

1. EURO AREA AND EU OUTLOOK

1.1. INTRODUCTION

New developments since the autumn shape the outlook

Europe is still firmly in the grip of the pandemic. The resurgence in infections in the autumn forced many Member States to reintroduce or tighten containment measures that affect economic activity. More recently, new, more contagious variants of the coronavirus have been spreading around the globe, aggravating the epidemiological situation and leading to renewed lockdowns across the EU.

On the positive side, the breakthrough development of vaccines in the autumn and the start of vaccination campaigns in late 2020 or early 2021 in all Member States has brightened the outlook beyond the near term. Furthermore, the agreement reached between the European Commission and the United Kingdom on the terms of their future cooperation with the European Union reduces the cost of the UK leaving the Single Market and Customs Union, compared to what was assumed in the Autumn Forecast. The Council and the European Parliament reached consensus on the Multiannual Financial Framework and NextGenerationEU and, a few days later, a political agreement on the Recovery and Resilience Facility (RRF) was reached, which will help Member States pave the way to a sustainable recovery. This endorsement of forceful EU policy action has reinforced a strong upside risk for the EU’s economic outlook. Finally, in the summer months, the European economy rebounded more strongly than previously expected, while activity appears to have been relatively resilient in the fourth quarter amid the second wave of the pandemic.

A delayed but stronger recovery

Overall, while the outlook for the near term looks weaker than expected last autumn, growth in the European economy is set to resume this spring and gather momentum in the summer, as progress in vaccinations allows for a gradual unfreezing of economic activity. External demand is also set to support the recovery on the back of an improved outlook for the global economy. These positive forces should allow the EU economy – on

aggregate, though not for all Member States – to reach the pre-crisis level of output within the forecast horizon. Uncertainty and risks surrounding this baseline forecast remain elevated and crucially related to the evolution of the pandemic and the pace, efficiency and effectiveness of vaccination rollout.

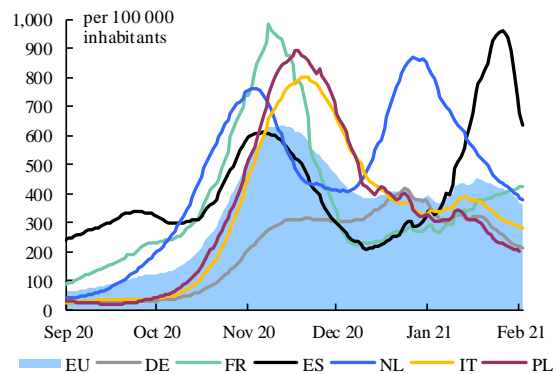
The Winter 2021 Interim Forecast provides an update of the Autumn 2020 Forecast, published on 5 November 2020, focusing on GDP and inflation developments in all EU Member States.

1.2. EVOLUTION OF THE PANDEMIC AND INTERVENTIONS TO STEM IT

The EU is still firmly in the grip of the pandemic

Following a sharp increase in infections to around 640 per 100,000 inhabitants in mid-November, the 14-day incidence of the virus in the EU decreased towards the end of last year and has fluctuated within an elevated range of 350-450 since late December (see Graph 1.1 and 1.2). Still, the situation remains very different and changeable across Member States. In early 2021, the infection’s curve appeared to be getting worse in some Member States (e.g. France, Portugal and Ireland), but improving in others (e.g. Germany, The Netherlands, Italy and Poland). The emergence and subsequent spread of new, more infectious variants of the virus may have contributed to sustaining high infection numbers in recent weeks and is likely to put Member States under further pressure in the short term.

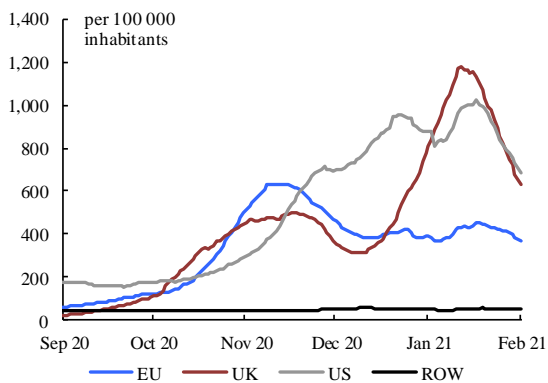
Graph 1.1: Cumulative number of new COVID-19 cases in the last 14 days, EU



Source: WHO.

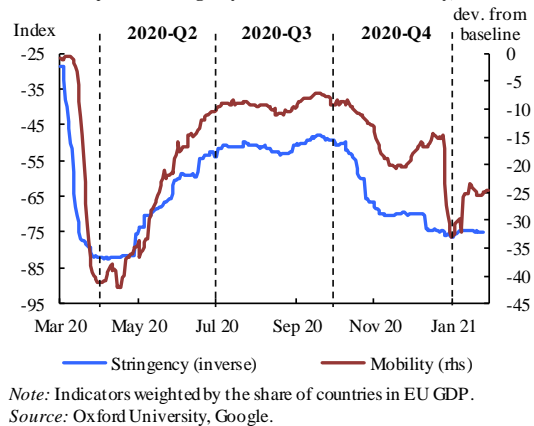
The rise in infection rates in the autumn led to a surge in hospitalisations that has strained the capacity of intensive care units, forcing governments to reintroduce containment measures, restrict cross-border movements or reinstate lockdowns. These interventions, however, have generally been less stringent and more targeted than those imposed in March and April last year. Industry and construction have been largely allowed to operate, while schools and kindergartens have generally remained open, which together with an extensive use of remote working, has prevented the denting of the labour force. At the same time, restrictions on social gatherings and non-essential shopping came at a time of the year when these normally peak due to the festive season, amplifying the economic fallout.

Graph 1.2: Cumulative number of new COVID-19 cases in the last 14 days, international comparison

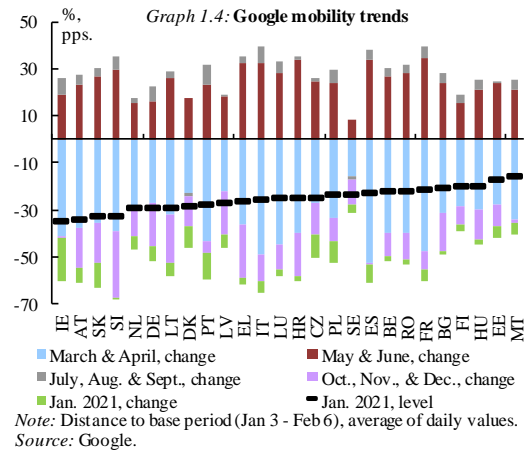


Accordingly, the Oxford Stringency Index showed an increase for the EU in the fourth quarter of 2020 and again in January (to 65.1 and 75.1, respectively), but remained below its April 2020 peak (82.0). Both imposed and self-imposed restrictions led to a sharp fall in mobility, as measured by the Google mobility index (see Graph 1.3). Compared to the period between 3 January and 6 February 2020 - before the outbreak of the pandemic in Europe - average mobility in the EU was about 17% lower in the fourth quarter of 2020, and declined further (to -26%) in January 2021. This compares to -25% and -9% on average in the second and third quarters of last year, respectively. The extent and timing of the decline in mobility varied considerably across Member States (see Graph 1.4). Some countries that had been spared a major surge in infections and hospitalisations in spring last year recorded their largest decline in mobility in the last quarter (e.g. Czechia, The Netherlands).

Graph 1.3: Stringency of restrictions and mobility, EU



Graph 1.4: Google mobility trends



Vaccination underway in the EU

The official rollout of vaccinations in the EU began on 27 December 2020, marking the materialisation of a positive risk highlighted in the Autumn Forecast. So far the European Commission has secured 2.3 billion doses from six different vaccine producers for the use in Member States. Despite some organisational challenges and temporary supply shortages, vaccination campaigns are proceeding across all EU Member States, with the number of vaccinations administered reaching an average of 3 doses per 100 people in early February, with large cross-country differences.

Around the world, the situation and outlook for the pandemic varies by region

Outside the EU, the epidemiological situation varies widely both within and between regions. The increase in infection and mortality rates in both the US and the UK has far outstripped the EU in recent weeks (see Graph 1.2). At the same time,

vaccination campaigns appear to have progressed quickly in both countries, which improves the epidemiological outlook beyond the near term. Asia still shows relatively low aggregate numbers, with China and, to a lesser extent, Japan and South Korea appearing to have effectively contained the spread of the virus, despite some small outbreaks recently. On the other hand, there are signs of an uptick in infection rates in larger Latin American economies and parts of Africa.

1.3. GLOBAL ECONOMY: RECENT DEVELOPMENTS AND OUTLOOK

Swift bounce back after an unprecedented slump of the global economy

Following a severe contraction in the first half of last year, the global economy rebounded strongly in the third quarter, as virus containment measures were eased and aggressive and broad-based policy responses cushioned the impact of the crisis on incomes and kept credit channels open. The Global Composite PMI rose to around 53 points in the fourth quarter of 2020 (up from 52, on average, in the second), signalling expansion, with an improving situation in manufacturing in the US and most emerging market economies. Industrial production grew further in October and November, confirming the strong recovery in the goods sector, even if spending on consumer goods contracted in advanced economies in November as mobility faltered.

Weaker near-term growth due to renewed COVID-19 outbreaks, but overall improved outlook amid stronger policy support

Real GDP growth in the third quarter of 2020 surpassed expectations in a number of economies, which implies an upward revision to the 2020 forecast and a higher carryover for 2021. Conversely, global economic activity at the start of 2021 is likely to have been dented by renewed outbreaks of the pandemic, the widespread

reintroduction of containment measures, and additional uncertainties around the emergence of new variants of the virus. At the same time, vaccination campaigns are progressing in advanced economies, which should help to sever the link between infections and economic activity progressively over the course of the forecast horizon. Moreover, the unprecedented fiscal and monetary stimulus measures that were put in place in several advanced economies in spring 2020 have been reinforced by new stimulus packages in Japan and the US.

Overall, real global GDP (excluding the EU) is projected to have contracted by 3.4% in 2020 and is set to rebound by 5.2% and 3.8% in 2021 and 2022, respectively. Compared to the autumn, the outlook has improved for the major advanced economies and Asian emerging market economies, but remains broadly unchanged for other regions. These projections are underpinned by an assumption that, globally, virus containment measures will remain in place throughout 2021, though they will be eased in the second half of the year in advanced economies and somewhat later in the emerging markets, reflecting the roll-out of vaccination campaigns.

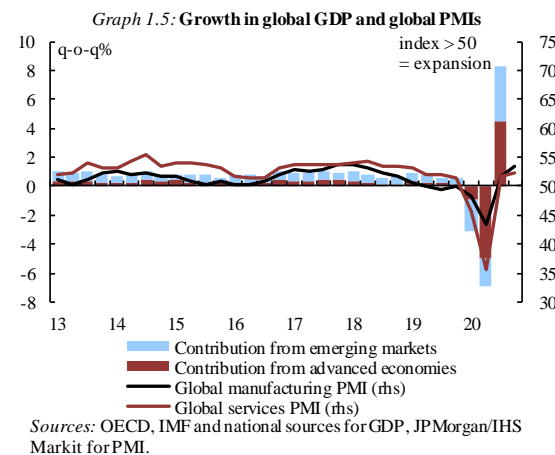


Table 1.1:

International environment

(Annual percentage change)

				Winter 2021 interim forecast			Autumn 2020 forecast		
	2017	2018	2019	2020	2021	2022	2020	2021	2022
Real GDP growth									
World (excl.EU)	3.9	3.7	3.0	-3.4	5.2	3.8	-3.8	4.7	3.7
Trade volumes									
World (excl.EU) exports of goods and services	5.2	3.8	0.2	-9.1	6.5	4.6	-10.5	6.0	4.4
World (excl.EU) imports of goods and services	5.9	4.2	-0.5	-9.4	7.5	4.9	-10.3	6.3	4.1

The global (ex-EU) recovery in trade continues for goods but lags for services

Global (non-EU) trade in goods rebounded strongly in the third quarter of 2020 from a sharp and broad-based contraction in the first half of the year. Momentum is expected to have slowed since then due to the impact of renewed containment measures on global demand and hampered global supply chains. While the new export orders component of the Global Manufacturing PMI came in firmly above 50 points in the fourth quarter, it decreased close to the stagnation threshold in January. Going forward, growth in the global goods trade (excluding the EU) is projected to recover in line with global economic activity and should continue to benefit from the strong uptick in manufacturing activity. By contrast, the recovery of trade in services, after a steep contraction in the first half of 2020, has been subdued, and is forecast to remain so until the restrictions on tourism activities and travel are lifted. Global trade tensions and trade policy uncertainty are likely to continue to weigh on trade over the forecast horizon. Overall, world imports of goods and services (excluding the EU) are forecast to grow by 7.5% in 2021 followed by 4.9% in 2022.

Oil prices shoot up on expanded production cuts

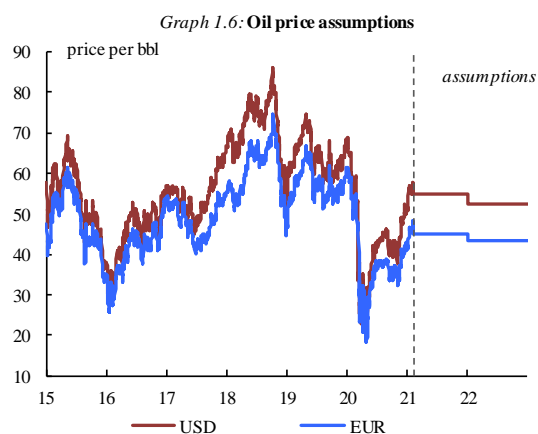
Oil prices have been rising since November 2020 reflecting sharp production cuts by OPEC+, compounded by a reduction of output by other producers, weakening USD, and, recently, the surprise announcement by Saudi Arabia to cut production by an additional 1 million barrels/day in February and March 2021. At the same time, inventories have fallen and demand for oil has recovered somewhat at the end of 2020, though remaining subdued compared to 2019 levels. Against this backdrop, market expectations of oil prices now average USD 54.2 per barrel in 2021 and USD 51.9 per barrel in 2022.

1.4. FINANCIAL MARKETS

Global financial markets have remained on a positive trend since the autumn

Global financial markets recovered further from their trough in March 2020, despite the ongoing pandemic and renewed containment measures

implemented in many regions and particularly in Europe.



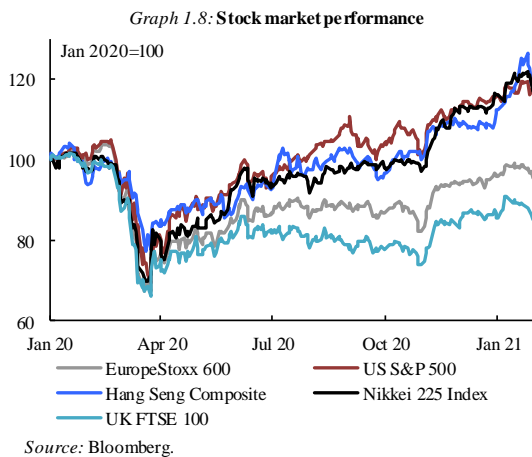
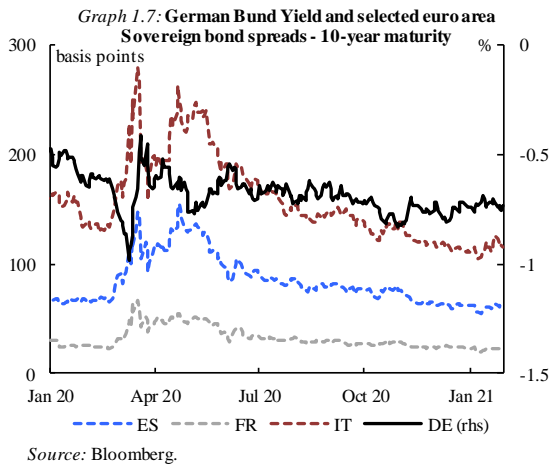
In the US, stock markets have risen well above their pre-pandemic levels, while long-term Treasury yields have increased, driven by the expectation of additional fiscal policy stimulus and an improved economic outlook. Markets have also started to price in a more inflationary environment, as the 10-year Treasury breakeven rates (the difference between the inflation-protected and nominal yields of the same maturity) rose above 2% for the first time since 2018.

The positive news about the breakthrough in vaccines and additional policy support in advanced economies has triggered a rapid rise in emerging market economies' stock markets. Spreads of emerging market sovereign debt have been compressed, particularly among investment grade issuers, driven by the global rotation towards emerging markets' more risky assets. Foreign capital inflows (mainly debt) into emerging market economies recovered rapidly towards the end of the year, in particular into China, while their currencies have strengthened vis-à-vis the USD.

European markets have mirrored global trends...

European stock markets have rallied since November. The announcement of effective vaccines, additional monetary easing and economic data confirming the ongoing industrial recovery in the euro area boosted the Euro Stoxx 50. On the bond markets, the increase in Europe's benchmark yields has been more limited than in the US (e.g. 10-year Bund yields added about 10 bps. over the past three months). Spreads of most euro area Member States vs German bunds have

tightened further in recent months, supported by the agreement reached in December on the Multiannual Financial Framework, NextGenerationEU and the Recovery and Resilience Facility (RRF). On the European corporate bond markets, spreads have narrowed further over the past few months, reaching roughly pre-pandemic levels for all credit ratings.



...also helped by further monetary easing by the ECB...

In response to the expected economic fallout caused by the resurgence of the pandemic in the fourth quarter of 2020, the ECB took a broad set of monetary policy easing measures at its December 2020 meeting. Most notably, the ECB extended the horizon for its net asset purchases under the pandemic emergency purchase programme (PEPP) to at least the end of March 2022 and increased its total envelope by €500bn to €1,850bn. It also extended the duration of reinvestments of maturing securities bought under the PEPP by twelve months, to the end of 2023. Moreover, the ECB

announced additional liquidity-enhancing measures to support the flow of credit to households and firms. In this respect, it prolonged the very favourable conditions of its targeted longer-term refinancing operations (TLTRO III) as well as the duration of the collateral easing measures adopted in April 2020. It also announced three additional TLTRO III operations to be conducted between June and December 2021 and raised the total amount that banks are entitled to borrow in these operations. The ECB also plans to conduct four additional pandemic emergency longer-term refinancing operations (PELTROs) in 2021. These measures should help support liquidity conditions in the euro area financial system and preserve the smooth functioning of money markets by providing an effective liquidity backstop.

The ECB also extended until March 2022 the Eurosystem repo facility (EUREP) and all the bilateral and temporary swap and repo lines set up with EU central banks outside the euro area. These measures have been designed as a precautionary backstop to address possible euro liquidity needs in non-euro area Member States, but also to reduce possible spillovers of market dysfunctions from those economies to euro area bond markets. At the same time, most EU central banks have kept their monetary policies unchanged or taken additional easing measures to ensure that their monetary policies remain sufficiently accommodative to support the economic recovery from the pandemic crisis.

...with the euro stabilising on foreign exchange markets.

At the end of January 2021, the euro was broadly stable in nominal effective terms compared to the autumn. Since then, the euro appreciated against safe haven currencies such as the USD and the Japanese yen in the context of an improvement in global risk sentiment. However, this appreciation was broadly offset by the euro's depreciation against the currencies of major emerging countries, including China, Russia and Turkey, and against the pound sterling following the EU-UK trade and cooperation agreement reached in December.

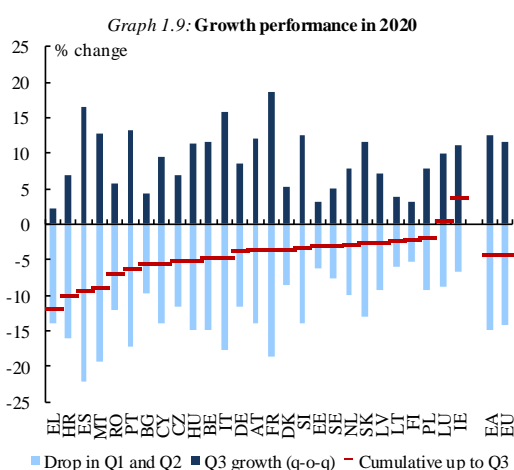
1.5. RECENT ECONOMIC DEVELOPMENTS IN THE EU

1.5.1. Economic growth

The European economy recovered some ground in the third quarter ...

Economic activity bounced back strongly in the third quarter of 2020 as containment measures were lifted, but failed to recover fully. After an unprecedented contraction in the first half of the year, GDP increased by 11.5% (q-o-q) in the EU (12.4% in the euro area) in 2020-Q3, more than expected in the Commission’s Autumn Forecast.

Just as the crisis brought about by the pandemic was broad-based but uneven, so was the bounce-back. Member States that saw activity fall more sharply in the first half of the year, enjoyed stronger increases in the third quarter. While this vigorous rebound helped to close two-thirds of the output loss incurred in the first half of the year, it left real GDP about 4¼% below its pre-crisis levels (2019-Q4) in both the EU and the euro area (see Graph 1.9). The gap compared to pre-crisis levels was highest in Greece (about -12%), Croatia (-10 ¼%), Malta and Spain (both close to 9%), reflecting the stronger reliance of these countries on tourism. It was smallest in Poland (-2%), Finland and Lithuania (both -2 ½%). Only Luxembourg and Ireland reported output levels close to, or higher than, their levels at the end of 2019.



...on the back of strong domestic demand.

The strong outturn in the third quarter was largely driven by private consumption (13.2% q-o-q) and gross fixed capital formation (11.9%). Growth also

benefitted from a strong increase in public consumption (4.3%), as well as from a positive contribution from net exports, while inventories continued to subtract from growth. Private consumption was supported by a reduction in saving, as reflected in the household’s saving rate in the EU, which fell to 16.1% of gross disposable income from 23.4% in the second quarter. However, it still remained well above the pre-crisis levels (11.9% and 15.6% in 2019-Q4 and 2020-Q1, respectively).

Among the GDP components, private consumption remained 4 ½% lower than before the crisis. While durable goods consumption fully recovered, this has not been sufficient to offset shortfalls in other items. Excluding Ireland, the gap in investment spending also stood at -4 ¼% in the EU. Despite a strong rebound in goods exports, services failed to keep pace amid restrictions to travel and tourism (see also Box 1.1).

The performance across sectors was also asymmetrical in the first three quarters of the year. Gross value added in contact-intensive services ⁽¹⁾ remained severely depressed relative to pre-crisis levels (about -10%), despite strong growth in the third quarter. This contrasts with other services and construction (both -3 ¼%), as well as industry (-5%) where the gap was considerably smaller.

Fourth quarter outturn confirms the economy’s resilience to renewed containment measures...

According to Eurostat’s preliminary flash estimate, GDP in the EU contracted by 0.5% (q-o-q) in the fourth quarter of 2020 (0.7% in the euro area), lower than expected in the Commission’s Autumn Forecast, but still relatively benign given the aggravation of the epidemiological situation. While most of the 11 reporting Member States avoided an outright contraction, GDP growth slowed down significantly in all of them compared to the third quarter. Among the largest euro area countries, output fell in Italy (-2.0% q-o-q) and France (-1.3%) but remained broadly stable in Germany (+0.1%) and expanded somewhat in Spain (+0.4%). The relatively mild outturn despite the resurging pandemic contrasts with the sharp contraction in the second quarter when the first wave hit the European economy. First, as

⁽¹⁾ Wholesale and retail trade, transport, accommodation and food service activities, arts, entertainment and recreation.

Box 1.1: An update on the tourism sector: insights from big data

Tourism is a major contributor to the economies of several Member States. This box describes developments in 2020 to identify key patterns that emerged during the pandemic to help assess the sector’s recovery prospects for 2021.

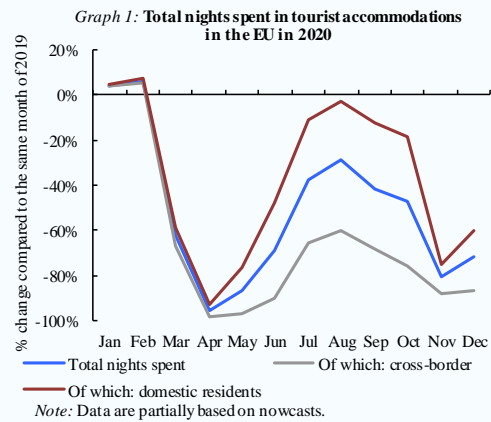
As Eurostat data on nights spent by visitors in 2020 are not yet fully available, this analysis relies on complementary nowcasts of total nights spent per country, for one to sometimes several months (see Table 1). These nowcasts are based on a real-time dataset of 45 million customer reviews for 2.3 million AirBnB holiday listings in the EU, following the methodology presented in the autumn 2020 forecast.⁽¹⁾ These nowcasts also make a distinction between nights spent by domestic tourists and non-residents by using the language of each review as a proxy.

A strong home bias helps to explain differences between countries...

The patterns of nights spent in tourist accommodations closely reflected the first and second major wave of COVID-19 cases in 2020, with some differences (see Graph 1). The decline in nights spent during the first wave was more pronounced and only slightly stronger for cross-border travel than for domestic tourism. During the summer season, tourism recovered some ground to its pre-pandemic levels but then suffered another setback. Over this period, cross-border travel was affected much more strongly than domestic tourism, hinting at a sizeable home bias.

For the EU as a whole, nights spent by domestic residents in 2020 declined by almost 30% compared to 2019. By contrast, those by non-resident tourists declined by about 70%. In 2020 as a whole, cross-border tourism was between 53% (Luxembourg) and 79% (Spain and Romania) lower than in 2019 (see Table 1). Where cross-border tourists mostly rely on car travel (e.g. Croatia, Netherlands), the decline turned out to be less strong than where air travel predominates.

⁽¹⁾ See European Commission (DG ECFIN). (2020). ‘Tourism in pandemic times: an analysis using real-time big data’. European Economic Forecast – Autumn 2020. Special Topic 3.3. Institutional Paper 136 for further methodological explanations.



...with city tourism most heavily affected...

City travel has been much more affected by the crisis than coastal and rural regions (see Graph 2 and Map 1).⁽²⁾ *City tourism*, which normally accounts for about 60% of customer reviews across the EU, contributed the most to the decline in tourism activity in the EU in 2020. In addition to a possible change of preferences, cities have been hit more than other regions due to their reliance on spring and autumn tourism, business travel, short trips, and non-EU visitors. Overall, city tourism was down by about 30% on average compared to expected levels in 2020.⁽³⁾ While several metropolitan areas have been more affected than others (e.g. -80% in Dublin, vs. -55% in Hamburg), the extent of the slump in city tourism contributed strongly to the overall decline in tourism in the respective Member State (see Graph 2).

In contrast, *coastal tourism* performed better, and on average contributed less to the tourism decline than suggested by its importance (coastal tourism accounted for 29% of EU reviews in 2019). Coastal regions in Denmark, Germany, France, the Netherlands, and Poland in particular saw activity in the third quarter close to, or even exceeding, expected levels.⁽⁴⁾ Most Mediterranean Member States saw coastal tourism decline more strongly in view of their dependence on air travel, yet this

⁽²⁾ AirBnB customer reviews further allow for more granular insights by statistical region (NUTS 3).
⁽³⁾ The expected level represents the number of overnight tourism trips that could have been expected for 2020 under normal circumstances. For more details please see the reference in footnote 1.
⁽⁴⁾ The overall decline in reviews for coastal regions in these Member States is mostly due to an underperformance in off season week-ends during Q2 and Q4.

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Box (continued)

Table 1:

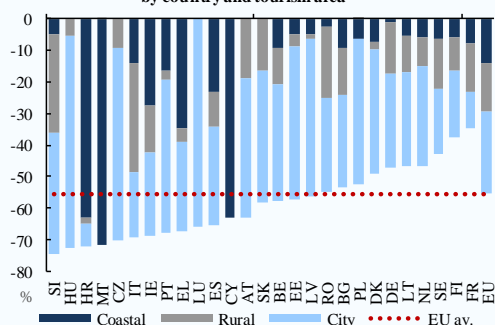
Tourism activity overview - nights spent in tourism accommodations

Country	Nights spent 2020, total		Nights spent, non-residents		Nowcast	Country	Nights spent 2020, total		Nights spent, non-residents		Nowcast
	Millions	% change y-o-y	Millions	% change y-o-y	Estimates from		Millions	% change y-o-y	Millions	% change y-o-y	Estimates from
Greece	39	-73%	27	-77%	Nov	Luxembourg	1	-49%	1	-53%	Dec
Malta	3	-71%	2	-74%	Nov	Latvia	3	-47%	2	-60%	Dec
Ireland	11	-70%	5	-73%	Jan	Lithuania	5	-45%	1	-72%	Nov
Spain	145	-69%	61	-79%	Dec	Czechia	31	-45%	8	-72%	Nov
Cyprus	6	-64%	6	-65%	Jun	Poland	52	-44%	7	-64%	Dec
Portugal	30	-61%	14	-74%	Dec	Slovakia	10	-44%	2	-62%	Nov
Hungary	14	-57%	4	-76%	Dec	Slovenia	9	-42%	3	-71%	Nov
Croatia	41	-55%	35	-58%	Dec	Germany	268	-39%	33	-63%	Nov
Bulgaria	12	-55%	5	-72%	Oct	Austria	79	-39%	51	-44%	Nov
Italy	200	-54%	65	-70%	Nov	Finland	14	-38%	2	-66%	Dec
Romania	15	-51%	1	-79%	Nov	Sweden	40	-37%	5	-71%	Nov
Belgium	21	-51%	7	-68%	Dec	France	282	-37%	43	-69%	Jan
EU-27	1443	-50%	418	-69%	-	Denmark	23	-32%	5	-63%	Dec
Estonia	4	-49%	1	-67%	Nov	Netherlands	86	-31%	22	-58%	Nov

Note: Number of nights spent reported via Eurostat, augmented by nowcasts based on AirBnB-reviews for the month indicated until Dec 2020.

decline was less pronounced than in their major cities (Italy, Spain, Portugal, Greece). Finally, *rural tourism* in some tourism-intensive regions saw activity comparable to that in coastal regions, most notably in France. Still, other rural areas saw a stronger deterioration, which may be related to declining sightseeing and business travel.

Graph 2: Cumulative drop in reviews 2020, by country and tourism area

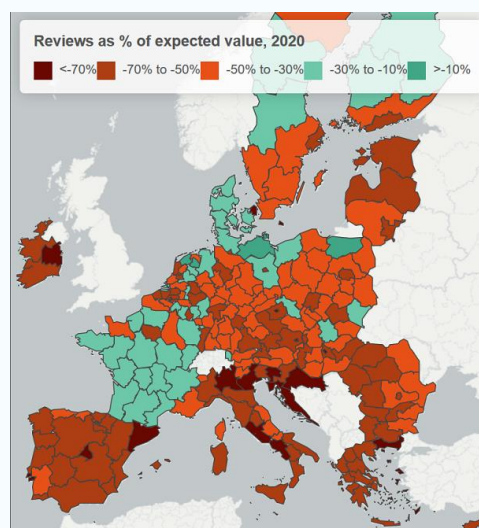


Note: Bars represent reviews 1 Jan to 31 Dec 2020, as % of total expected reviews over that period

...and also bound to lag behind in the recovery.

The pandemic will continue to shape the sector’s outlook this year both directly via government restrictions on non-essential travel and indirectly, insofar as potential tourists want to limit health risks, until herd immunity is achieved. It is likely that business and city trips will continue to be heavily affected. Additionally, planning uncertainty might also have a big impact in 2021, especially for areas typically reached by air transport. Most importantly, it is expected that extra-EU travel will take more time to recover. As a consequence, city travel will take an additional hit. Moreover, since incoming tourists from outside the EU, on average, spend more by day, revenues will remain affected.

Map 1: Regional tourism performance, Jan-Dec 2020



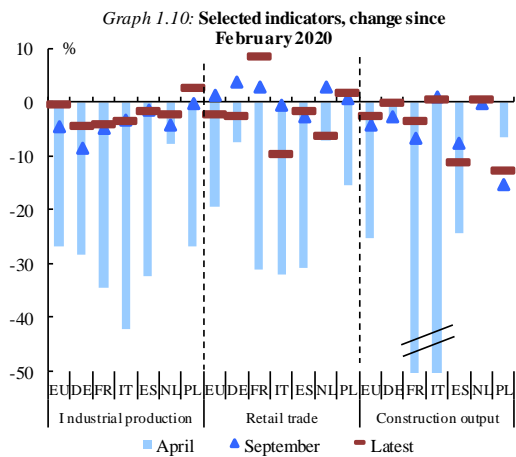
On the upside, strong pent-up demand as well as high savings are likely to lead to a stronger summer season than in 2020. Given planning uncertainty and the possible wish to avoid crowds, this pent-up demand will likely result in more spontaneous trips in the home country or to destinations reachable by car. Thus, a relatively more forceful recovery in coastal and rural tourism can be expected. All in all, tourism flows on the whole are not expected to fully recover to their pre-crisis levels in 2021. (5)

(5) For further information see IATA (2020). ‘Deep losses continue into 2021’. Press release No. 95, 24 November 2020. and EUROCONTROL (2020). ‘Five-year forecast 2020-2024’. November 2020.

suggested in Section 1.2, despite a markedly higher incidence of infections in the late autumn/winter wave, containment measures were more targeted and relatively less stringent, on average, than those enacted back in spring. Second, households and businesses appear to have gradually learned to live with the pandemic, weakening the link between stringency and mobility restrictions on the one hand, and economic outcomes on the other.

Solid industrial output contrasts with weak services

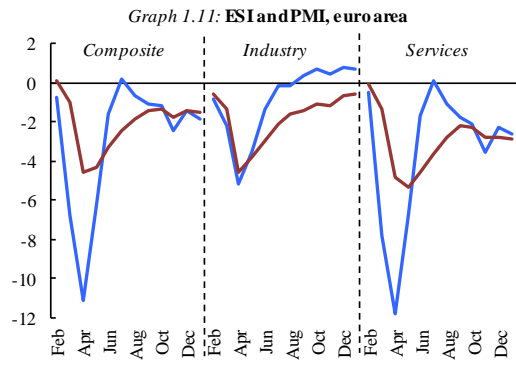
After growing strongly in the third quarter (by 16.4% q-o-q), *industrial production* in the EU continued to recover in the fourth quarter, rising in November 2020 for the seventh month in a row ⁽²⁾ and nearly returning to its February level. Likewise, *construction output*, continued to expand in November but remained about 2 ½% short of its pre-crisis level (see Graph 1.10). By contrast, following its full recovery in August, *retail sales* weakened again in November as restrictions were tightened across the EU (see Graph 1.10.). ⁽³⁾ ⁽⁴⁾



Survey data confirm that this divergence across sectors persisted throughout the fourth quarter (see Graph 1.11). According to Commission surveys, euro area *industrial confidence* increased to -8.8

⁽²⁾ It has to be noted however, that November’s reading was largely due a significant increase in Ireland (+52.8%) without which production would have turned out broadly flat.
⁽³⁾ These developments were to a large extent driven by sales in France, Belgium and Austria, which saw strong monthly slumps at or above 10% in November.
⁽⁴⁾ The 10% rise in sales via mail order or internet compared to the third quarter was not enough to offset a 7 ½% fall in sales of textiles, clothing, footwear and leather goods, as well as in automotive fuel.

points, on average, in the fourth quarter (back to its pre-crisis level) from -13.6 in the third, fuelled by sizeable improvements in the assessment of order books. Similarly, Markit’s Eurozone *Manufacturing PMI* was up to 54.6 on average in 2020-Q4, from 52.4 in 2020-Q3. While the Commission’s *services confidence* indicator also improved somewhat, on average, in the fourth quarter (compared to the third), it has so far recovered only some 50% of the losses incurred in the first two quarters of 2020. Markit’s *Services PMI* fell back into contractionary territory during the last four months of the year and its average reading of 45.0 in Q4 still remains shy of its pre-crisis level in 2019-Q4.



Note: Standardised data a based on 2000-07 sample, last observation January 2021.
 Source: IHSMarkit, European Commission.

Policy support continues to cushion the hit to the labour market

In 2020, the widespread use of job retention schemes, supported by the EU instrument for temporary *Support to mitigate Unemployment Risks in an Emergency* (SURE), as well as other types of government interventions, cushioned the impact of the COVID-19 shock on jobs and incomes. The labour market has nevertheless seen the most dramatic changes in its history.

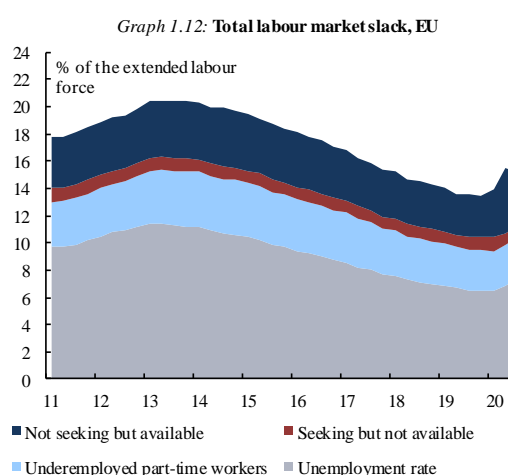
Never before has such a substantial decrease in employment (persons and hours worked) occurred so quickly, and never before has so much of that decline already been recovered in the subsequent quarter. Following an unprecedented decline in the first half of the year, in the third quarter 2020, the number of employed persons rebounded in the EU and in the euro area. However, the increase by 0.9% in the EU (as compared to the second quarter, 1.0% in the euro area), implied that the number of employed persons remained 2.1% (2.2% in the euro area) lower than in the fourth

quarter of 2019. Likewise, solid growth during the same period in the number of hours worked (11.8% and 14.8% in the EU and euro area, respectively) still left their level significantly lower (by 3.7% and 4.6%) compared to the fourth quarter of 2019.

Increases in unemployment have remained contained. Following a peak in July at 7.8% (8.7% in the euro area), the unemployment rate continued to fall in the second half of 2020, as economic activity rebounded and the impact of the new containment measures remained limited. The unemployment rate stabilised in December at 7.5% in the EU (8.3% in the euro area). This is still about 1.2 pps. higher (1.4 pps. in the euro area) than in February 2020.

The evolution of labour market slack,⁽⁵⁾ however, suggests that the impact of the pandemic has been more severe than indicated by the traditional measures of employment and unemployment. The indicator increased markedly in the second quarter of last year and dropped only slightly in the third quarter, remaining above its pre-pandemic level (see Graph 1.12). The increase in the second quarter was mainly due to large flows out of the labour force, especially in some Member States rather than increases in unemployment. These flows included people available to work but not seeking, due to the shutdown of many businesses or to parental responsibilities for taking care of children, or due to discouragement in light of the grim outlook. As activity resumed in the third quarter, the fall in the share of people available for work but not seeking offset the increase in the unemployment rate, suggesting that many people started searching for a job (again).

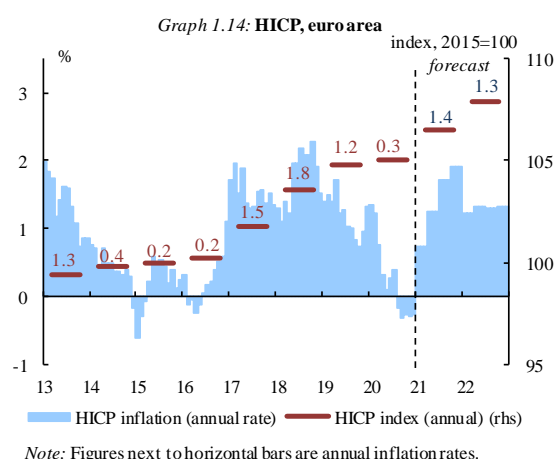
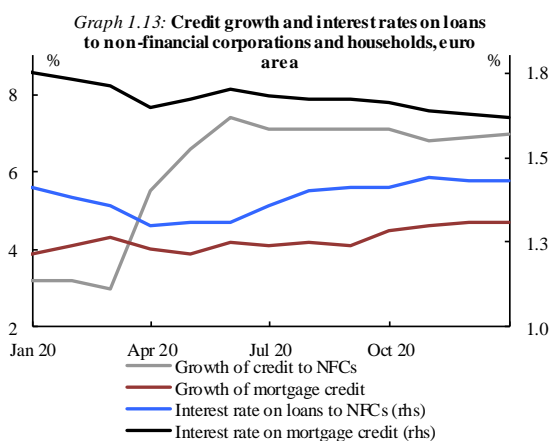
⁽⁵⁾ According to Eurostat's definition, labour market slack is the sum of unemployed persons, underemployed part-time workers, persons seeking work but not immediately available and persons available to work but not seeking, expressed as a percentage of the extended labour force, which adds up the aforementioned sum and the employed persons. Unemployed persons are all persons without work, who are available to start work within two weeks, and who have actively sought employment at some time during the four previous weeks.



Private sector funding has been sustained despite tighter credit standards

The annual growth rate of loans to the private sector stood at 4.7% in December 2020, broadly stable since August, but higher than before the crisis. Lending to non-financial corporations continues to be strong, after having picked up decisively in March/April 2020. The annual growth rate of lending to non-financial corporations stood at 7% in December, compared to 3.1% for households (see Graph 1.13). Non-financial corporations have also increasingly tapped the markets for their funding needs. The annual growth rate of outstanding debt securities issued by euro area enterprises stood at a robust 11.6% at the end of November. Listed shares issued by euro area enterprises gained some traction, increasing by 1.1% year-on-year at the end of November.

While government guarantees on loans to enterprises have supported bank lending during the pandemic, the ECB Bank Lending Survey pointed to further tightening of credit standards in the euro area across all loan categories in the fourth quarter of 2020. Banks' terms and conditions tightened mainly on the back of more stringent collateral requirements and wider loan margins. The tightening of credit standards for corporations is also consistent with the observed decline in the actual take-up of guaranteed loans. Businesses' demand for loans or drawing of credit lines continued to decline, while households' demand for housing loans increased.



1.5.2. Price developments

Weakness in inflation extends across many categories

The impact of the pandemic has extended to inflation developments in both the euro area and the EU. Headline inflation in the euro area, as measured by the Harmonised Index of Consumer Prices (HICP), averaged -0.3% in the fourth quarter of 2020 and remained in negative territory since August. Inflation rates have differed substantially across the non-euro area Member States, from just above 3.5% in Poland, to negative in Croatia.

Headline inflation was driven lower predominantly by the sharp fall in energy inflation, but also by services inflation depressed by demand shortfalls. In the euro area, energy inflation averaged -8% in the fourth quarter, as the impact of the pandemic shock on oil prices felt in March exerted negative base effects. Services inflation declined to just over 0.5% in the fourth quarter, a full percentage point below its average over 2019. The drop in demand and in oil prices led in turn to negative non-energy industrial goods inflation, thus dominating remaining supply side constraints reflected, for example, by higher shipping costs. As a result, euro area core inflation (all items excluding energy and unprocessed food) fell rapidly to 0.4% in 2020-Q4, from 1.3% in the same quarter of 2019. The initial supply shock that drove food prices higher in spring last year has abated in both processed and unprocessed food. Tax cuts in a number of countries, especially in Germany, and the euro's appreciation, also weighed on euro area inflation.

1.6. NEW FACTORS SHAPING THE OUTLOOK AND ASSUMPTIONS UNDERPINNING THE FORECAST

The pandemic and the measures taken to contain it are set to remain key determinants of activity, with two new developments coming to the fore: (i) the aggravation of the epidemiological situation, due in part to the emergence of new, more infectious variants, and the ensuing tightening of containment measures at the turn of the year; (ii) the start of mass vaccinations campaigns that could allow for withdrawal of containment measures earlier than expected in the Autumn Forecast. Other important new elements affecting the European economy over the forecast horizon include the improved outlook for external demand, and the Trade and Cooperation Agreement (TCA) reached between the European Commission and the United Kingdom on 24 December and provisionally in application since 1 January 2021.

A challenging race between injections and infections

The Autumn Forecast factored in an interruption in the economic rebound towards the end of 2020, against the background of a resurgence in COVID-19 infections (the 'second wave'). Since then, the pandemic has tightened its grip on the EU economy, forcing many Member States to reintroduce or tighten containment measures (see Section 1.2), and raising the potential for additional measures in the near term⁽⁶⁾.

⁽⁶⁾ Following recommendations of the European Centre for Disease Prevention and Control in 'Integrated COVID-19 response in the vaccination era'. 1 February 2021. Stockholm: ECDC; 2021

The start of vaccinations in all Member States has brightened the outlook. The question is now how quickly the vaccine can be rolled out, and at what point restrictions can be loosened. In its recent Communication,⁽⁷⁾ the European Commission called on Member States to accelerate vaccinations, with the targets of vaccinating at least 80% of people over the age of 80 and 80% of health and social care professionals in every Member State by end March, and a minimum of 70% of the adult population by summer 2021. These targets take into account the number of doses that are expected to be delivered in the coming months, as foreseen in the contracts with manufacturers, (see Section 1.2), and assume no delays in their administration. Provided vaccination is accompanied by continued efforts to contain the virus, through physical distancing and limited social contacts, the achievement of these targets would considerably ease pressure on hospitals (including intensive care units) and reduce the number of deaths starting from the second quarter of 2021.

Evidence is still lacking as to the efficacy of the vaccine in cutting transmissions. A high number of infections, sustaining pressure on the health system, may persist until vaccinations reach a critical mass of people. Furthermore, the new variants increase uncertainty around the epidemiological outlook by raising important questions about the effectiveness of the vaccines (for which preliminary evidence is reassuring), and the implications of higher infectiousness on prospects for herd immunity.

The forecast crucially hinges upon assumptions on the stringency of virus containment measures...

Given current epidemiological trends, the possibility of a renewed tightening of containment measures cannot be ruled out in the near term in some Member States. However, the subsequent inoculation of the most vulnerable groups in society is expected to allow for a very gradual relaxation of containment measures from their highs in the first-quarter, leading to a progressive ‘unfreezing’ of the sectors where activity is currently most restricted or subdued. While there may be differences in the approach of Member States to lifting restrictions, with some putting

more weight on overall infection targets⁽⁸⁾, reduced pressure on health-care systems should, on average, lead to a gradual lifting of containment measures starting in the course of the second quarter.

Overall, this forecast assumes that after a significant tightening in the fourth quarter of 2020, containment measures remain strict in the first quarter of 2021 before easing marginally towards the end of the second quarter, and then more markedly in the second half of the year, when the most vulnerable and an increasing share of the adult population should have been vaccinated. It is assumed that containment measures will be marginal towards the end of 2021, with only targeted sectoral measures still present in 2022. These technical assumptions are subject to risks related to, inter alia, the emergence of new variants, progress in vaccinations, and global epidemiological developments. Meanwhile, economic agents continue adapting to and learning to live in the COVID-19 environment, leading to a progressively decreasing impact of a given level of restrictions on economic activity.

... and a new outlook for external support.

The EU-UK free trade agreement implies a somewhat less negative impact on activity in the EU and the UK compared to the WTO terms assumed in the Autumn Forecast. Model estimates suggest that the cumulative impact of the UK leaving the EU amounts to around -½% of GDP over 2021-2022 for the EU (compared to around -¾% under the WTO scenario). Details of the analysis are summarised in Box 1.2.

A somewhat stronger rebound of the global economy than expected in the autumn is likely to support the European economy in 2021 and 2022. The improved outlook for the major advanced economies, with new policy measures in the United States and Japan, as well as better prospects for Asian emerging market economies, are set to provide a welcome boost to external demand for EU exporters starting from the second half of this year.

⁽⁷⁾ See ‘A united front to beat COVID-19’ Communication from the Commission to the European Parliament, the European Council and the Council, 19 January 2021

⁽⁸⁾ The rate of daily new infections is set to take longer to subside, likely persisting at elevated levels until herd immunity is achieved.

Box 1.2: The Trade and Cooperation Agreement between the EU and the UK and model simulation of the short-term economic impact of the included Free Trade Agreement

On 24 December 2020, the European Commission and the United Kingdom reached agreement on a Trade and Cooperation Agreement (TCA). Following the Council decision of 30 December 2020, the TCA is provisionally in application since 1 January 2021⁽¹⁾. The TCA consists of a Free Trade Agreement (FTA), a close partnership on citizens' security, and an overarching governance framework. This box, after a brief description of the FTA, presents the results of a simulation that estimates its short-term economic impact, used as input for the forecast.

The EU-UK FTA covers a broad range of areas, including goods, services, investment, competition, subsidies, tax transparency, air and road transport, energy and sustainability, fisheries, data protection, and social security coordination. In goods trade, the FTA provides for zero tariffs and zero quotas on all goods complying with the appropriate rules of origin. Both parties have also committed to ensuring a robust level playing field by maintaining high levels of protection in areas such as environmental protection, the fight against climate change and carbon pricing, social and labour rights, tax transparency and subsidy control. The TCA provides for commitments on effective, domestic enforcement with an effective role for UK courts, a binding dispute settlement mechanism and the possibility for both parties to take remedial measures, as well as rebalancing measures in case of significant divergences on level playing field standards. The agreement also provides for e.g. continued and sustainable air, road, rail and maritime connectivity and for a new framework for energy trading and interconnectivity. It includes a chapter on fisheries, with a joint management of fish stocks in EU and UK waters⁽²⁾.

Even though the TCA goes beyond traditional agreements in scope and depth, an FTA cannot match the level of economic integration that is enjoyed by being a Member State of the EU. As a consequence of the UK's decision to leave the

Single Market and Customs Union, the EU and the UK form two distinct and separate regulatory and legal spaces⁽³⁾. Free movement of persons, goods, services and capital between the UK and the EU has ended. This has inevitably created significant new non-tariff barriers (NTBs) to trade in goods, services and to cross-border mobility and exchanges.

To consistently reflect the FTA in the forecast, its impact on the UK economy and that of its trading partners in the EU is assessed through the simulation model that was used in the 2020 Autumn Forecast to estimate the impact of the 'WTO assumption', against the benchmark of trade relations under EU⁽⁴⁾. The simulation focuses on the short-term impact on trade flows, and does not look at dynamic trade adjustments over the medium and long-term. It does also not include effects of potential changes in migration flows, the exchange rate or productivity. The simulation uses data that do not take into account the impact of the COVID-19 pandemic.

The model

The model is static and builds on the global-input output tables published by the OECD⁽⁵⁾. The impact of the FTA on production and value added is estimated through a trade shock, based on the assumptions on tariffs, non-tariff barriers and trade elasticities set out below.

In line with the FTA, tariffs in the scenario analysis were set at zero⁽⁶⁾. The increase in NTBs resulting from the UK leaving the EU is estimated at sector level, based on the Commission's internal assessment. The tariff equivalent of the NTBs amount to 10.9% and 8.5 % on average (trade-

⁽¹⁾ The agreement was signed by the EU and the UK on 30 December, and ratified by the UK Parliament on the same day.

⁽²⁾ For details on the EU-UK Trade and Cooperation Agreement, please see: https://ec.europa.eu/info/reasons-united-kingdom/eu-uk-trade-and-cooperation-agreement_en.

⁽³⁾ Union rules relating to goods and the Union Customs Code will continue to apply to and in Northern Ireland.

⁽⁴⁾ For further information on the WTO assumption or the model used, please see box 1.4.2 "Technical assumption on the future trading relations between the EU and the UK and model simulation of their economic impact", European Commission 2020 Autumn forecast.

⁽⁵⁾ www.oecd.org/sti/ind/inter-country-input-outputtables.htm, released in December 2018, latest data from 2015.

⁽⁶⁾ Potential costs of complying with new rules of origin are modelled as small tariff increases.

(Continued on the next page)

Box (continued)

weighted at sectoral level) for EU and UK imports, respectively.

In the model, part of the increase of NTBs is applied with immediate effect, with the remainder gradually phasing in over time⁽⁷⁾. Additional temporary disruptions are assumed to occur in the first quarter of 2021, reflecting the observed initial difficulties for economic actors in adjusting to the new EU-UK trading relations. The trade elasticities used in the model are based on the sectoral trade substitution elasticity estimates used in the Global Trade Analysis Project (GTAP) model of trade and taken from Hertel and van der Mensbrugge (2016)⁽⁸⁾, adjusted to make them appropriate for a short-term analysis. The UK's current FTAs with 3rd countries are taken into account, but no new agreements are assumed to be signed over the forecast horizon.

⁽⁷⁾ While many NTBs such as customs checks or the need for certificates to prove compliance with EU standards already apply since 1 January 2021, others will only come into play at a later stage (e.g. the impact of a potential divergence between EU and UK standards).

⁽⁸⁾ Hertel, T. and D. van der Mensbrugge (2016). "Chapter 14: Behavioral Parameters (Center for Global Trade Analysis)". Purdue University, West Lafayette, In Global Trade Analysis Project (GTAP).

Results

For the EU on average, the exit of the UK from the European Union on FTA terms is estimated to generate an output loss of around ½ % of GDP by the end of 2022, and some 2 ¼ % point for the UK. Compared to the 'WTO assumption' that was modelled in the Autumn forecast, the EU-UK FTA reduces this negative impact for the EU on average by about 1/3 and for the UK by about 1/4. Whereas the FTA sets tariffs and quotas on goods at zero, there is a significant increase in NTBs for both goods and services. Member States with a higher share of goods trade with the UK therefore benefit relatively speaking more from the FTA than those with a higher share of trade in services.

In sum, while the FTA improves the situation as compared to an outcome with no trade agreement between the EU and the UK, it cannot come close to matching the benefits of the trading relations provided by EU membership.

As the pandemic crisis gets protracted, some important questions become more relevant

- *The duration and timing of the eventual withdrawal of supportive policy measures in the Member States.* This forecast assumes that supportive policies will continue in general as long as official containment measures pose serious limitations to business activity. This differs significantly across Member States and depends on the types of policies in place, the fiscal space available, and other country-specific factors. A premature withdrawal of such support measures remains an important downside risk.
- *The extent of lasting damage inflicted by the pandemic.* A delayed recovery increases the potential for permanent scars to the fabric of Europe's economies and societies, predominately through bankruptcies and higher unemployment. This is particularly relevant for sectors that rely on face-to-face contacts where restrictions continue to weigh heavily on revenues, increasing insolvency risks.

Emergency policy measures and monetary policy support have continued to cushion the shock and so far largely kept European firms afloat, by preventing or delaying bankruptcies of affected viable firms. However, there is also a risk of keeping an increasing number of non-viable firms alive, which may have negative implications for long-term productivity⁽⁹⁾ ⁽¹⁰⁾. The labour market is therefore more and more likely to suffer from hysteresis effects, with negative implications for inequality. Importantly, this forecast assumes that a large wave of post-crisis insolvencies can be avoided, even if such an outcome constitutes a significant downside risk to the baseline.

- *The outlook for the household saving rate.* Given its currently elevated level, (see Section 1.5.1) the household saving rate is expected to gradually come down in line with the

⁽⁹⁾ Claeys, G., M. Hoffmann and G. Wolff (2021) 'Corporate insolvencies during COVID-19: keeping calm before the storm', Bruegel Blog, 7 January

⁽¹⁰⁾ Banerjee, R. and B. Hofmann (2020). 'Corporate zombie: anatomy and life cycle'. BIS Working Papers 882, September.

relaxation of containment measures over the course of 2021. Forced savings are set to come down faster, as soon as spending opportunities open up again, in particular in currently inactive service sectors (e.g. tourism). On the other hand, precautionary savings may remain at a higher level for somewhat longer due to the protracted pandemic crisis and related uncertainty, before coming down eventually as the pandemic is finally brought under control and household sentiment improves. At the same time, persistently higher precautionary savings as a legacy of the COVID-crisis remains a clear negative risk for the economic outlook.

The Recovery and Resilience Facility still not fully incorporated in the forecast

- The incorporation of the Recovery and Resilience Facility (RRF) into the forecast remains in line with the usual no-policy change assumption and is unchanged from the Autumn Forecast. Following the political agreement reached on the RRF in December 2020, preparation of national Resilience and Recovery Plans (RRPs) has intensified in virtually all Member States. In most cases though the status of the draft RRFs is not sufficiently advanced to allow for their incorporation in the Winter Forecast. In line with the customary no-policy-change assumption, the forecast only incorporates those measures that have either been adopted or credibly announced *and* specified in sufficient detail, notably in national budgets. The economic projections for only a few Member States take account of some measures expected to be financed under RRF. In particular, the projections for France incorporate measures from the French Recovery Plan, amounting to 1.6% of GDP in 2021, part of which is expected by the government to be financed by the RRF. This implies that RRF could fuel stronger growth than projected in this forecast, supporting a faster and more sustainable recovery in the EU Member States, once RRFs are implemented.

1.7. THE OUTLOOK FOR THE EU/EA

1.7.1. Economic growth outlook

The year 2021 is set for a subdued start ...

Survey indicators point to depressed economic activity at the start of the year. In the EU, the Commission's *Economic Sentiment Indicator* (ESI) edged down to 91.2 in January 2021, moving further away from its pre-crisis level (103.6 in February 2020). Similarly, Markit's *Flash Purchasing Managers Composite Output Index* for the euro area slipped further into contractionary territory, to 47.5, down by 1.6 points compared to December. It has now remained below the no-change threshold of 50 for the third month in a row.

January also saw the Commission's *consumer confidence* in the EU weakening to its lowest level since May last year, dampened by growing concerns about the general economic situation, a deterioration in households' views on their past and future financial conditions, as well as in their intentions to make major purchases. This has coincided with an increasing number of respondents reporting scope for saving. Forward-looking indicators for the labour market also hint at a deteriorated economic situation. In January, the Commission's *Employment Expectations Indicator* decreased in the EU and the euro area and stood markedly below their long-term averages and much lower than in February 2020.

The dichotomy between the performance of industry and services appears to have continued in early 2021, as highlighted by January readings of the Commission's surveys and Markit's PMIs. Furthermore, the Commission's latest quarterly survey ⁽¹⁾ estimated that capacity utilisation in the services sector declined to 85.7% in 2021-Q1 (from 86.5% in 2020-Q4), while recovering in industry to 77.7% (from 76.5%). This increase occurred amid rising shortages of materials and/or equipment reported by managers as hindrances to higher output.

...with the resurging pandemic delaying the rebound further into 2021.

Following the output contraction in the last quarter of 2020, the European economy is expected to open 2021 on a weak footing under the weight of

⁽¹⁾ Conducted in January 2021.

the pandemic. Moreover, while the EU-UK agreement has alleviated some of the drag on growth (compared to the Autumn Forecast), the UK's departure from the Single Market and the Customs Union is still expected to weigh on growth (see Box 1.2), particularly in the first quarter of 2021. Overall, real GDP is set to shrink by 0.8% and 0.9% q-o-q in the EU and euro area, respectively in the first quarter of 2021, thus leading the European economy into a technical recession. Real GDP is projected to fall in most Member States, with the steepest contractions in Portugal (-2.1%), Ireland (-1.6%) and Austria (-1.4%).

Looking beyond the first quarter, as vaccination campaigns gain momentum and containment measures are gradually relaxed, activity in the EU and the euro area is expected to start picking up, though only moderately in the second quarter. In line with the assumption of a significant lifting of restrictions in the second half of 2021, growth is expected to accelerate to 3.0% in the third quarter and remain solid in the fourth quarter (1.0% q-o-q) in both the EU and the euro area, benefitting also from stronger external demand. The seasonal drop in infections as well as a significant relaxation of containment measures should also allow countries with large tourism sectors to benefit from recovering intra-EU (domestic and foreign) tourism traffic over the summer. Thereafter, growth is expected to moderate.

Consumption to drive growth as confidence returns

As new consumption opportunities open up, the recovery is set to be driven by private consumption, even after an initial outburst of pent-up demand. A large stock of accumulated savings⁽¹²⁾, sheltered household incomes, brightening sentiment, and favourable financing conditions are set to create conditions for a sustained strengthening of private consumption. Government consumption is projected to continue playing a supportive role.

Significant idle capacity in capital-intensive sectors, lower profitability, as well as higher debt compared to the pre-crisis period, are set to act as dampening factors for private investment spending. However, as vaccination campaigns progress and uncertainty dissipates, a highly

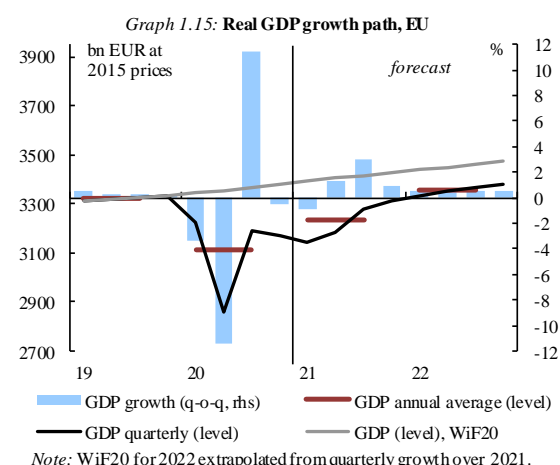
⁽¹²⁾ Excess household savings are estimated at about 3% of euro area GDP in the first three quarters of 2020.

accommodative monetary policy and targeted government support schemes are all expected to lead firms to increase investment. Gross fixed capital formation is expected to continue firming up gradually throughout the forecast horizon as idle capacity falls and public investment rises.

In line with the stronger-than-previously-expected recovery in demand from major trading partners (see Section 1.3), export growth is set to gain traction, despite the adverse (lagged) effects of the recent appreciation of the euro's exchange rate. Prospects, however, are set to remain muted in the export of services, due to the likely delayed normalisation in hospitality and transportation services for tourists originating from extra-EU markets.

Stronger growth from mid-2021 helps advance the recovery to pre-crisis levels...

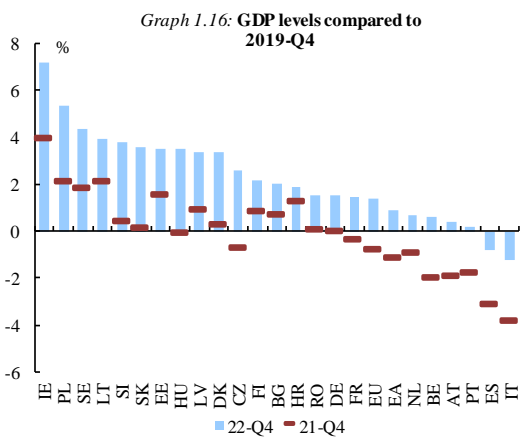
After contracting by an estimated 6.3% and 6.8% in 2020 (in the EU and the euro area, respectively), growth is forecast to rebound to 3.7% and 3.8% in 2021 (in the EU and the euro area, respectively). As the recovery takes hold and boosted by a high carry over, the 2022 annual EU GDP growth rate is forecast at 3.9% (3.8% in the euro area). Marking a notable improvement compared to the Autumn Forecast, GDP is now expected to reach pre-crisis levels by mid-2022 on average in both the EU and the euro area (see Graph 1.15).



However, this faster-than-expected return to the pre-crisis output levels will still leave a sizeable gap to the volume of GDP that would have been reached under the growth path that was projected before the outbreak of the pandemic (illustrated by the distance between the black and grey lines in Graph 1.15).

...which, however, is set to be uneven across countries.

Significant country divergences are set to persist over the forecast horizon. This is best reflected in the wide dispersion of real GDP recovery paths towards 2019-Q4 levels (see Graph 1.16). In addition to the different severity of the pandemic’s shock and the ensuing stringency and duration of containment measures, the expected speed of the recovery reflects differences in the structure of each economy, particularly the relative importance of tourism and leisure activities as well as the magnitude of policy responses.



While some Member States are expected to see the distance to their pre-crisis output levels close by the end of 2021, others are forecast to take longer. This is particularly the case for Spain and Italy, which are not expected to reach those levels by the end of the forecast horizon.

1.7.2. Inflation outlook

Inflation outlook to remain subdued despite temporary boost from base effects

The delayed recovery into the second quarter of this year is set to continue dampening aggregate demand pressures on prices. In addition, the euro appreciation against the dollar, by approximately 4% since early November, is expected to weigh on prices of imported goods, including oil.

The increase in oil prices close to their levels in January 2020 puts upward pressure on inflation (see Section 1.3). With oil prices assumed to stay just above USD 50 per barrel, significant positive base effects should kick in from March until at least 2021-Q3. Moreover, the recent large increase

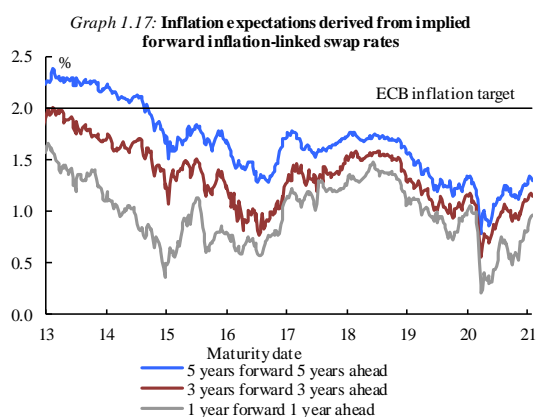
in global shipping costs is expected to have a temporary cost-push impact on imported goods inflation, until backlogs in orders are cleared and the supply of shipping capacity adjusts.

Taking into account these factors, the inflation outlook for the euro area and the EU has improved slightly in 2021 and remains unchanged in 2022 compared to the autumn. In the euro area, inflation is forecast to increase from 0.3% in 2020 to 1.4% in 2021 (see Graph 1.14). In 2021, weak underlying price pressures are expected to be temporarily neutralised by strong positive base effects in energy inflation in line with the current oil price assumptions. Moreover, in the second half of this year, strong pent-up consumer demand following the relaxation of lockdown measures is likely to meet some supply side constraints as production capacity adjusts. Most of the upward revision for 2021 since the autumn comes from Germany, which saw a strong increase in inflation in January due to the reversal of VAT tax cuts and the introduction of new energy taxes. In 2022, as supply adjusts and base effects taper out, euro area inflation is expected to moderate again towards 1.3%.

Market-based inflation expectations have recovered in line with oil prices

Despite inflation remaining negative in the last two months of 2020, market-based measures of inflation expectations along the maturity spectrum have increased since November last year and at the end of January 2021 stood close to January 2020 levels, i.e. before the COVID-19 crisis struck. Much of this increase can be attributed to the recovery in oil prices, especially in November. At the cut-off date for this forecast, inflation-linked swap rates at the one-year forward one-year-ahead horizon stood at 1% (see Graph 1.17).

On a longer horizon, the three-year forward three-years-ahead rate implies an average inflation of 1.1% while the widely-watched five-year forward five-years-ahead indicator stood at just 1.3%, which is below the ECB’s definition of medium-term price stability.



1.8. RISKS TO THE OUTLOOK

Uncertainty and risks surrounding this baseline forecast remain elevated. They are crucially related to the evolution of the pandemic and the efficiency and effectiveness of vaccination rollout. The scenario analysis presented in Box 1.3 illustrates some of those risks.

Risks have become more balanced compared to the Autumn Forecast

As compared to the autumn, risks have become more balanced as some downside risks have diminished and some upside risks have materialised. This relates first and foremost to the multiple approval of COVID-19 vaccines, but also the Trade and Cooperation Agreement between the EU and the UK reducing the cost of the UK leaving the Single Market and Customs Union, as well as the diminishing risk of a further intensification of trade disputes.

Positive risks are mainly related to the possibility that the vaccination process leads to a faster easing of containment measures and therefore an earlier and stronger recovery.

Also, the strength of the rebound could surprise on the upside, as economic growth could benefit from a burst of post-crisis optimism, which could unleash stronger pent-up demand and investment projects, thanks to historically high household savings, low financing costs, and supportive policies.

Similarly to the EU, the outlook for the global economy is subject to high uncertainty around the path of the pandemic and the vaccination process, but the materialisation of positive risks for the

global outlook would have positive growth spillovers for the EU. Finally, following the results of the US Presidential election, the risks related to the persistence of global trade tensions and the weakening of global economic governance have subsided.

Last but not least, an ambitious and swift implementation of the NextGenerationEU programme, notably its Recovery and Resilience Facility, should provide a strong boost to the EU economy.

On the *downside*, there is the risk that a flaring up of contagions as a result of new and reportedly more contagious variants of the coronavirus, or a slow rollout of vaccinations, could delay the lifting of virus containment measures and have negative effect on confidence, keeping precautionary savings at persistently high levels and withholding investment decisions.

A protracted crisis could also leave deeper scars on the fabric of the European economy and society than assumed in the forecast, through widespread bankruptcies and higher unemployment as the policy support measures are lifted. Insolvencies would in turn lead to a surge in non-performing loans, causing stress in the banking sector and financial markets. More generally, the widening disconnect between the current upbeat market valuations and a real economy dominated by corporate weaknesses and high uncertainty is a source of concern. Unemployment, which would also result from more widespread insolvencies, could become entrenched due to hysteresis effects and skills mismatches in the process of sectoral reallocation. This would then lead to a surge in inequality, given the particularly adverse impact of the crisis on workers on temporary or precarious jobs, the lower-wage earners, and more vulnerable cohorts (youth, women). Carefully designed exit strategies from current support schemes would therefore seem vital, as premature withdrawal could pose important risks in this respect across the EU.

In addition, the large cross-country divergences observed since the outset of the crisis could become entrenched, leading to fragmentation that would disrupt the functioning of the internal market, cause efficiency losses and ultimately become self-reinforcing.

The risks to the inflation outlook are broadly balanced

In the short term, *upside* risks stem from protracted supply and shipping capacity constraints. In addition, an increase in firm bankruptcies in some sectors may strengthen the pricing power of incumbent firms. The annual statistical update in the weights of the categories in the consumption basket, published in February, may artificially affect inflation in 2021. As the pandemic lowered

the consumption of many non-essential services such as in the hospitality sector and package holidays in 2020, the adjustment of weights may be skewed in favour of components that have higher inflation, especially food. Finally, a stronger than projected recovery in 2022 could also increase price pressures. On the *downside*, the weaker near term outlook could further depress underlying demand pressures and wage growth.

Box 1.3: The road out of the crisis: an update of alternative scenarios

Exceptional risks continue to surround the forecast...

A year has passed since the outbreak of the COVID-19 pandemic in Europe. While the rollout of vaccination campaigns makes the road ahead clearer and brighter, the evolution of the pandemic remains a decisive determinant of the economic outlook.

According to the key assumption underpinning this forecast, the stringency of measures taken to contain the virus is expected remain high throughout the first quarter of 2021, ease marginally in the second quarter, and fall markedly, yet not completely, thereafter. As a result, real GDP in the euro area is forecast to shrink somewhat in the first quarter before posting a moderate uptick in the second, with the rebound strengthening markedly from the third quarter onwards.

The possibility of surprises, which could have either positive or negative implications for the growth outlook, however, cannot be excluded. A faster-than assumed pick-up in the production and distribution of vaccines could boost confidence among households and firms and facilitate a faster reduction in voluntary social distancing as well as in the tightness of restrictions to mobility and economic activity. By contrast, a flaring up of contagion as a result of new and reportedly more contagious mutations of the coronavirus, or a slow rollout of vaccinations, could delay the lifting of virus containment measures and have the opposite effect on confidence.

The scenarios presented in this box shed light on some of the uncertainties surrounding the outlook. The analysis makes use of the Commission's Global Multi-Country (GM) Model, an estimated macroeconomic model in the New-Keynesian tradition⁽¹⁾, which has been augmented to capture key features of the pandemic-induced crisis. In

⁽¹⁾ The Global Multi-Country (GM) DSGE model has been developed by DG ECFIN and the Joint Research Centre of the European Commission. For a detailed description, see Albonico, A., L. Calès, R. Cardani, O. Croitorov, F. Di Dio, F. Ferroni, M. Giovannini, S. Hohberger, B. Pataracchia, F. Pericoli, P. Pfeiffer, R. Raciborski, M. Ratto, W. Roeger and L. Vogel (2019). 'The Global Multi-Country Model (GM): an Estimated DSGE Model for the Euro Area Countries'. ECFIN Discussion Paper No. 102.

particular, the model incorporates forced savings (or 'lockdown shocks') which have been driven by social distancing and the closure of non-essential services, and which were found in the autumn 2020 forecast to represent about two-thirds of the increase in household savings in 2020.⁽²⁾

... and thus warrant alternative scenarios ...

Two alternative scenarios have been designed around the baseline forecast to illustrate the possible path for the economy under a set of stylised assumptions.⁽³⁾ The *upside scenario* incorporates an earlier and more meaningful relaxation of containment measures occurring in the second quarter of this year.⁽⁴⁾ This improves consumer confidence and encourages households to reduce both forced and desired savings, unleashing pent-up demand. These positive developments would extend into the summer season, when intra-EU tourism would experience a faster recovery than expected under the central projection.

The *downside scenario* illustrates the impact of restrictions to daily life staying in place throughout 2021. In this scenario, the recovery would be delayed though not derailed. Compared to the forecast baseline, depressed confidence prompts households to accumulate a greater share of their income as savings. Moreover, the slower relaxation of restrictions in this scenario results in a more protracted period of sluggish economic activity that leads to more persistent damages to the economic fabric, exemplified in the simulations by a tightening of financial conditions. Damage to balance sheets and the higher rate of bankruptcies associated with this scenario take their toll on both

⁽²⁾ See Special Issue 3.1 'The road out of the crisis remains bumpy and uncertainty' in European Commission (DG ECFIN) (2020). 'European Economic Forecast: Autumn 2020'. *Institutional Paper* 136, pp. 61-65.

⁽³⁾ Both scenarios focus on developments in the euro area. They also do not include additional discretionary fiscal or monetary policy action beyond the baseline.

⁽⁴⁾ Specifically, the upside scenario assumes that the stringency of containment measures in 2020-Q2 is around 1/3 lower than the forecast baseline and remains below after that date. As a consequence, together with the assumed confidence gains, the model predicts that the savings rate is around 2 pps. below baseline in the second half of 2021.

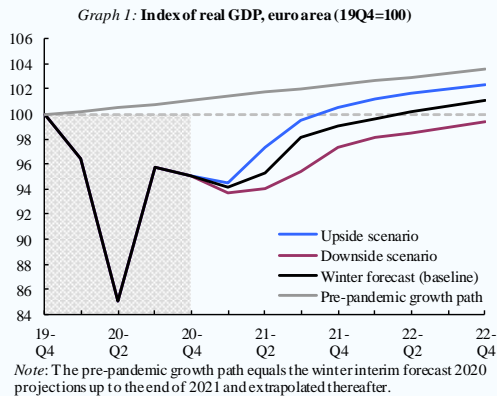
(Continued on the next page)

Box (continued)

employment and output, as does a prolonged shortfall in business investment. ⁽⁵⁾

... to illustrate the impact of upside risks ...

Based on this set of assumptions, the *upside scenario* projects a fast and forceful rebound from the crisis (see Graph 1). In this scenario, the quarterly growth rate of the euro area would likely exceed 3% in 2021-Q2, mostly on the back of a boost from consumer spending. This is significantly faster growth than expected in the baseline scenario. The performance in 2021-Q3 would be equally vigorous on the back of a strong summer tourism season. Confidence effects continue to support economic activity thereafter, with household savings returning close to pre-pandemic levels. Overall, the annual rate of growth in the euro area would reach around 5 ¼% in 2021 and around 4% in 2022 (see Graph 2) and output would surpass its end-2019 levels by the end of 2021.



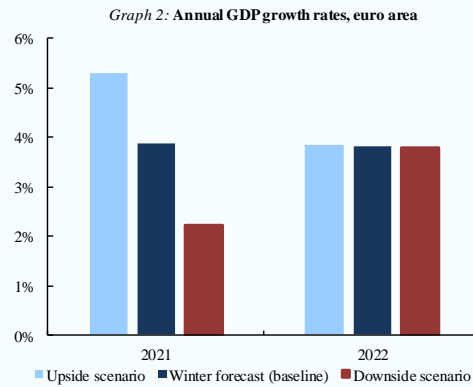
... as well as still significant downside risks.

By contrast, the slower pace assumed for the lifting of restrictions in the *downside scenario* leads to persistently high savings and lower confidence that dampens private consumption. With demand subdued for a longer time, the financial position of firms would become more vulnerable, which combined with tighter credit conditions, would delay the start of the recovery until later in 2021.

⁽⁵⁾ The model simulation illustrates these adverse developments with a stylised (and persistent) risk premium shock of around ½ of the size identified during the financial crisis in 2008-2009.

Furthermore, impaired capital accumulation in this scenario would erode the productive capacity of the economy and weaken potential output to some extent. Euro area GDP growth under these assumptions would be around 2 ¼% in 2021 ⁽⁶⁾, but would pick-up at a rate close to that of the central projection in 2022. Output in this scenario fails to recover to pre-pandemic levels before the end of the forecast horizon.

Finally, it is worth highlighting that even if positive growth surprises were to materialise in line with those described in the *upside scenario*, output would not reach the level that was projected before the pandemic. ⁽⁷⁾



⁽⁶⁾ Additional adverse shocks to confidence and increases in forced savings ('lockdown shocks') imply that the households' savings rate remains around 2 pps. higher than in the central projection.

⁽⁷⁾ The pre-pandemic growth path coincides with the path for GDP as projected in the winter 2020 interim forecast, the last Commission forecast before the pandemic outbreak. Euro area GDP was forecast to grow by 1.2% in 2020 and 2021. See European Commission (2020): 'European Economic Forecast: Winter 2020'. Institutional Paper 121.