

September 29th, 2020

Eurozone GDP starts to recover

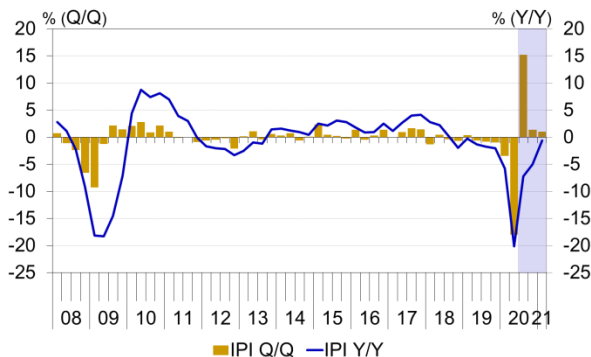
- After a sharp contraction in Q2, GDP and the other economic aggregates will recover from the third quarter of 2020 on.
- Annual inflation will remain low, with a moderate acceleration in the first quarter of 2021.
- The outlook is subject to high uncertainty, with both upside and downside risks depending on the effectiveness of economic policies and the evolution of the pandemic.

Unprecedented fall of economic activity

In the second quarter, global economic activity declined sharply due to COVID-19 pandemic containment measures. International merchandise trade decreased in volume by historic 12.5%, despite a rebound in June (+7.6%).

In the euro area, GDP contracted by 11.8% in Q2 2020 compared to the previous quarter. The drop in economic activity was driven by all demand components, which recorded the largest negative contributions in recent years: consumption expenditure decreased by 12.4% and gross fixed capital formation by 17% compared to the previous quarter. In Germany, GDP fell by 9.7%. Italy and France had steeper declines (-12.8% and -13.8% respectively) while in Spain the fall was even stronger (-18.5%). The quarterly national accounts data, however, hid sharp fluctuations of monthly indicators such as retail sales and industrial production. The steep decline in March and April was followed by a rebound in May and June.

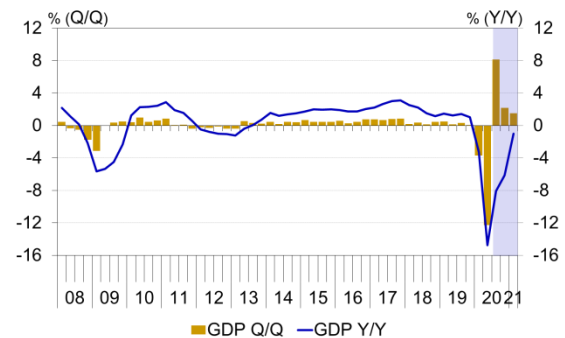
FIGURE 1 | Eurozone Industrial Production Index
Seasonally and working day adjusted



The recovery scenario is confirmed by the positive development of the Economic Sentiment Indicator (ESI), which continued in August. Consumer confidence improved slightly but remains below its long-term average. In addition, confidence improved substantially

in all sectors with the service sector still lagging behind due to deteriorating demand expectations. Industrial production continued to expand in July (+4.1% compared to the previous month), although at a slower pace than in the previous two months. After a decrease of -15.8% in Q2, compared to the previous quarter, industrial production is likely to rebound strongly in Q3 (+15.2%), before it is expected to recover with more moderate rates of +1.4% and +1.0% in Q4 2020 and Q1 2021 respectively. Capacity utilization in manufacturing sector has increased to 73% in Q3, but it is still about 10 percentage points lower compared to pre-COVID values.

FIGURE 2 | Eurozone GDP Growth
Seasonally and working day adjusted



The development in the manufacturing sector is expected to drive GDP in the euro area, which is forecast to rebound in Q3 (+8.2%) and continue at a moderate pace in Q4 and Q1 2021 (+2.2% and +1.5% respectively). Overall, the seasonal and calendar adjusted GDP is expected to decline by 8.0% in 2020 compared to the previous year.

Private consumption will rebound strongly in Q3 (+9.2%) and continue its recovery in the following quarters (+2.3% and +0.9% in Q4 2020 and Q1 2021).

Due to high uncertainty, a subdued development of domestic and foreign demand is expected. This is also likely to slow the recovery process of capital

investment. Compared to industrial production, gross fixed capital formation is projected to rebound to a lesser extent in Q3 (+10.2%) and then increase at +3.0% and +2.3% in Q4 and Q1 2021.

Inflation remains low

After more than four years of price increases, the annual change in the harmonized index of consumer prices (HICP) turned negative in August (-0.2%, following +0.4% in July). The deflationary trend mirrors low energy prices and the slowdown in food prices, but also core inflation decreased noticeably, driven by the fall in demand and by the temporary reduction in German VAT rates, which came into force in July.

Under the technical assumptions that the Brent price remains at \$43 per barrel and that the dollar/euro exchange rate is stable at 1.18 over the forecast horizon, inflation will fluctuate around zero in Q3 and Q4 2020. On average, in 2020, inflation is forecast to increase slowly (+0.3%). In the first quarter of 2021, the annual growth rate of the HICP is expected to pick up slightly, taking into account both the restoration of the usual VAT rates in Germany and the weaker base effects of past energy price fluctuations.

FIGURE 3 | Eurozone Inflation

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



Source: Eurostat and Ifo-Istat-KOF Forecasts

High uncertainty for the scenario

The outlook is subject to high uncertainty, especially given that the number of new coronavirus infections is currently surging in many European countries. Upside and downside risks are therefore dominated mostly by the evolution of the pandemic. Upside risks include the prompt discovery and distribution of a functional vaccine, which, in the short run, would bolster consumer and business confidence and strengthen domestic demand and growth prospects.

On the downside, if contagions were to increase stronger than expected, more stringent containment measures would be required. Confidence would remain weak for a longer period and increase precautionary savings, thereby negatively affecting consumption and investments.

Table 1 | Forecast Overview

| | 2020 | Q3 20 | | Q4 20 | | Q1 21 | |
|----------------------------------|------|-------|------|-------|------|-------|------|
| | | q/q | y/y | q/q | y/y | q/q | y/y |
| Industrial Production | -9.6 | 15.2 | -7.3 | 1.4 | -5.0 | 1.0 | -0.6 |
| Gross Domestic Product | -8.0 | 8.2 | -8.1 | 2.2 | -6.1 | 1.5 | -1.0 |
| Private Consumption Expenditures | -8.7 | 9.2 | -8.5 | 2.3 | -6.5 | 0.9 | -1.2 |
| Gross Fixed Capital Formation | -8.6 | 10.2 | -6.5 | 3.0 | -8.9 | 2.3 | -1.7 |
| Headline Inflation | 0.3 | -0.3 | 0.1 | 0.1 | -0.1 | -0.2 | 0.3 |

Change in % seasonal and working day adjusted

Source: ifo-Istat-KOF-Forecasts

Methodological note

This quarterly publication is prepared jointly by the German ifo Institute, the KOF Swiss Economic Institute, and the Italian Istat Institute. The forecast results are based on consensus estimates building on common macroeconomic forecast methods by the three institutes. They are based on time-series models using auxiliary indicators from business surveys by national institutes, Eurostat, and the European Commission. The joint three-quarter forecast covers Eurozone industrial production, GDP, consumption, investment, and inflation. Further country-specific and global economic analysis is available by:

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