Eurozone				
	2019	**2020e**	**2021e**	**2022e**
Economic outlook (% yoy)				
GDP	1.3	-6.8	3.3	4.2
- Private consumption	1.3	-7.9	2.8	5.5
- Fixed Investment	5.7	-9.1	1.3	6.1
- Net exports (contribution pps)	-1.0	-0.8	0.5	-0.7
Inflation	1.2	0.3	1.6	0.7
- Core inflation	1.0	0.7	1.1	0.6
Interest and exchange rates (eop)				
ECB deposit rate	-0.5	-0.5	-0.5	-0.5
3M Euribor rate	-0.4	-0.6	-0.6	-0.6
10yr yield (Bund)	-0.2	-0.6	-0.5	-0.4
EUR/USD	1.12	1.22	1.15	1.10
Brent oil (USD/barrel)	66	52	50	55
Source: ABN AMRO Group Economics				

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