OVERVIEW: REBOUND INTERRUPTED

Resurgence of pandemic deepens uncertainty

The nascent recovery of the European economy has been interrupted by a resurgence of the COVID-19 pandemic…

The COVID-19 pandemic caused an economic crisis unique in its severity. Following the disruptions in the first half of 2020, the initial phase of the economic recovery, helped by unprecedented policy support, was quick to materialise when containment measures were eased across Europe. In recent weeks, however, the resurgence in infections has led to the re-introduction of containment measures in many Member States. These are expected to weigh on economic activity and sentiment in the short run, with negative effects on consumption and investment, though to a lesser extent than in the spring, as the approach so far has been more targeted. Accordingly, after what appears to have been an exceptionally strong rebound in the third quarter, EU GDP growth looks set to stall in the fourth quarter of 2020.

… which means that uncertainty surrounding the outlook remains particularly high.

Beyond the short run, the uncertainty surrounding the outlook will remain elevated as long as the pandemic hangs over the economy. Producing forecasts in these exceptional circumstances is particularly challenging and important technical assumptions have been made. It is assumed that virus containment measures will remain to some degree in force throughout the forecast horizon. After their significant tightening in the fourth quarter of 2020, the stringency of the measures will gradually ease in 2021 and 2022. Moreover, the economic impact of a given level of restrictions is assumed to diminish over time as the health system and economic agents adapt to the

Table 1:

Overview - the autumn 2020 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2020	2021	2022	2020	2021	2022	2020	2021	2022	2020	2021	2022	2020	2021	2022
Belgium	-8.4	4.1	3.5	0.4	1.4	1.6	5.9	7.0	6.2	0.7	0.6	0.4	-11.2	-7.1	-6.3
Germany	-5.6	3.5	2.6	0.4	1.4	1.3	4.0	4.0	3.8	6.2	6.6	6.6	-6.0	-4.0	-2.5
Estonia	-4.6	3.4	3.5	-0.5	1.4	2.1	7.5	7.8	6.7	2.8	2.0	1.2	-5.9	-5.9	-5.1
Ireland	-2.3	2.9	2.6	-0.5	0.3	1.6	5.3	8.9	8.7	5.7	0.2	-1.1	-6.8	-5.8	-2.5
Greece	-9.0	5.0	3.5	-1.3	0.9	1.3	18.0	17.5	16.7	-6.2	-6.4	-4.8	-6.9	-6.3	-3.4
Spain	-12.4	5.4	4.8	-0.2	0.9	1.0	16.7	17.9	17.3	1.8	2.5	2.8	-12.2	-9.6	-8.6
France	-9.4	5.8	3.1	0.5	0.9	1.5	8.5	10.7	10.0	-3.0	-2.8	-1.6	-10.5	-8.3	-6.1
Italy	-9.9	4.1	2.8	-0.1	0.7	1.0	9.9	11.6	11.1	2.9	3.1	2.9	-10.8	-7.8	-6.0
Cyprus	-6.2	3.7	3.0	-0.9	0.9	1.3	8.2	7.8	7.2	-10.4	-10.1	-9.9	-6.1	-2.3	-2.3
Latvia	-5.6	4.9	3.5	0.3	1.3	1.8	8.3	8.0	7.5	2.3	1.2	0.1	-7.4	-3.5	-3.3
Lithuania	-2.2	3.0	2.6	1.3	1.5	1.7	8.9	8.0	6.9	4.6	3.7	2.9	-8.4	-6.0	-2.8
Luxembourg	-4.5	3.9	2.7	0.2	1.5	1.8	6.6	7.1	7.1	0.8	1.2	1.8	-5.1	-1.3	-1.1
Malta	-7.3	3.0	6.2	0.8	1.3	1.6	5.1	4.7	4.1	0.5	0.1	1.4	-9.4	-6.3	-3.9
Netherlands	-5.3	2.2	1.9	1.1	1.3	1.4	4.4	6.4	6.1	8.4	8.0	7.9	-7.2	-5.7	-3.8
Austria	-7.1	4.1	2.5	1.5	1.7	1.7	5.5	5.1	4.9	2.3	2.9	3.2	-9.6	-6.4	-3.7
Portugal	-9.3	5.4	3.5	-0.1	0.9	1.2	8.0	7.7	6.6	-0.9	-0.5	-0.5	-7.3	-4.5	-3.0
Slovenia	-7.1	5.1	3.8	0.0	0.9	1.8	5.0	4.8	4.4	5.0	4.4	3.1	-8.7	-6.4	-5.1
Slovakia	-7.5	4.7	4.3	2.0	0.7	1.4	6.9	7.8	7.1	-3.1	-1.6	-0.9	-9.6	-7.9	-6.0
Finland	-4.3	2.9	2.2	0.4	1.1	1.4	7.9	7.7	7.4	-1.5	-1.2	-1.7	-7.6	-4.8	-3.4
Euro area	**-7.8**	**4.2**	**3.0**	**0.3**	**1.1**	**1.3**	**8.3**	**9.4**	**8.9**	**2.6**	**2.6**	**2.8**	**-8.8**	**-6.4**	**-4.7**
Bulgaria	-5.1	2.6	3.7	1.2	1.4	1.8	5.8	5.6	5.0	3.5	4.0	4.4	-3.0	-3.0	-1.4
Czechia	-6.9	3.1	4.5	3.4	2.3	2.0	2.7	3.3	3.2	-2.3	-2.0	-1.5	-6.2	-4.7	-3.7
Denmark	-3.9	3.5	2.4	0.3	1.1	1.3	6.1	5.8	5.5	6.7	6.8	7.2	-4.2	-2.5	-1.9
Croatia	-9.6	5.7	3.7	0.1	1.2	1.5	7.7	7.5	6.9	-1.7	-0.4	0.3	-6.5	-2.8	-3.2
Hungary	-6.4	4.0	4.5	3.4	3.3	3.0	4.4	4.4	3.9	-1.1	-0.3	-0.3	-8.4	-5.4	-4.3
Poland	-3.6	3.3	3.5	3.6	2.0	3.1	4.0	5.3	4.1	1.8	1.5	1.1	-8.8	-4.2	-3.0
Romania	-5.2	3.3	3.8	2.5	2.5	2.4	5.9	6.2	5.1	-4.6	-4.8	-4.9	-10.3	-11.3	-12.5
Sweden	-3.4	3.3	2.4	0.6	0.8	1.3	8.8	9.2	8.1	4.4	3.9	4.0	-3.9	-2.5	-1.4
EU	**-7.4**	**4.1**	**3.0**	**0.7**	**1.3**	**1.5**	**7.7**	**8.6**	**8.0**	**2.5**	**2.5**	**2.7**	**-8.4**	**-6.1**	**-4.5**
United Kingdom	-10.3	3.3	2.1	0.9	2.3	2.9	5.0	7.3	6.2	-3.1	-2.9	-2.7	-13.4	-9.0	-7.6
China	**2.1**	**7.3**	**5.6**	:	:	:	:	:	:	:	:	:	:	:	:
Japan	-5.5	2.7	0.9	0.1	0.1	0.3	3.1	2.9	2.7	2.3	2.8	2.9	-13.9	-5.6	-3.5
United States	-4.6	3.7	2.5	1.1	1.6	1.8	7.7	6.2	5.4	-3.0	-3.4	-3.2	-15.3	-6.9	-4.7
World	-4.3	4.6	3.6	:	:	:	:	:	:	:	:	:	:	:	:

COVID-19 environment. Given the uncertainty about the future trading relationship between the UK and the EU, it is also assumed, without any prejudice to the outcome of the ongoing negotiations, that the EU and the UK will trade on WTO Most Favoured Nation (MFN) rules from 1 January 2021 onward. This implies a much less beneficial trade relationship with economic costs for the UK, and to a lesser extent, the EU.

Growth is expected to resume but the recovery to remain incomplete…

Under these assumptions, activity is set to pick up again in the first quarter of 2021 but to remain constrained by virus containment measures and the impact of the less beneficial trading relations with the UK. Over the following quarters of 2021, the technical rebound from this year's trough should continue and the gradual decline in the level of stringency assumed should support a pick-up in activity. As these factors lose importance in 2022, economic growth is expected to moderate. Overall, EU GDP is forecast to contract by about 7½% this year before rebounding by 4% in 2021, which is less than previously forecast, and by 3% in 2022. This implies that the output in the European economy would barely return to pre-pandemic levels in 2022.

…with divergences across countries.

The depth of the recession in 2020 and the speed of the recovery in 2021 and 2022 is expected to vary widely across Member States. This does not only reflect differences in the severity of the pandemic and the stringency of containment measures, but also differences in economic structures and domestic policy responses.

Following an unprecedented recession, the global economy is set to bounce back…

The economic impact of the COVID-19 pandemic has not been confined to the EU. Global economic activity plunged into an unprecedented recession in the first half of 2020. Extraordinary macroeconomic policy measures around the world have helped cushion the impact and, together with the relaxation of containment measures, helped to spur a cyclical, though uneven, rebound over the summer. Localised containment measures of differing intensity and timing are assumed to remain in force over the course of 2021, before easing gradually in the remainder of the forecast horizon. As a result, global GDP (excluding the EU) is expected to contract by about 3¾% in 2020, a considerably worse outcome than during the Global Financial Crisis. Supported by the cyclical recovery in private demand and the accommodative macroeconomic policy mix, the global economy (excluding the EU) is forecast to expand by about 4¾% in 2021, and to moderate to about 3¾% in 2022.

…but very unevenly across regions and countries…

In advanced economies outside the EU, the outlook has improved slightly since spring, reflecting the less severe than expected contraction in the first half of the year and the swifter-than-expected recovery, especially in the US. Across these economies, private consumption is set to continue strengthening as labour markets recover and fiscal policies are assumed to remain supportive, but the recovery in investment and trade is expected to be more subdued. China is projected to continue recovering quickly, benefitting from an early end to its lockdown phase at the beginning of the year, increasing foreign demand and targeted policy support. However, in many countries in Latin America, Sub-Saharan Africa and emerging Asia, limited policy space, an uncertain health situation and dwindling foreign currency revenues hinder recovery prospects.

...amid a gradual recovery in global trade.

Global (non-EU) imports are expected to contract sharply by around 10% this year. Following a trough in the second quarter, trade flows have been rebounding on the back of pent-up demand and a rebuilding of inventories. Still, disruptions in global value chains, uncertainty generated by the evolution of the pandemic and possible new containment measures, as well as the lingering trade conflict between the US and China are all projected to weigh on merchandise trade. The recovery in services trade is set to be even slower given the severe impact of containment measures on tourism and travel. Global imports (excluding the EU) are forecast to grow by about 6¼ % in 2021, before slowing to 4% in 2022, under the impact of protracted disruptions to global supply chains and accelerating de-globalisation trends.

Financial markets have held up despite rising risks...

Notwithstanding the recent adjustment in risk premia, financial markets have held up well over the last few months, globally and in the EU, thanks mainly to central banks' massive liquidity provision around the world. The comprehensive monetary policy easing by the US Federal Reserve contributed to an appreciation of the euro against a wide range of currencies. In the euro area, the ECB monetary policy remained highly accommodative, confirming, in September, the continuation of its pandemic emergency purchase programme (PEPP). As a result, bond markets continued to price in low credit and interest risk and equity markets have remained quite resilient despite the COVID-19 related economic damages and the resurgence of the pandemic in Europe. While favourable market-funding conditions are cushioning the economic impact of the pandemic, they also reveal a 'decoupling' of the financial sphere from the real economy.

...with monetary and fiscal policies supporting lending...

Monetary policy and support measures for businesses in Europe have supported bank lending, particularly towards non-financial companies. The increase in bank lending, largely backed by state guarantees, provided vital support to preserve corporate operations and has helped to avoid widespread bankruptcies. However, as banks' risk tolerance has diminished, they may tighten credit standards to enterprises as state guarantees are withdrawn.

...while the resilience of the European banking sector could be tested.

Over the next two years, the health of the banking sector will be crucial for its capacity to provide lending to the economy. European banks entered the COVID-19 crisis with significantly stronger capital positions compared with 2008 but their profitability remains low. As the number of corporate defaults and the volume of non-performing loans are set to rise, particularly in the sectors most affected by the containment measures, bank stocks have underperformed EU equity markets in general. However, the sound liquidity and solvency positions of EU banks should continue to support their ability to provide funding to the domestic economy.

Private consumption is set for a gradual rebound after its fastest drop on record...

The hit on GDP components in the first half of 2020 was broad based. Government consumption, however, played a key stabilising role as public employment was preserved and the acquisition of intermediate goods (e.g. medical supplies) surged. In contrast, the impact of the COVID-19 pandemic on private consumption was particularly severe as consumer spending (in particular on services and durable goods) was heavily disrupted by the spring lockdown that led to an accumulation of forced savings. Despite persisting social distancing measures, private consumption is expected to have recovered ground in the third quarter, fuelled by pent-up demand and policy measures supporting household purchasing power. Still, this bounce-back is expected to be interrupted towards the end of the year amid the resurgence of the pandemic and the introduction of more stringent containment measures. All in all, private consumption is forecast to shrink by more than 8% this year in both the EU and the euro area. This fall will be followed by a relatively strong rebound next year, as households gradually release accumulated savings and adjust their spending patterns to the pandemic reality. Private consumption growth is, however, forecast to moderate in 2022, largely due to lingering uncertainty about job and income prospects which are likely to keep precautionary savings elevated.

… while the recovery in investment should remain incomplete…

Similarly to private consumption, lockdowns and persisting pandemic-related uncertainty weighed heavily on investment, forcing firms to revisit their spending plans and households to postpone or cancel construction projects. After a steep fall in the first half of the year, investment spending is expected to experience a technical rebound in the second half of 2020 supported by the gradual easing of bottlenecks to both supply and demand. Going forward, remaining idle capacity in capital-intensive sectors, lower profitability and elevated uncertainty are expected to weigh on investment intentions. On the other hand, capital spending is set to benefit from highly accommodative monetary policies, increased public investment and targeted government support schemes for firms. Consequently, gradually diminishing economic slack and easing pressure on company profit margins should help relaunch some postponed investment plans. Nevertheless, investment in the EU and the euro area are not expected to remain their pre-pandemic level.

…and net exports contribute little to the economic recovery.

The COVID-19 crisis took a particularly severe toll on the EU and euro area's external trade in the first half of the year as a sudden and synchronised drop in global demand interacted with supply-side constraints due to lockdowns, border closures, travel bans and internal restrictions to mobility. The shock on Member States was further amplified by their high integration in global value chains. Countries with a strong exposure to contact-intensive service sectors, such as tourism and transport saw their exports plummet. As heightened uncertainty, remaining trade tensions and continued restrictions to cross-border mobility and tourism cloud the outlook, foreign demand for European goods and services is forecast to rebound only partially in the forecast horizon. Following a projected contraction by about 11½% in 2020, euro area and EU exports are thus set for a gradual and incomplete recovery over the next two years. As imports are broadly expected to mirror the evolution of exports, the contribution from net exports to growth in the EU and the euro area is expected to be relatively modest over the next two years after being negative this year.

Job retention policies cushioned EU labour markets…

The COVID-19 pandemic has put EU labour markets under severe strain. Job losses during the first half of the year were unprecedented though the decline was much more contained than the drop in economic activity, as was the rise in the unemployment rate. The relatively muted shock on labour markets is largely due to the successful implementation of ambitious policy measures in all Member States, such as short-time work schemes and other support policies to avoid mass lay-offs and large income losses.

…but further adjustment is expected...

A significant amount of labour market slack (on the back of a drop in working hours and workers leaving the labour force) has accumulated since March. As activity resumes, hours worked are set to increase faster than headcount employment. Employment may also encounter further losses when short-time work schemes are discontinued. Also, the reallocation of workers across sectors from the hardest hit activities towards less affected or new ones, is usually a lengthy process as it requires workers to acquire new skills. Headcount employment is therefore expected to decline slightly next year before increasing again in 2022. Despite the expected economic rebound next year, the EU unemployment rate is set to rise further from 7.7% this year to 8.6% next year as workers should progressively re-enter the labour force. It is expected to decline in 2022 to 8.0%. Significant differences in performance between countries are expected to persist over the forecast horizon, reflecting pre-existing vulnerabilities in certain Member States.

…which should exert downward pressure on prices.

A significant fall in energy prices pushed euro area headline inflation into negative territory in August and September. Core inflation, which excludes energy and unprocessed food prices, also dropped substantially during the summer on the back of lower prices for services (especially tourism-related services), but also industrial goods. HICP inflation in the euro area is expected to hover around 0% in the second half of this year and to reach 0.3% on average in 2020. Over the next two years, euro area inflation is set to tick higher but to remain moderate at 1.1% in 2021 and 1.3% in 2022. The assumed stabilisation of oil prices will generate a positive base effect in 2021 but core inflation, while picking up somewhat, is expected to remain subdued. Overall, downward pressures on prices are set to dominate as weak demand, labour market slack and the recent appreciation of the euro should more than offset the upward pressures caused by supply side disruptions.

Public deficit and debt are set to rise sharply…

The euro area’s general government deficit ratio is expected to increase significantly (by around 8 pps.) to 8¾% of GDP this year. This deterioration reflects the operation of automatic stabilisers and the sizeable discretionary fiscal measures put in place to cushion households and firms from the negative impact of the COVID-19 pandemic, against the background of the activation of the general escape clause of the Stability and Growth Pact in March. The deficit ratio is set to ease by around 2½ pps. in 2021 and by 1½ pps. in 2022 under a no-policy-change assumption. In 2021 this reflects the unwinding of pandemic-related emergency measures, as well as the expected rebound in economic activity. Mirroring the spike in deficits, the euro area aggregate debt-to-GDP ratio is projected to jump by around 15pps. this year, reaching nearly 102%, and continue rising by around 1 pp. cumulatively over 2021 and 2022.

…amid a very expansionary fiscal stance this year.

The fiscal stance for the euro area is projected to be strongly expansionary in 2020 due to the sizeable emergency fiscal measures taken by Member States. These measures are assumed to be phased out gradually in the course of 2021 under a no-policy-change assumption. Monetary policy is set to remain broadly accommodative over the entire forecast horizon. The ECB’s continuation of easing measures (e.g. asset purchases) combined with subdued inflation expectations are assumed to keep real long and short-term interest rates negative.

Uncertainties and risks remain exceptionally large.

There is an elevated degree of uncertainty surrounding the economic outlook related to the evolution of the pandemic, as well as policy responses and behavioural changes by economic agents. Many risks to the outlook are related to these uncertainties.

Principally, the pandemic could become more severe and last longer than assumed in this forecast, requiring more stringent and protracted containment measures in 2021. The economic implications of this would be clearly more negative in terms of lower growth and higher unemployment than forecast in the baseline. The pandemic could also leave deeper scars on the EU economy than incorporated in this forecast. These could come primarily from higher numbers of corporate bankruptcies and hysteresis effects on labour markets. As an open economy, the EU economy would be particularly affected if the global economy were to turn out weaker, and disruptions in global value chains more severe, than expected due to adverse development in the pandemic and increased trade tensions. Finally, the possibility of financial market stress cannot be excluded in the euro area and the rest of the EU. In particular, the banking sector could be tested by markets as higher corporate defaults would lead to an increase in non-performing loans.

On the upside, faster medical advances in the treatment and prevention of COVID-19, including a fast and widespread deployment of a vaccine, would accelerate the relaxation of distancing measures, improve confidence and result in a quicker return to a more normal economic situation. Moreover, a trade agreement between the EU and the UK would exert a positive impact on economic activity in the EU from 2021, as compared to the forecast baseline of the UK and EU trading based on WTO Most Favoured Nation (MFN) rules. Last but not least, the Next Generation EU programme, including its Recovery and Resilience Facility, could provide a stronger boost to the EU economy, as the likely benefits of this powerful EU policy response could only be partially incorporated into the autumn forecast.