Eurozone economic outlook

December 22nd, 2020

Second Covid wave hampers recovery

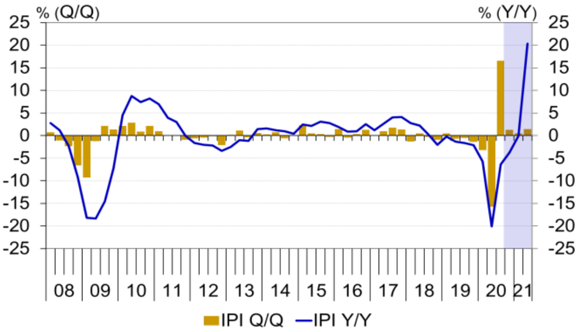
- *After a sharp recovery in Q3, economic activity will decrease again in Q4 due to new lockdowns.*
- *Annual inflation will remain low, with a moderate acceleration in the first quarter of 2021 but the speed will accelerate in Q2.*
- *The outlook is subject to both upside and downside risks, depending on the effectiveness of economic policies, the evolution of the pandemic, the rollout of vaccines and the effects on the economy of Next Generation EU funds.*

Strong recovery of economic activity in Q3

In the third quarter, euro area GDP recovered sharper than expected from the unprecedented downturn in the first half of 2020. From May onwards, the gradual release of containment measures triggered the recovery of economic activity: GDP increased by 12.5%, after -11.7% in Q2, although remaining 4.4% below its pre-crisis level (Q4 2019). The recovery was driven mostly by a rebound in private consumption, which increased by 14%, but is still 4.6% below its pre-crisis level. Gross fixed capital formation and exports grew also strongly by 13.4% and 17.1% respectively.

The recovery has been stronger in the countries, which recorded a steeper fall previously. In France, Italy and Spain, GDP increased markedly (18.7%, 15.9% and 16.7% respectively), while the recovery was less pronounced in Germany (8.5%). The quarterly national accounts data, however, hides the sharp fluctuations of monthly indicators, such as retail sales and industrial production. The steep decline in March and April, related to the lockdown measures, was followed by a stronger rebound until July and a slower recovery afterwards.

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

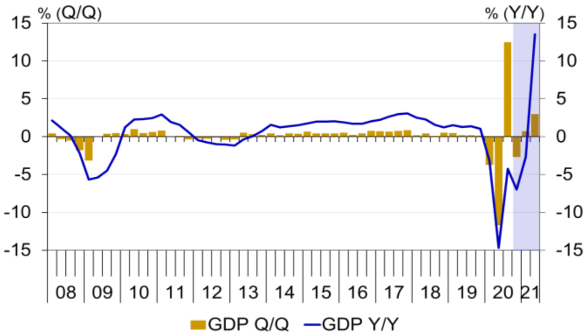


Source: Eurostat and Ifo-KOF Forecasts

At the current edge, the new containment measures enacted since November lead to a slowdown in economic activity. The Economic Sentiment Indicator (ESI) decreased again in November remaining clearly below its long-term average. The decline in confidence was stronger in services and retail sectors and for consumers while the manufacturing sector experienced a small drop in confidence. The industrial production expanded in October (+2.1% compared to the previous month), reflecting the positive contribution of Germany.

In the next months, new containment measures are expected to dampen the recovery, especially in the service sector, but also in the manufacturing sector. However, given the strong overhang, industrial production will expand by 1.3% in Q4, compared to the previous quarter, and slow down to 0.5% in Q1. An uptick in the recovery is expected in Q2 2021 (1.4%). Due to the base effect of the very low second quarter in 2020, the year-on-year growth rate will increase to over 20%. Capacity utilization in the manufacturing sector has increased to 76% in Q4, but it is still about 5 percentage points lower compared to pre-COVID levels.

FIGURE 2 | Eurozone GDP Growth
Seasonally and working day adjusted



Source: Eurostat and Ifo-KOF Forecasts

The underutilization of capacity and the high uncertainty about the further evolution of the pandemic will slow down the recovery of capital investment. Gross fixed capital formation is projected to decrease in Q4 (-3.1%). In the following quarters, given a possible relaxation of containment measures over spring 2021, a timely start of the distribution of Next Generation EU funds and the beginning roll-out of mass vaccination programs, capital investment should recover modestly by +1.5% in Q1 accelerating to +4.4% in Q2. Private consumption is expected to decrease in Q4 (-3.7%) due to new containment measures, but will rebound in Q1 and Q2 2021 (+0.7% and +2.7% respectively). GDP in the euro area is expected to fall again in Q4 by -2.7% with a decline by -7.3% in 2020 compared to the previous year. Given the assumptions mentioned above, GDP should recover by +0.7% in Q1 and +3.0% in Q2.

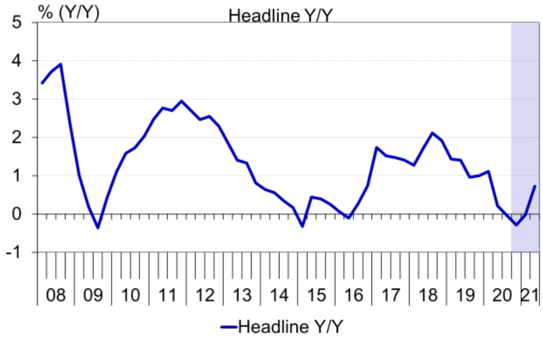
Price pressure remains subdued

The annual change in the harmonized index of consumer prices (HICP) stayed negative in November at -0.3%. This reflects past decreases in energy prices, as well as the temporary reduction in German VAT rates, which came into force in July. The inflation rate is assumed to remain low at -0.3% in Q4. For the entire year 2020, prices are expected to increase by 0.2%.

The VAT reduction in Germany will be revoked in January, leading to an increase in inflation also in the euro area aggregate. Nonetheless, under the technical assumptions that the Brent price remains at $51 per barrel and that the dollar/euro exchange rate is stable at 1.22 over the forecast horizon, underlying price pressure will remain subdued due to weak demand, especially in the tourism and travel-related sectors. Considering this, the annual growth rate of the HICP will be stationary in Q1 2021 and will increase by +0.7% in Q2 2021.

FIGURE 3 | Eurozone Inflation

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



Source: Eurostat and Ifo-KOF Forecasts

Risks to outlook still tilted negative

The outlook is subject to high uncertainty, especially given that the number of new infections in many European countries are still high. Therefore, both upside and downside risks are due mostly to the evolution of the pandemic. While the risks are still tilted to the downside, the discovery of several functional vaccines and the prospect of roll-outs in the near future are encouraging. In addition, the settlement concerning the Next Generation EU funds improves the outlook for later next year. Nonetheless, downside risks prevail especially in the short run, given the upcoming holiday season. A third wave of infections at the beginning of next year and additional containment measures would dampen economic activity. Further, a hard and chaotic Brexit at the beginning of next year could lead to short-term disruptions in supply chains and thus production.

Table 1 | Forecast Overview

	Q4 20		Q1 21		Q2 21		2020
	q/q	*y/y*	q/q	*y/y*	q/q	*y/y*	
Industrial Production	1.3	*-3.7*	0.5	*0.0*	1.4	*20.3*	-9.0
Gross Domestic Product	-2.7	*-7.0*	0.7	*-2.7*	3.0	*13.5*	-7.3
Private Consumption Expenditures	-3.7	*-8.2*	0.7	*-3.2*	2.7	*13.5*	-8.1
Gross Fixed Capital Formation	-3.1	*-13.0*	1.5	*-6.3*	4.4	*16.4*	-9.5
Headline Inflation	0.0	*-0.3*	-0.3	*0.0*	1.5	*0.7*	0.2

Change in %, seasonal and working day adjusted

Source: ifo-Istat-KOF Forecasts

Methodological Notes

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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