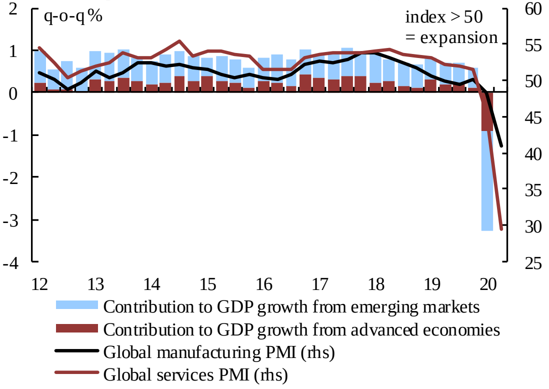
1. EURO AREA AND EU OUTLOOK

1.1. AN UNEVEN RECOVERY FOR THE GLOBAL ECONOMY

The COVID-19 pandemic and the confinement measures taken to limit its spread have caused a sharp slump in the global economy. The progressive spread of the virus earlier this year prompted authorities around the world to implement restrictions on mobility and public health measures in a bid to flatten the curve of infections and prevent healthcare systems from being overloaded. As a result, real global output (excl. EU) is estimated to have contracted by 3.3% q-o-q in the first quarter, the sharpest fall since WWII. China led the global decline, as all non-essential business activity in large parts of the country nearly froze in January and February. Most major economies also contracted in the first quarter, but to a lesser extent, as in the majority of countries confinement measures and social distancing were imposed only toward the end of the quarter. The slump in domestic demand in China together with increasing uncertainty about the economic outlook, extreme financial market volatility and the collapse in commodity prices, all further contributed to the abrupt downturn in the global economy.

The collapse in economic output is likely to be even deeper in the second quarter, reflecting the spread of the pandemic and the corresponding intensification of containment measures. Business activity is likely to have reached a trough in April when the global composite PMI fell to an all-time low of 26.2 (see Graph 1.1). Employment levels have also fallen at record rates. An estimated 160 million jobs were lost in March and April cumulatively across the non-EU G20 countries, with low-wage employment disproportionately affected across emerging markets (mainly in India) and advanced economies (mostly in the US). The downturn in the services sector was particularly fierce, especially in tourism, transport and recreation sectors. Manufacturing output was also severely affected, though less so than the services sector. New export orders plummeted, indicating a fast contraction in global trade. However, a moderate improvement in global activity followed in May as governments began relaxing containment measures to varying degrees and implemented unprecedented fiscal and monetary policy support measures. Activity in China has been recovering particularly swiftly since the relaxation of lockdown measures. Businesses have restarted operations, although capacity utilisation rates remain lower than usual, particularly among SMEs.

Graph 1.1: **Growth in global GDP and global PMIs**



Sources: OECD, IMF and national sources for GDP, JP Morgan/IHS Markit for PMI. 2020 Q2 PMI is the average over April and May.

Nevertheless, the global economic outlook remains subject to extraordinary uncertainty as the pandemic continues to progress, with the number of daily new infections globally still increasing and many containment measures still in force. The number of active cases globally has been growing at an average daily rate of around 1% over the past month. High rates of new infections are increasingly concentrated in a number of emerging market economies and the number of cases in the US has recently re-accelerated. There have also been a number of new localised outbreaks in some

Table 1.1:
International environment

(Annual percentage change)				Summer 2020 interim forecast			*Spring 2020 forecast*		
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	***2019***	***2020***	***2021***
					Real GDP				
World (excl. EU)	3.5	3.9	3.7	**3.0**	**-3.9**	**4.9**	*3.0*	*-2.9*	*5.0*
					Trade volumes				
World (excl. EU) exports of goods and services	1.9	5.6	3.4	**0.4**	**-11.8**	**6.2**	*0.4*	*-11.5*	*6.4*
World (excl. EU) imports of goods and services	1.3	6.0	4.1	**0.1**	**-11.5**	**6.1**	*0.1*	*-10.3*	*6.7*

Asian countries. Overall, efforts to contain the pandemic have succeeded to varying degrees in different parts of the world, increasing the uncertainty about the economic fallout.

Bleaker global outlook as the pandemic hits emerging markets…

The outlook for global growth outside the EU has weakened further since the spring. This is mainly due to sharply deteriorating prospects in a number of emerging markets where COVID-19 infections have risen more than expected and where lockdowns have been stricter and longer. Some countries have also seen a resurgence in new cases. Thus, real global GDP (excluding the EU) is forecast to contract by around 4% in 2020 before bouncing back by 5% in 2021. This implies that by the end of the forecast horizon global GDP should recover to a level above that of 2019 but substantially below that expected before the pandemic. These projections are underpinned by the assumption that the number of active COVID-19 cases globally will remain high but that there will not be any major second wave of infections. A number of public health measures are also assumed to remain in place over the forecast horizon but this does not include any renewal of strict confinement measures.

In the major advanced economies (excl. EU) the economic outlook remains broadly unchanged. In the US, bold monetary and fiscal policies taken in response to the COVID-19 crisis corroborated by recent better-than-expected economic data suggest that a tentative consumer-led recovery has begun. Nevertheless, the increasing rate of new infections in the country is expected to weigh on consumer and business confidence. In Japan, the economic recovery is also taking hold as expected after lockdown measures were ended in late May and an additional fiscal stimulus (3% of GDP) is set to support the rebound in the second half of this year. On the other hand, the prospects of the UK economy have slightly deteriorated, mainly due to pressures on corporate balance sheets and continued uncertainty about both COVID-19 and the future EU-UK trading relationship.

Across emerging markets, the recovery in China is progressing broadly as anticipated, but the outlook in many others has turned bleak. In Latin America and India in particular, the lockdowns imposed by the authorities have been stricter and longer than assumed and economic prospects have deteriorated substantially. In some major EU trading partners (e.g. Russia, Turkey) the recovery has been delayed as well, as authorities have extended their lockdowns in response to a significant rise in COVID-19 cases.

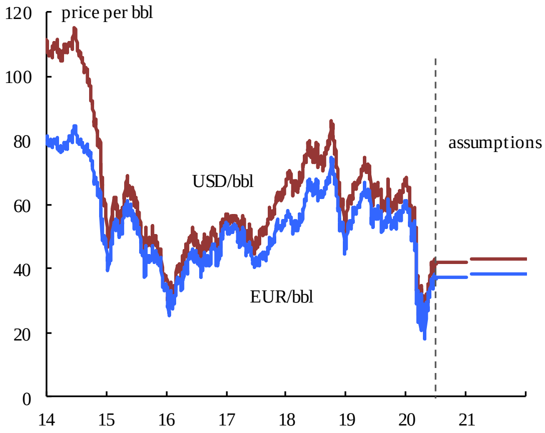
…while the slump in global trade is confirmed…

Global trade has contracted sharply since the beginning of the year, broadly in line with the projections in the spring forecast. The WTO estimates that the volume of merchandise trade in 2020-Q2, when the virus and associated lockdown measures affected a large share of the global population, may have fallen by as much as 18.5%, year-on-year. This is expected to be followed by some rebound in the third quarter. Trade in services has been equally affected and is set to take even longer to recover, especially in the tourism and hospitability sectors. Over the medium term, the pandemic experience may accelerate the recent trend towards re-shoring production. This could shorten supply chains and structurally reduce trade flows, but also efficiency-led long-term investment and the international division of labour. The persistent uncertainty surrounding US trade policies and the functioning of the WTO will also weigh on the rebound in trade. Overall, world imports of goods and services (excluding the EU) are projected to fall sharply by over 11½% in 2020 followed by an incomplete rebound of around 6% in 2021.

… but oil prices have partially recovered.

After some pronounced volatility in oil prices in April, Brent crude prices have partly recovered and stabilised at around USD 40/bbl. On the supply side, the recovery was supported by the sizeable OPEC+ production cut agreement that came into effect on 1 May and which is expected to last until the end of July. Meanwhile, the acute storage capacity exhaustion in April has turned out to be less severe than feared. Over the forecast horizon, upward price pressures are expected to be largely contained as several producers are ready to step up production in case of further price increases. Overall, an average Brent oil price of around USD 42/bbl in 2020 and USD 43/bbl in 2021 is assumed. In euro terms, this would imply an upward revision of around 7% and 4% in 2020 and 2021, respectively, compared to the spring forecast (see Graph 1.2).

Graph 1.2: **Brent oil price assumptions**



1.2. GLOBAL FINANCIAL MARKETS HAVE BEEN ON A POSITIVE TREND SINCE SPRING

After the sharp reassessment of growth prospects and the deterioration of risk sentiment in February and March, global financial markets have been recovering since April on the back of an unprecedented easing of global monetary policy and sizable fiscal support, as well as hopes for a strong economic recovery based on a quick re-opening of economic activities.

The US Fed slashed interest rates aggressively, sharply expanded its balance sheet through asset purchases, and set up several facilities to lend to struggling entities across the economy. As a result, global equity markets have rebounded strongly from their March lows with some indices, particularly in the US, now approaching or surpassing pre-crisis levels, decoupling from a much more gradual recovery in the real economy. At the same time, US bond markets have recovered, as well. In the US, the 10-year Treasury yield has moved sideways over the past few months, while spreads on corporate bonds have compressed as abundant market liquidity has led to a surge in corporate debt from already high levels.

The huge boost to liquidity provision in the advanced economies has spilled over to emerging markets despite the risk posed by still rising infection rates in a number of countries. Lower global interest rates have also provided space for additional rate cuts by emerging market central banks. As a result foreign investors have gradually returned to emerging markets in search of yield, lifting equity prices and compressing long-term yields and corporate spreads. As sentiment improved, the US dollar has weakened, particularly against emerging markets currencies.

Investor sentiment has improved significantly in the EU as well; first in response to monetary easing and bold fiscal policy actions, then following reports that the pandemic had peaked and that Member States were ending their confinement periods, and most recently in the light of some encouraging macroeconomic data.

The ECB has further eased its monetary policy since the spring forecast …

In light of signs that the euro area is facing an unprecedented economic contraction, the ECB has taken additional monetary policy easing measures in recent months to ensure the necessary degree of monetary accommodation and a smooth transmission of monetary policy across sectors and euro area Member States. At its meeting at the end of April, the ECB announced additional liquidity-enhancing measures to support the flow of credit to households and firms. It has further eased the conditions for the targeted longer-term refinancing operations (TLTRO III) and launched a new series of non-targeted pandemic emergency longer-term refinancing operations (PELTROs). This new measure aims to support liquidity conditions in the euro area financial system and to help preserve the smooth functioning of money markets by providing an effective liquidity backstop. At its meeting at the beginning of June, the ECB decided to substantially increase the envelope for the pandemic emergency purchase programme (PEPP) by €600 bn to a total of €1,350 billion to further ease the monetary policy stance in response to the pandemic-related deterioration in its inflation outlook. At the same time, the ECB extended the horizon for net purchases under the PEPP to at least the end of June 2021 and decided to reinvest the maturing principal payments from securities purchased under the PEPP until at least the end of 2022.

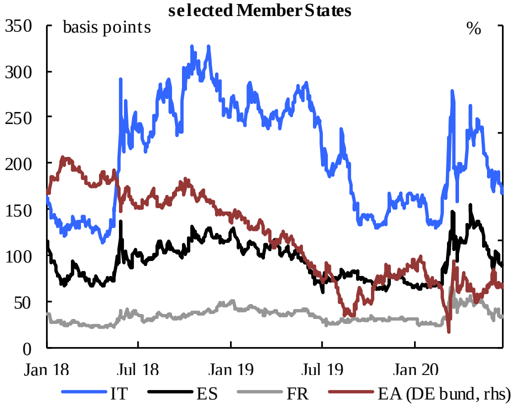
… and the euro has strengthened on the back of improved investor sentiment.

The euro has appreciated by over 2% in nominal effective terms compared to mid-May, reaching its highest level in almost two years at the end of June. This appreciation has been mostly driven by the euro's rise against other major currencies such as the US dollar, the Japanese yen and the Chinese yuan.

Euro area bond and equity markets reflect investors' renewed risk appetite…

Bond yields of the euro area's highest-rated sovereigns have remained broadly in negative territory since late April, trading within a tight range. The benchmark 10-year German bund yield has oscillated between -0.6% and -0.3% over this period. At the same time, sovereign bond spreads of most euro area Member States have narrowed since late April, returning to levels seen in 2019 (see Graph 1.3). This is indicative of investor confidence in this market segment, not least thanks to the ECB's launch of the PEPP in March and the additional measures taken since.

Graph 1.3: **Euro area bond yields and spreads of selected Member States**

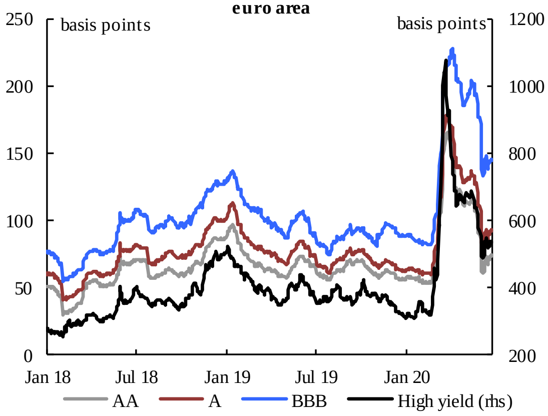


Source: Bloomberg.

A similar narrowing of spreads has taken place on European corporate credit markets since end-April, as the ECB's PEPP and extended APP have also helped this market segment. Spreads have narrowed considerably but remain above their pre-crisis levels. The widespread deterioration of corporate debt quality could imply downgrades of currently BBB-rated bonds to the non-investment grade segment. This concern is reflected in the spreads of BBB-rated corporate bonds, which have narrowed by less than for higher ratings (see Graph 1.4).

Stock markets have also recovered since end-April with broad-based gains across countries and sectors. EU banking stocks have significantly underperformed the broad market over this period, as the sector's low profitability has come under greater pressure from the flattening yield curve and the risk of a new wave of non-performing loans. EU banks, however, entered the crisis with more solid capital buffers than in the 2008 financial crisis, making them more resilient to shocks. Furthermore, they enjoy favourable funding conditions and have taken up significant volumes of central bank funding.

Graph 1.4: **Corporate bond spreads, 5-year maturity, euro area**



Source: Bloomberg.

… while private sector funding has picked up.

Bank lending flows to the private sector remain robust, increasing further to 4.9% annually in May, thanks to a significant pick-up in lending to the corporate sector. The annual growth rate of adjusted loans to non-financial corporations rose to 7.3% in May from 6.6% in April and 3.2% at the start of the year. For households, the annual growth rate of adjusted loans moderated to 3.0% in May from 3.4% in March and 3.7% in January. While the ECB's Bank Lending Survey for the first quarter indicates a slight tightening of credit standards for both enterprises and households, credit provision by banks to corporates has increased since April. To the extent this is driven by emergency liquidity needs and liquidity support measures, the drawing of credit lines and phasing in of government guarantees, the recent increase in bank lending is unlikely to signal corporate investment activity. In parallel, corporate bond issuance has surged for higher-rated borrowers while net equity issuance, though positive, remains very low.

Overall, global financing conditions are expected to remain volatile over the forecast horizon, swayed by economic news and policy measures compounded with fears of further pandemic-driven disruptions. While global equity valuations have recovered and debt markets assume low interest rates for longer, markets remain vulnerable to downward adjustments. In particular, EU equity and corporate bond markets could be undermined by a weaker than expected recovery of corporate earnings and a wave of corporate defaults.

1.3. WARMING UP THE ECONOMY AFTER 'HIBERNATION'

The euro area economy has taken an historic hit…

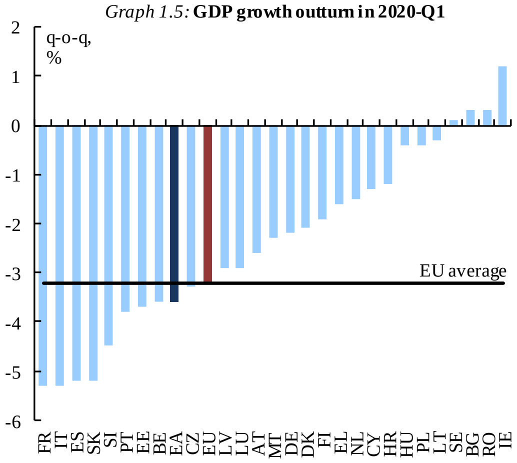
In an effort to flatten the growth curve of infections, stringent lockdown measures were implemented causing a wave of supply and demand shocks hitting the European economy. As the economy was put into what has been described as a state of 'hibernation', the lockdown is reflected in the sharp drop of 45% in mobility between March and mid-May compared to pre-pandemic levels. [1]

The pandemic has resulted in worker absenteeism and factory shutdowns that have reverberated across supply chains. These have been aggravated by the closure of shops, restaurants and other services as a result of containment measures. At the same time, social distancing and reduced person-to-person contacts have weighed on consumer demand through reduced household spending, while uncertainty and concerns about jobs and incomes have led consumers to delay purchases. Uncertainty about sales and profits has also prompted firms to refrain from going ahead with planned investment or entering new ventures. Furthermore, a synchronised global retrenchment has dampened external demand.

The first glimpse into the negative impact on economic output was provided by data from business and consumer surveys in March. The early hit was then fully revealed in the GDP outturn for the first quarter, which confirmed that the European economy had slipped into contraction after almost seven years of uninterrupted growth. Compared to the last quarter of 2019, GDP contracted by 3.6% in the euro area, and fell by 3.2% in the EU. This is consistent with activity levels in the euro area having dropped by about 25% in the last two weeks of March, when the strictest forms of lockdown were imposed across Member States. [2]

Economic disruptions have been broad based across countries. GDP expanded or remained almost unchanged in only four Member States and fell in all others (see Graph 1.5). [3] There were, however, significant differences in the magnitude of the output loss. Among the largest euro area countries, above-average GDP contractions were reported in France, Italy and Spain (at around -5%) while Germany (-2.2%) and the Netherlands (-1.5%) saw smaller hits. Differences across countries can be largely attributed to the different timing and stringency of lockdowns and containment measures, as well as to different economic structures, particularly exposure to tourism and services reliant on person-to-person contact.

Graph 1.5: **GDP growth outturn in 2020-Q1**



…with no sector spared…

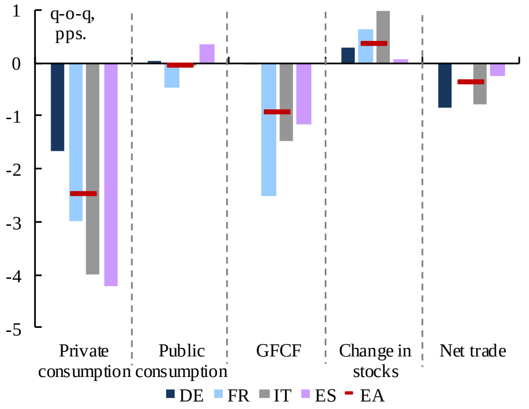
In the euro area, private consumption took the greatest hit in the first quarter, decreasing by 4.7% (q-o-q). While the consumption of both durable and non-durable goods fell, the former saw the sharpest drop. Investment spending also contracted, declining by 4.3%, with construction falling the most compared to other investment categories. The picture is, however, somewhat varied across the largest euro area countries, with construction picking-up strongly in Germany and the Netherlands thanks to a good start of the year, while falling significantly in France, Spain and Italy. Government consumption declined much more mildly (-0.4%). With exports falling more significantly than imports, net trade subtracted about 0.4 pps. from growth, while inventories started to pile up (see Graph 1.6).

[1] Google mobility index accounting for the average length of stay in retail and recreation activities, groceries, pharmacies, transit stations, residency and at work.

[2] Estimation assuming that the level of economic activity in 11 of 13 weeks was similar to that of end-2019. For a similar approach see Banco de España (2020). 'The initial economic impact of the health crisis and the lockdown measures on the euro area countries'. *Economic Bulletin 2*, Box 3, June.

[3] Among these, Germany, France and Italy have by now recorded two consecutive quarters of contraction, thereby entering into a technical recession.

Graph 1.6: **Contributions to GDP growth, EA and selected Member States, 2020-Q1**



The impact has also been highly asymmetrical among industries. The sharpest declines were observed in trade, transport, accommodation and food services as well as arts, entertainment and other service activities (both at -6.8% q-o-q). Agriculture, forestry and fishing, together with financial and insurance activities saw the mildest declines (at -0.8%).

…and strong indications that the second quarter will turn out worse…

While restrictions were being phased out towards the end of the second quarter, the lockdown occupied a much greater portion of the second quarter than in the first, aggravating the economic fallout. Mobility, pollution and electricity indicators reveal a large reduction of activity over the period between April and mid-May. The extent of the damage is already visible in more standard hard and soft data.

Retail spending in April fell by 11.7% in the euro area, a testament to the strict restrictions during the month after a similar decline in March. The euro area average, however, hides significant differences among countries. Sales in April were about 30% below their February readings in France, Italy and Spain, compared to about 10% below in Germany.

Commission surveys hint at a significant piling-up of involuntary or 'forced' savings, rather than precautionary savings. This is suggested by the large divergence between consumers' assessment of their *savings at present* and those for the following year. [4] In the same vein, the ECB's monetary statistics also show a substantial flow into deposits placed by households. These are now growing at their fastest rate since April 2009. [5]

New passenger car registrations fell by 45% in April. Although they rebounded strongly in May, they are still about 50% below their level three months earlier. [6]

Industrial production collapsed by 17.1% in April, resulting in a cumulative contraction of about 27% since February. Output fell in almost all industrial activities. Looking at its breakdown by sector, only two sectors out of 30 managed to pull through with increased output in April. The most affected industries were the manufacture of motor vehicles, trailers and semi-trailers (about -70%), as well as that of leather and related products (around -60%) followed by clothing (around -40%). Most activities saw output contractions of between 15% and 25%.

Euro area *production in construction* fell by 14.6% in April but was highly uneven across countries. While France and Spain both saw production fall by more than one quarter of total output, the reduction in Germany and the Netherlands was only in the single digits.

Overall, these indicators suggests that the euro area economy was operating at between 25-30% below its capacity at the depth of the crisis. Survey results point to a trough in April and a gradual recovery starting in May and gathering pace in June.

The Markit *Purchasing Managers Composite Output Index* (PMI) reached an all-time low in April before showing signs of bottoming-out in May and rising again in June when the flash estimate approached the no-change threshold of 50 (from 13.6, to 31.9 and 47.5 respectively). While it is still consistent with continued output contraction last month, it adds to evidence that the recession has likely moved beyond its trough.

[4] The jump in the French household savings rate (up 4½pps. to 19.6% in 2020-Q1, the highest since 1978) suggests that consumers have funds available to support a rebound in spending in coming months.

[5] From an annual growth rate of 5.7% in January to 7.0% in May.

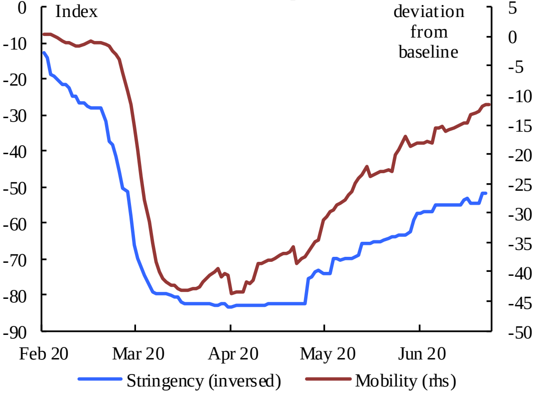
[6] This highlights the postponable nature of durable goods consumption, which usually experiences wider swings compared to households' income. Still, contrary to the consumption of leisure and other 'social' services, which are permanently lost, a fall in the flow of durable goods compared to the desired stock can be expected to build pent-up demand, which will prove supportive in the recovery phase. See ECB (2010). 'Household consumption of durable goods during the last recession'. ECB *Monthly Bulletin*, July.

Similarly, the Commission's *Economic Sentiment Indicator* (ESI) for the euro area hit an all-time low of 64.8 in April but moved up slightly in May and further up in June to 75.7. It is however still well below the 103.4 level seen in February. As expected, the services sector appears to bear the brunt of the hit. The Commission's *services confidence* indicator declined significantly more than industry confidence in April and continued declining in May, while rebounding in June thanks to a second month of rallying demand expectations. By contrast, *industrial confidence* showed stronger signs of improvement on the back of brighter production expectations, which were almost back to their February level in June and which provide a glimmer of hope for the months to come.

…but a gradual turnaround is taking place.

There have been nascent signs of revival since the stringency of containment measures began to ease in May (see Graph 1.7). While on average, euro area *mobility* [7] in the second quarter is estimated at about 30% below its base period level, by the end of June it stood at about -10%, bottoming-out from about -45% towards the end of March.

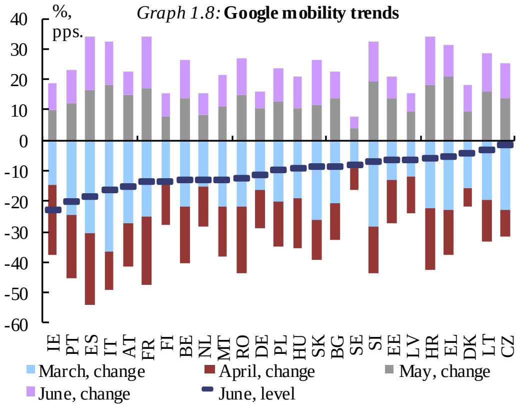
Graph 1.7: **Stringency of restrictions and mobility, euro area composite**



Source: Oxford University, Google.

The enforcement and easing of lockdowns show non-negligible differences across countries (see Graph 1.8). The *stringency index* [8] for instance ranged between 60 in Germany, about 70 in Italy, 75 in Spain and around 80 in France on average between April and mid-June. Mobility levels have been moving in lock-step. While recovering, these were still below their usual levels in June and quite different among Member States: -20% in Ireland, Portugal and Spain, -15% in Italy, Austria and France, compared to about -10% in Germany and close to pre-crisis levels in Czechia.

Graph 1.8: **Google mobility trends**



Note: Distance to base period (Jan 3 - Feb 6), average of daily values.
Source: Google.

Other real time indicators, such as German *truck toll activity* [9] and *pollution levels* [10] in the euro area also hint at a gradual pickup in activity starting in the second half of May. The former fell to a trough of close to -15% during the month of April, compared to the same period in the previous year, started to catch up in May and settled at about -5% in June. Pollution levels also saw their lowest reading in April, falling to about 30% below their minimum over the past four years, but rose significantly in June to only about 10% below. Also *electricity consumption* has increased from April's lows although at a slower pace (see Graph 1.9). [11]

At the same time, the expectations of an economic turnaround continuing in the second half of the year in the euro area are increasing. According to the *ZEW Financial Market Survey*, financial market experts' expectations for euro area economic growth rose for the second time in a

[7] GDP weighted index of 17 euro area countries. Percentage deviation from the base period (for each day of the week, the median between 3 January and 6 February).

[8] As reported by Oxford Government Response Tracker, which collects publicly available information on 17 indicators of government responses.

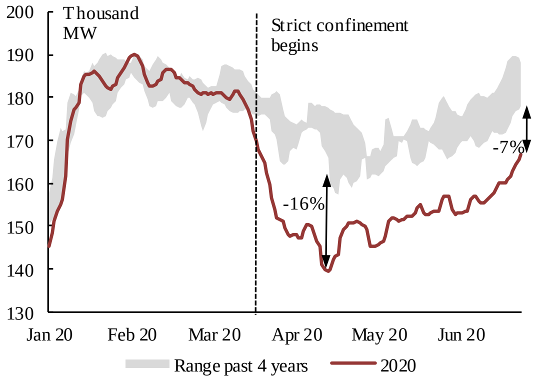
[9] Truck toll data capture the evolution of transport services and thus give insights into the evolution of the country's industrial activity. See Destatis (2020). 'Truck toll mileage index is updated every day for the time being'. *Press release* 129, 9 April.

[10] Measured as average weekly nitrogen dioxide (NO2) concentrations, as published by the European Environment Agency. Calculations consider the average reading across all station types and cities of a given country. Composite based on the GDP-weighted values for DE, FR, IT and ES.

[11] Similarly, the French statistical office estimates that the economy is was operating at about 12% below normal in June, up from 22% in May and 29% in April. See Insee (2020). 'Point de conjoncture'. *Insee conjoncture*, 17 June.

row, climbing to its highest since 2015 in June. In late June, Citigroup's daily *Economic Surprise Index* jumped from an historical low in the first half of May, although it has only recovered about half the ground it has lost since January.

Graph 1.9: **Electricity consumption, euro area**



Note: Temperature adjusted 7-day rolling average.
Source: ENTSO-E, NOAA.

All in all, given that containment measures lasted well into the second quarter and that the easing of containment measures has been gradual rather than sudden, the GDP loss in the second quarter is likely to be a multiple of that recorded in the first. However, the positive signals on the latest indicators provide some hope of a swift recovery in the second half of 2020.

Pent-up demand and government support measures kick-start the recovery…

As highlighted in the spring forecast, economic projections remain subject to more fundamental uncertainty ([12]) than usual. As a result, the present forecast is again based on a larger than usual number of assumptions (e.g. concerning the evolution of the pandemic, the path of containment measures, speed of the rebound).

Importantly, this forecast is based on the assumption that the pandemic has peaked in Europe and that there will not be a major second wave, while at the global level infections continue to spread but not accelerate anymore. It is assumed that the gradual lifting of containment measures will continue to allow the economy to recover at a relatively strong pace. Nonetheless, the dampening impact of mandatory or voluntary social distancing, in particular on services, is taken into account. It is also assumed that fiscal and monetary policy measures announced up to the cut-off date of this forecast are successful in preserving the economic fabric (e.g. products, processes and human capital), thus avoiding large scale bankruptcies and layoffs. Still, insolvencies and destruction of employment is expected across Member States in 2020. ([13]) To cast some light on the effects of changes in these assumptions on the outlook, Box 1.1 presents an update of the model-based scenarios discussed in section I.3 ('*How the pandemic shaped the forecast*') of the spring forecast 2020.

Private consumption in the euro area has fallen sharply in the first half of this year as consumers lacked the opportunity or confidence to spend. At the same time, household income has been partially sheltered by targeted government measures and automatic stabilisers resulting in increased precautionary and forced saving. ([14])

These excess savings, coupled with a rebound in consumer confidence, offer room for consumption to crawl back to some extent over the upcoming quarters. However, in the currently highly uncertain environment, consumer behaviour may take time to normalise, maintaining saving rates at a higher than usual level.

Government consumption is projected to offer the first line of defence against the economic fallout this year and should benefit from exceptional and front-loaded spending. Governments have also enacted or announced a wide range of discretionary policy measures. These come on top of automatic stabilisers and are expected to provide for a countercyclical impulse to growth. ([15])

([12]) Different dimensions of uncertainty reflect the lack of data (e.g. about important parameters of the pandemic such as the true number of infected people), lack of information about the probability of key events (e.g. mutations of the virus, availability of a vaccine) as well as uncertainty about the adequacy of standard economic and econometric tools in the current situation.

([13]) See European Commission (DG ECFIN) (2020). 'European Economic Forecast: Spring 2020'. *Institutional Paper 125*, 8 May.

([14]) On the financial resilience of households, see Zabai, A. (2020). 'How are household finances holding up against the Covid-19 shock?'. *BIS Bulletin* 22. June. Policymakers have enacted a range of measures to alleviate the impact of the shock, including reducing debt burdens (i.e. debt moratoriums and lowering interest rates), unemployment benefits and expanded social protection programmes, salary subsidies (i.e. short-time work schemes) and moratoriums on tax payments.

([15]) Importantly, this forecast takes into account all fiscal packages credibly announced, including the ones announced since the spring forecast. So far, Member States have committed to provide liquidity support for sectors and

After a steep fall in the first half of the year, *investment* is projected to pick up in the second half of 2020, in line with the gradual resumption in activity. However, the recovery in investment is expected to be sluggish given the strong increase in idle capacity [16] and the elevated uncertainty around the outlook for domestic and external demand. [17] This is compounded by liquidity constraints as well as lower profits which may prove existential for many firms. Left with larger debt burdens, distressed firms may sell assets, reduce investment, or go into insolvency.

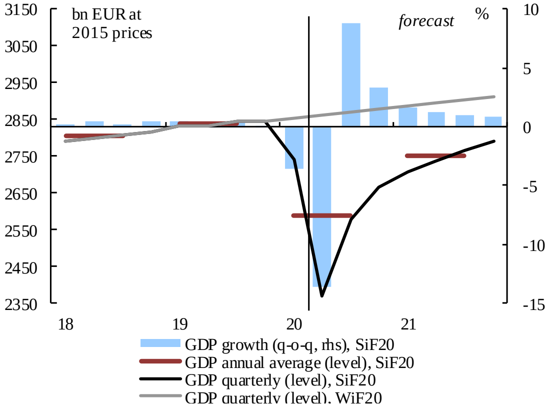
In 2021, investment is expected to grow more quickly than other demand components as expectations brighten, the strain on company profit margins diminishes and capacity utilisation recovers. The recovery should receive significant backing from monetary policy, stepped-up public investment and targeted government support schemes.

Most of the impact of the pandemic on euro area *exports* and *imports* is estimated to have occurred primarily in the first half of this year when demand and supply crashed simultaneously. Starting from the second half of the year, export growth is projected to gain some traction, in line with the expected recovery in major trading partners. But the prospects for a strong catch-up are muted by the severe global aftershocks of the crisis. As the lifting of containment measures follows different patterns in different parts of the world, a swift rebound may be delayed. Also, trade tensions and heightened uncertainty add to the challenges facing a revival in trade. As regards services, the lost output, particularly in travel and tourism, is expected not to be recouped. [18]

Taking all things together, the euro area will experience a technical recession in the first half of this year with an expected cumulative hit of around 17% of GDP. The GDP loss is forecast to be particularly pronounced in the second quarter (-13 ½% q-o-q), a deeper contraction than expected in spring (-12 ¼% q-o-q). A rebound is forecast for the second half of the year, also boosted by supportive discretionary fiscal and regulatory measures.

For 2020 as a whole, the euro area economy is forecast to contract by about 8 ¾%, a deeper contraction than envisaged in the spring. As the shock wears off, a lower starting level in 2020 and a high carry over into 2021 should boost the annual growth rate to about 6%. This results in an incomplete recovery, as it implies that GDP at the end of 2021 will be about 2% smaller than it was before the crisis in 2019 and about 4 ½% below the level forecast in winter (see Graph 1.10).

Graph 1.10: **Real GDP growth path, euro area**



Projections for 2021 are based on a purely technical assumption of status quo in terms of trading relations between the EU and the UK. This is for forecasting purposes only and reflects no anticipation or prediction of the outcome of the negotiations between the EU and the UK on their future relationship.

...which will be gradual and uneven across countries.

While many countries have been pushed into recession by a common shock, the impact on output is heterogeneous. Similarly, countries are likely to emerge from it in an asymmetric way, with a wide dispersion of recovery paths (see Graph 1.11). This reflects the different timing at which containment and social distancing measures were introduced and lifted; the structure of the

companies facing disruptions, consisting of public guarantee schemes and deferred tax payments. These are currently estimated to amount to around 23 ½% of EU GDP. Also, measures with a direct budgetary impact are estimated at about 4½% of GDP. The “Next Generation EU” package proposed by the Commission by contrast is not yet reflected in this forecast as it has not yet been adopted by co-legislators.

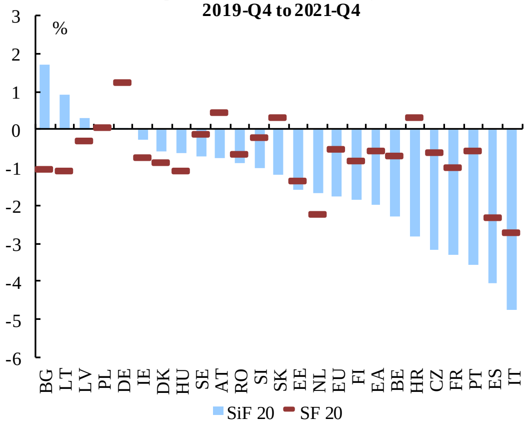
[16] According to Commission’s surveys conducted in April, capacity utilisation in the manufacturing sector is estimated to have dived to 69.7% in the second quarter to close to its historical low of 69.4% in 2009-Q3.

[17] An increased push to repatriate supply chains (‘reshoring’) and undo their fragmentation could increase domestic investment in the near-term but dampen productivity prospects and long-term growth, a key metric for the return on investment.

[18] See Schuler, T. (2020). ‘Impact of the COVID-19 lockdown on trade in travel services’. ECB *Economic Bulletin* 4, June, pp. 46-50.

economy, particularly the importance of tourism and leisure activities; as well as the magnitude and effectiveness of the policy response. Likewise, the shortfall of investment induced by the crisis is set to differ substantially across countries.

Graph 1.11: **Cumulative GDP growth, 2019-Q4 to 2021-Q4**



Over the forecast horizon the recovery is expected to be incomplete in a large majority of euro area countries, as the level of GDP at the end of the last quarter of 2021 is forecast to be inferior to what it was in the last quarter of 2019. Among the largest euro area economies, this difference is forecast at about -4 ¾% in Italy, -4% in Spain and -3 ¼% in France. In Germany, output is forecast to return to its pre-crisis level. However, these considerations only capture one part of the output loss, because in a situation without the pandemic, all Member States had been expected to see positive GDP growth rates throughout the entire period.

1.4. PANDEMIC CAUSES NEW EMPLOYMENT CHALLENGES

In the first half of 2020, the euro area *labour market* underwent a massive deterioration induced by the COVID-19 pandemic and the measures taken to contain it. This has translated essentially into a sharp decline in the number of hours worked. However, the restrictions in the euro area economy since March have yet to fully feed through to employment statistics thanks to the measures taken to contain the COVID-19 impact on labour markets but also due to reporting lags. Although economic activity shrank significantly in the first quarter, employment in the euro area fell by only 0.2% (0.1% in the EU). This is in stark contrast to the normally close link between developments in employment and GDP growth.

The recent increases in *unemployment* have also been small compared to the decline in economic activity. In April 2020, the second month after COVID-19 containment measures were implemented by most Member States, the unemployment rate increased only slightly in the euro area (to 7.3% from the multi-year low of 7.1% in March) and in the EU (from 6.4% to 6.6%). The institutional set-up and some statistical and legal issues explain why the containment measures have not led to larger increases in the unemployment rate and why substantial differences have emerged across countries:

First, extended *short-time work schemes* have played an important role in keeping employees attached to their jobs even in periods without any or with substantially reduced economic activity. This contrasts significantly with several non-EU countries such as the US where temporary lay-offs push employees to register as unemployed. In the EU, the number of persons notified for short-time work have reached unprecedented levels (e.g. in Germany). However, these numbers only indicate how many companies consider the schemes as a precaution and not the actual number of persons receiving short-time allowance, which will remain unknown for some time. In addition, working time accounts and a reduction of overtime hours helped to smoothen the impact of the shock. However, these schemes are not identical in all Member States, which contributes to marked differences. In the future, the EU's new instrument for temporary Support to mitigate Unemployment Risk in an Emergency (SURE) should limit such differences by assisting Member States to cover the costs directly related to the creation or extension of national short-time work schemes.

Second, to be counted as unemployed, a person has to be available to the labour market, which was not possible everywhere during strict lockdowns. Many persons only loosely attached to the labour market were also discouraged from actively seeking a job and therefore did not count as unemployed. This *statistical issue* helps in part to explain why the pandemic initially had a dampening effect on unemployment rates in some cases, such as in France and Italy. In Italy, for example, the unemployment rate fell in April to 6.3% from 8.0% in March, before moving higher in May.

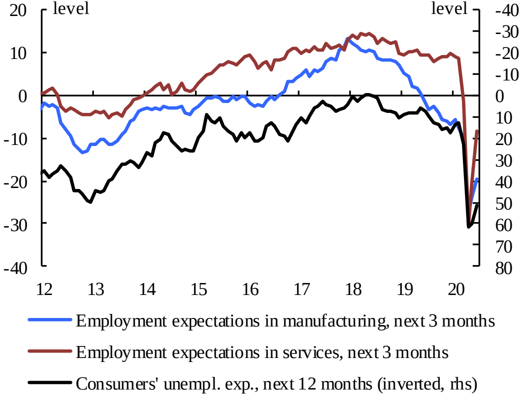
Third, in some countries, legal issues impact on the development of labour market statistics, including unemployment rates. In several Member States, changes in the legal framework of the economy have made lay-offs more difficult or almost impossible. This includes measures that exclude insolvencies for some time or that explicitly forbid companies to lay off staff because of the crisis or during a state of emergency (‘dismissal bans’), as for example in Italy and Spain.

The burden of the labour market deterioration is carried unevenly across labour market categories. Persons employed in relatively unstable low-paid part time jobs felt the development first. The youth unemployment rate has increased more than the overall rate. Self-employed persons have also suffered massively from the shutdowns, whereas those able to work remotely and/or employed in the public sector or critical sectors were less affected.

Forward looking indicators of the labour market signal the impact of the deteriorated economic situation and outlook. In April, the Commission’s Employment Expectations Indicator (EEI) had fallen to all-time troughs in both the euro area and the EU, but started to rebound in May. This pattern, including new all-time lows, was shared by employment expectations in services and retail trade (see Graph 1.12), whereas expectations in manufacturing and construction followed the same directions but did not fall as much as during the Global Financial Crisis. Similarly, consumers’ unemployment fears fell slightly in May and June after a sharp deterioration in April, but remained below historical peaks. Over the coming months, the labour market outlook has the potential to brighten given that many persons in services and retail are expected to return to their jobs as restrictions are progressively eased.

However, a number of factors are expected to slow the labour market’s return to its pre-pandemic situation. Many short-time work subsidy schemes are limited in time and despite recent extensions, the schemes will not indefinitely preserve the employment relationship and support incomes. In the case of a prolonged period of weak economic activity and with an increasing number of firms expected to downsize their activities or go out of business, schemes cannot fully prevent an eventual increase in unemployment. In the second half of the year, a number of companies are likely to see liquidity problems turn into solvency problems that make liquidation or bankruptcy unavoidable. Continued social distancing measures that limit a wide range of services could play a role in this. Without a significant recovery in demand, which depends on the easing of containment measures and therefore on the evolution of the pandemic, it will be difficult to sustain an improvement in labour market indicators over the medium term. Layoffs in the wake of bankruptcies are likely to leave many jobseekers struggling to retain their skills and attachment to the labour market, which does not bode well for the labour market outlook.

Graph 1.12: **Employment expectations, Commission surveys, euro area**



The expected rise in unemployment rates across the EU may prove particularly hard to overcome in those Member States where unemployment was already relatively high before the start of the pandemic, where the economic rebound is expected to be sluggish, or labour markets and social safety nets lack efficiency and effectiveness.

1.5. A QUICK DROP IN INFLATION

Headline inflation fell strongly …

Headline inflation in the euro area, as measured by the Harmonised Index of Consumer Prices (HICP), averaged 1.1% in the first quarter of 2020, but fell quickly to 0.2% in the second quarter as the impact of COVID-19 led to sharp declines in the price of energy and a number of non-essential goods and services. Inflation stood just above zero in May, driven down by a 12% drop in the energy inflation component, and increased marginally to 0.3% in June as the strongly negative impact of the year-on-year fall in oil prices started tapering out. Nonetheless, food price inflation in the second quarter increased notably, particularly for unprocessed food which increased to 7.6% in April and 6.5% in May compared to last year. This category of goods has been affected by supply chain disruptions, shortages of seasonal workers in the agriculture sector and also by demand substitution. In June, food prices started to moderate again although they are likely to remain elevated for the rest of the year.

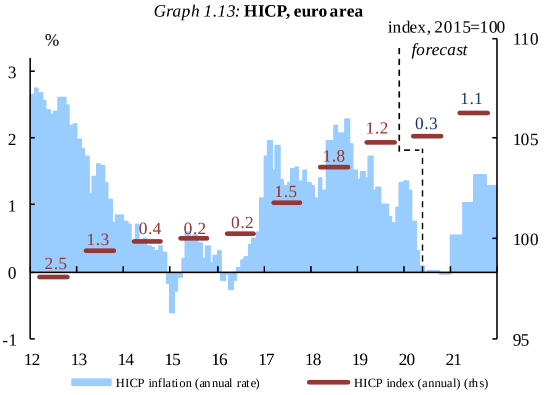
Euro area core inflation (all items excluding energy and unprocessed food) fell slightly to 1.1% in the second quarter after averaging 1.3% in the previous two quarters. Since the prices of many non-essential services have suffered from a lack of data collection since March, it will take several months to see the direct impact of COVID-19 on services inflation. The prices of services related to package holidays and accommodation and those of housing are likely to face further declines.

… and expected to remain depressed in 2020.

The inflation outlook has not changed substantially since spring but there are four important new factors that, overall, are expected to balance each other out. First, oil prices have recovered since May and currently stand above the oil price assumptions of the spring forecast. The decline in energy inflation is henceforth expected to be less negative in 2020. Second, food price inflation came in stronger than expected in the second quarter and will thus have a higher carryover effect for the rest of the year. These two effects will exert an upward push in inflation in 2020.

On the other hand, a number of Member States have announced temporary measures, such as selective reductions in VAT rates or facilitated rent reductions, which should lower the prices of certain categories of goods and services in 2020 with reversed and positive base effects in the second half of 2021. Finally, a weaker economic outlook will continue to exert a downward drag on general price pressures throughout the forecast horizon. Overall, euro area headline inflation is forecast to average 0.3% in 2020 and to increase to 1.1% in 2021 (see Graph 1.13).

Graph 1.13: **HICP, euro area**

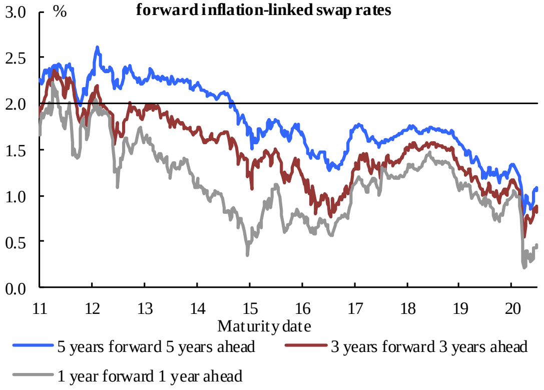


Note: Figures next to horizontal bars are annual inflation rates.

Inflation expectations remain low.

Market-based measures of inflation expectations along the maturity spectrum have recovered somewhat from the low levels recorded in mid-May. This followed a more convincing uptick in energy prices which are closely correlated with inflation expectations. At the cut-off date for this forecast on 30 June, inflation-linked swap rates at the one-year forward one-year-ahead horizon stood at 0.5% (see Graph 1.14). Swap rates at the three-year forward three-years-ahead horizon imply an average inflation of 0.9%. On a longer horizon, the widely watched five-year forward five-years-ahead indicator suggests inflation at just 1.1%, below the ECB's definition of medium-term price stability.

Graph 1.14: **Inflation expectations derived from implied forward inflation-linked swap rates**



Source: Bloomberg.

The latest ECB Survey of Professional Forecasters for the second quarter of 2020 shows HICP inflation expectations standing at 0.4%, 1.2% and 1.4% in 2020, 2021 and 2022, respectively. The figures were revised lower from the previous survey round (from 1.2%, 1.4% and 1.5%, respectively). Longer-term inflation expectations (for 2024) remained at 1.7%.

1.6. PROMINENT RISKS ON THE DOWNSIDE

The *uncertainty surrounding this summer interim forecast* is very high, as the scale and duration of the pandemic remain essentially unknown. There is also uncertainty regarding the duration and scope of the social distancing measures that may be needed after the relaxation of stricter containment measures in recent weeks.

Risks surrounding the growth projections are severe and most of them are on the downside. Major risks concern the total economic impact of COVID-19 on the EU economy, which will depend upon the scale and duration of the pandemic. The summer interim forecast is based on the assumption that the pandemic has exerted its biggest impact in the second quarter of 2020. We assume that containment measures will be gradually eased over the coming months and that there will be no new deterioration that requires strict containment measures to be reintroduced. Such a risk exists though, as the already implemented or announced *relaxations of containment measures could prove premature* and spark another outbreak (‘second wave’) before any treatment or vaccine is available.

The pandemic has inflicted high costs on firms, lowered their cash flows (revenues) and worsened their profit outlook. In the absence of a rapid recovery in demand, corporations may proceed with more widespread lay-offs when the temporary short-time work schemes come to an end. There is a significant risk that the negative impact for labour markets becomes more pronounced than envisaged in the baseline scenario. For most indebted corporates, there is a risk that initial liquidity strains could turn into solvency problems that lead to *default or bankruptcy*. A rise in corporate defaults could prevent companies from restructuring and end up in liquidations with further knock-on effects on employment. This could amplify and lengthen the pandemic shock while raising non-performing loans which would also negatively affect banks, particularly those with high exposures to pandemic-sensitive sectors or the hardest hit countries.

In such a context, financial market turmoil cannot be excluded, particularly given the recent decoupling of developments in financial markets and in the real economy. This would have further negative implications on companies’ access to credit and their funding costs. Frictions in credit markets could lower economic efficiency due to higher costs of capital and/or by capital being misallocated away from its most productive uses. For some sovereigns, the budgetary burden of implemented and planned measures could become more difficult to cope with than currently expected.

The recovery in Europe could still suffer from *insufficiently coordinated national policy responses* and a too limited common response at the EU level. In an environment where demand from the external environment seems out of reach as a substitute for strong domestic demand, this could hamper the rebound, leave deeper scars in the labour market and prolong the period of weak economic activity.

The global economic outlook is subject to exceptionally high uncertainty and risks given the spread of new infections in many countries. It is still impossible to predict the future path of the pandemic and the structural changes it may have on social behaviour, international trade and global value chains. In advanced economies outside the EU, similar risks as in the EU apply, notably insufficient policy response to prevent more permanent layoffs and corporate bankruptcies and a sharp reassessment of financial risks, market volatility and negative feedback effects, further weakening the recovery. This could also result in negative spillovers to emerging and low-income countries via both the financial and trade channels. Renewed capital outflows and currency depreciations in many of these countries risk undermining the stability of their domestic corporate and banking sectors, in the most vulnerable cases putting stress also on sovereign borrowing.

The downside risk of a *stronger-than-expected impact of the pandemic on the EU’s external environment* identified in the spring forecast has somewhat materialised, but a further deterioration cannot be excluded. This could also leave deeper scars than currently assumed in the EU’s external trade of goods and services. Finally, after the UK's exit from the EU at the end of January, the UK entered a transition period, which lasts until the end of 2020. It is possible that the transition period ends without any agreement on the future trading relationship. Even if a trade agreement between the EU and the UK is concluded, the future EU-UK trading relationship will be less beneficial than assumed in the purely technical assumption of an unchanged trading relationship, and will therefore lead to more negative outcomes for both sides, in particular for the UK for which trade with the EU is more important than trade with the UK for the EU. On a broader scale, the return of *protectionist policies* in the global economy could negatively affect trade and economic growth. The same could be said about a too strong re-nationalisation of cross-border production links (“de-globalisation”).

On the upside, a faster than expected availability of a vaccine against COVID-19 would allow social distancing measures to be removed earlier than currently assumed and improve economic conditions. On the policy side, the Commission’s proposal Next Generation EU, if agreed upon, would give a positive impulse to the EU economy, particularly in 2021.

As regards *risks surrounding the inflation outlook*, in the near term, the downside risks to the growth outlook remain the most relevant downside risks. A deeper recession and a slower rebound would negatively influence inflation expectations and limit price pressures. On the upside, a faster-than-expected rebound or a more favourable-than-assumed development in the external environment could push commodity prices up and lift external price pressures but also strengthen the price-setting power of euro area firms.