Leibniz Institute for Economic Research at the University of Munich

KOF Swiss Economic Institute

Eurozone economic outlook

April 9th, 2020

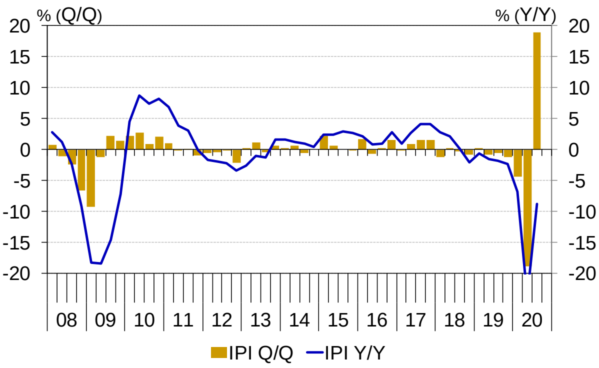
Eurozone slides into Recession

- *Measures to contain and slow the spread of the respiratory disease COVID-19 have a drastic impact on the global economy. Economic activity is projected to decline sharply in the first half of 2020.*
- *A massive drop in oil prices, weak demand and deteriorating labor market conditions are likely to stifle inflation.*
- *Structural problems and systemic downside risks increase substantially if containment measures are necessary for an extended period of time.*

Production declines sharply

The coronavirus pandemic is an unprecedented shock to the global economy. Governments have reacted swiftly by imposing lockdowns, quarantines, closures of companies and travel restrictions. This has led to production shortfalls, delivery bottlenecks and interrupted value chains worldwide. The pandemic weighs also heavily on demand since many private households restrict their consumption or postpone it into the future; out of fear of contagion or due to recommendations by the authorities. The resulting effects on the economy are difficult to quantify and subject to large uncertainty.

FIGURE 1 | Eurozone Industrial Production Index
Seasonally and working day adjusted

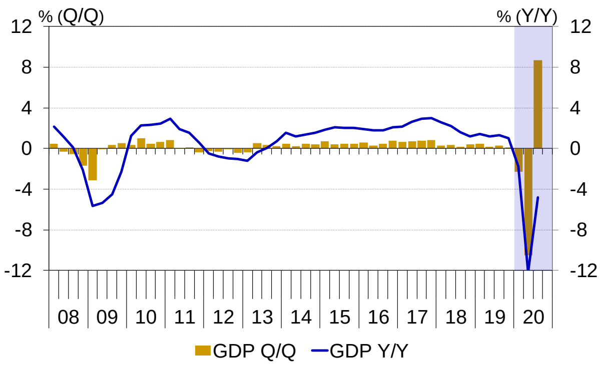


Source: Eurostat and Ifo-Istat-KOF Forecasts

Available coinciding and leading indicators for the euro area point towards a rapid deterioration of the current economic situation. The European Commission's economic sentiment indicator registered the strongest monthly decline on record, from just above its long-term average of 100 in February to 94 in March. This reflects tumbling consumer confidence as well as falling production and demand expectations in manufacturing, retail trade and services. The composite purchasing manager's index confirms this broad picture with a massive contraction from just above the growth threshold of 50 points in February to 31 in March. Both indicators collected survey responses in March before strict containment measures were enacted, which means a further deterioration can be expected.

At the beginning of this year, manufacturing in the euro area was about to recover from a prolonged slump in 2019. However, because of disruptions caused by the outbreak of the pandemic in many countries in the euro area, industrial production is expected to decline with -4% in Q1 2020, followed by a further drop of -18% in Q2. Based on the assumption that containment measures can be relaxed in summer, industrial production is expected to recover quickly in Q3 with +19% quarter-on-quarter.

FIGURE 2 | Eurozone GDP Growth
Seasonally and working day adjusted



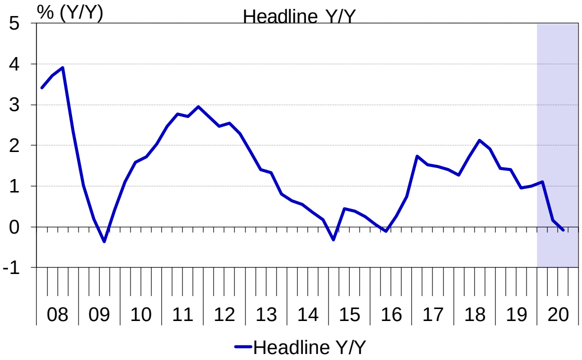
Source: Eurostat and Ifo-KOF Forecasts

The economy in the euro area is expected to slide into a deep recession in the first half of 2020. GDP growth is forecast to be -2% in Q1 and -10% in Q2, followed by a recovery in Q3 with +8%. Due to the lack of comparable events in the last decades and the unpredictable course of the pandemic, these estimates are subject to substantial uncertainty.

From a demand-side perspective, private consumption is likely to be the main drag on growth. Consumption is expected to fall with -3% and -14% in Q1 and Q2, respectively, before it will recover partially in Q3 (+12%). Gross fixed capital formation is also certain to decline, with -2% in Q1 and -10% in Q2, due to supply disruptions, planning uncertainty and a preference for liquidity. With uncertainty easing, Q3 should see a rebound of +10%. Government consumption will add to growth because of containment measures against COVID-19 and massive fiscal stimuli in many countries. Foreign demand is likely to contribute negatively to growth, as a result of the euro area's exposure to recessive international trade and a struggling global economy.

FIGURE 3 | Eurozone Inflation

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



Source: Eurostat and Ifo-KOF Forecasts

Price changes reach deflationary territory

Declining demand has led to a heavy plunge in oil prices, reinforced by the collapse of an agreement by OPEC and Russia to support the market by limiting production. Brent oil prices dropped from almost 70 USD per barrel at the beginning of the year to 23 USD by the end of March. In addition, core inflation is likely to fall as a result of deteriorating labor market conditions and weak demand for most goods and services. While there may be price increases for certain goods and services due to supply issues, they are unlikely to have a significant impact on overall consumer price developments.

Year-on-year, headline inflation is expected to remain at +1.1% in Q1 2020, before decelerating to +0.2% in Q2 and -0.1% in Q3. The inflation forecast assumes a gradual recovery of the Brent oil price to about 40 USD and a stable USD/EUR exchange rate at 1.10 over the forecast horizon.

Systemic risks flare up

These economic projections are subject to great uncertainty. The possibility of the pandemic receding sooner than anticipated is small, in particular since treatment is so far largely symptomatic and a vaccine will probably not be available within the forecasting horizon. The risks to the economic projections are therefore clearly tilted to the downside.

A more unfavorable course of the pandemic would require longer and possibly stricter containment measures, which could constrain production and compromise global supply chains even further. Despite massive liquidity provision by governments and central banks, a prolonged downturn would then lead to liquidity strains in the economy. Increased debt levels associated with low income flows and asset devaluations are likely to lead to solvency issues for thinly capitalized corporations and private households. An ensuing rise in loan defaults could in turn lead to problems in the banking sector.

This downward spiral could be accelerated by a loss of public trust in the ability of governments to provide the necessary liquidity and maintaining sustainable debt levels. In the euro area, this may be a threat for countries such as Italy and Spain. They have just recovered from the sovereign debt crisis and are now strongly affected by the coronavirus pandemic. A resurgence of the European debt crisis on a large scale thus constitutes a non-negligible risk to the forecast.

Table 1 | Forecast Overview

	2019	Q1 20		Q2 20		Q3 20	
		q/q	y/y	q/q	y/y	q/q	y/y
Industrial Production	-1,6	-4,4	*-6,8*	-18,0	*-23,0*	19,0	*-7,8*
Gross Domestic Product	1,2	-2,3	*-1,7*	-10,5	*-12,2*	8,7	*-4,8*
Private Consumption Expenditures	1,3	-3,3	*-2,5*	-13,6	*-15,9*	12,0	*-6,3*
Gross Fixed Capital Formation	5,5	-2,3	*2,9*	-10,0	*-11,8*	10,4	*1,2*
Headline Inflation	1,2	-0,6	*1,1*	0,7	*0,2*	-0,4	*-0,1*

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** Stefan Lautenbacher +49 89 92 24 1265
- **KOF Swiss Economic Institute** Florian Eckert +41 44 632 29 80