

Eurozone Update

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Aggressive Stimulus Is Facilitating an Economic Recovery, But Negative Rates to Remain the Status Quo for Years

A more severe drop in GDP than the U.S.; unemployment rate to rise as employers carry out permanent layoffs

Fiscal stimulus is limiting the increase in unemployment

The post-crisis Eurozone economy is coming into view. The Eurozone began to recover in the third quarter of 2020 after real GDP plunged an historic 11.8 percent in quarterly terms (not annualized) in the second quarter, even worse than the contraction in the United States. Consumer spending is leading the Eurozone's recovery; retail sales were 3.7 percent higher than a year earlier in August and up 3.1 percent from February. By contrast, construction and industrial output were still markedly below pre-crisis levels in the third quarter. The Eurozone's unemployment rate rose gradually to 8.1 percent in August from a cyclical low of 7.2 percent in February and March, undershooting the U.S. unemployment rate, which was in the double digits between April and September; the apparent discrepancy is because the Eurozone's statistics consider temporarily furloughed workers to be employed while in the U.S. they are counted as unemployed. The Eurozone's unemployment rate will continue to rise in the third quarter of 2020 and peak between 9 and 10 percent in the fourth quarter as permanent layoffs increase. Real GDP will rise sharply in the third quarter and grow above trend through 2021, but will not recover to its pre-crisis peak until late 2022; rising cases of coronavirus across the currency area since the late summer of 2020 pose a downside risk to this recovery.

The unemployment rate's peak in this crisis will likely be below the 10.3 percent peak in the 2008-2009 global recession or the 12.1 percent peak in 2013 during the sovereign debt crisis, demonstrating the effectiveness of the E.U.'s fiscal stimulus. The E.U. and its member state governments jointly funded a program of over €3.45 trillion euros in public health spending, loans to businesses, and replacement of workers' lost income (see Chart 1). This is equivalent to 25 percent of the E.U.'s pre-crisis GDP, but its immediate boost to economic activity is smaller: Instead of funding current expenditures, most of program is either loans to bolster business balance sheets or payments to households who have increased their savings.

The E.U.'s heads of state also created a Recovery Fund that marks an important step toward an E.U. fiscal policy. The Recovery Fund prioritizes funds to the countries hit hardest by the crisis, rather than

CHART 1: COMPOSITION OF THE EUROPEAN UNION'S 2020 FISCAL STIMULUS

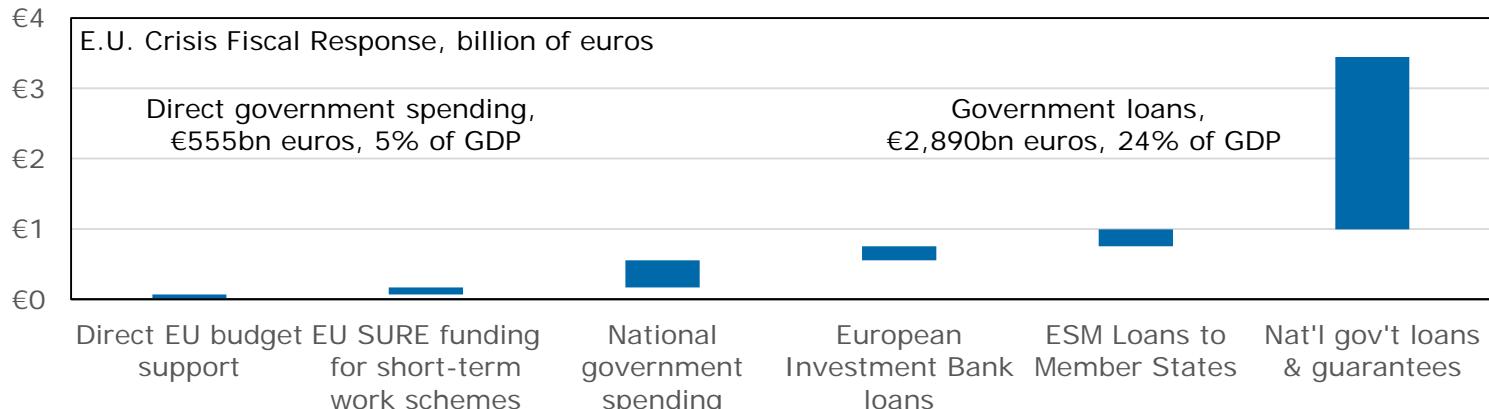


Chart sources: European Commission, IMF, news reports





EUROZONE UPDATE

E.U. Recovery Fund has bolstered confidence in the euro area and narrowed bond spreads

ECB wants higher inflation expectations, but will they do what it takes to create them?

PNC forecasts modest additional euro gains in 2021-22

by countries' share in E.U. GDP; and it is funded directly by the European Commission instead of national governments. That makes it more like a federal fiscal authority than past E.U. programs. Its direct economic impact is not large relative to the European Union's economy: €750 billion euros, of which €390 billion are direct public spending, with only 70 percent of the total to be spent in 2021 and 2022, or about 1 percent of GDP per year. But its impact is broader than that. By demonstrating that the E.U. now can conduct Union-wide fiscal policy more effectively than during the sovereign debt crisis, the Recovery Fund has bolstered financial markets' confidence in the euro area and compressed spreads between the yields of sovereign bonds issued by the E.U.'s weaker economies and its stronger ones.

Fiscal stimulus has taken some pressure off of the European Central Bank (ECB) to support the Eurozone's recovery singlehandedly. Like the Federal Reserve, the ECB launched an extremely aggressive stimulus program in the spring. They increased their budget for asset purchases by €1.47 trillion euros; loosened eligibility for negative rate loans to commercial banks and increased those loans by nearly €1 trillion euros; and kept other unconventional monetary tools where they started the year—the policy deposit rate is still negative at -0.5 percent, and the €20 billion euro per month open-ended QE program is running in parallel to emergency programs. The ECB will likely slow asset purchases in 2022 as the immediate crisis ends, but short-term interest rates will likely stay negative until at least 2024, ten years after the deposit rate first went negative.

The reason euro interest rates have been, and will continue to be, negative, is low trend inflation: Between 2008 and 2019, Eurozone inflation averaged 1.2 percent as measured by the benchmark HICP index, undershooting the ECB's target of below but near two percent. Financial markets price in inflation averaging the same 1.2 percent over the next five years. The ECB is reviewing its monetary policy strategy, looking for a way to convince financial markets that inflation will rise to the ECB target more quickly than that; if the ECB can make markets expect higher inflation, they might be able to end negative interest rates without raising real (inflation-adjusted) rates. ECB President Christine Lagarde has suggested the ECB could raise inflation expectations by adopting an inflation overshooting strategy: the ECB could commit to very accommodative monetary policy until inflation exceeds the target, to compensate for past inflation shortfalls. But inflation overshooting conflicts with Lagarde's other institutional project: Building a consensus between the ECB Governing Council's doves, who fear too-weak inflation, and its hawks, who are skeptical of quantitative easing and abhor negative rates. If consensus forces Lagarde to split the difference between these two groups, it could dilute the ECB's commitment to overshooting and keep inflation expectations low.

In August the euro appreciated to its strongest level since the first half of 2018 as the Recovery Fund spurred optimism about the currency area's prospects; it then gave back some gains in September as the ECB jawboned against the euro's appreciation and a second wave of coronavirus struck the E.U. PNC forecasts for the euro to appreciate modestly through 2022, since the yield premium on U.S. assets versus euro assets is smaller than prior to the downturn, and the Fed is likely to pursue its inflation target more aggressively than the ECB (see Chart 2).

CHART 2: EURO TO RISE IN 2021 AND 2022 AS FED PURSUES HIGHER INFLATION MORE AGGRESSIVELY THAN ECB

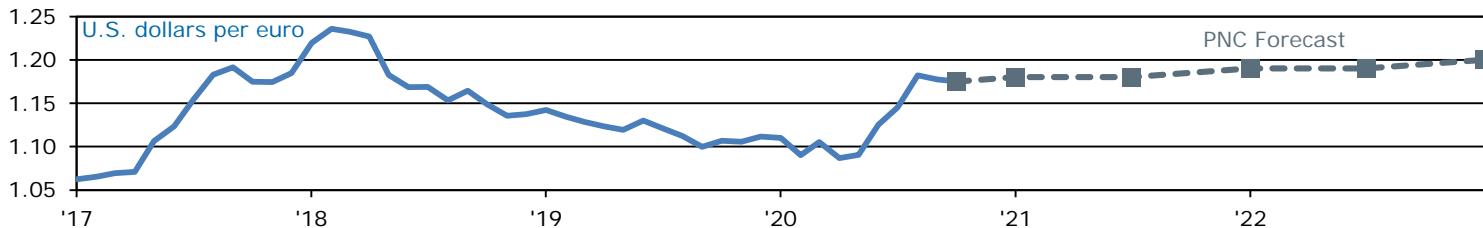


Table sources: Bloomberg, China National Bureau of Statistics, People's Bank of China, PNC Economics

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