

Eurozone Update

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ECB to Slow But Not End Its Quantitative Easing Programs in 2022; Euro Interest Rates to Stay Negative for Many Years

The Eurozone's economic recovery has hit its stride

The Eurozone's recovery finally hit its stride in mid-2021. Real GDP plunged 15% in the first half of 2020 (not annualized), rebounded in the summer and fall, and then fell for two straight quarters during the pandemic's winter wave. Real GDP finally rebounded a strong 8.9% annualized in the second and third quarters of 2021 as vaccinations accelerated and restrictions on activity lifted. Real GDP was just 0.6% lower in the third quarter than its pre-crisis level of the fourth quarter of 2019.

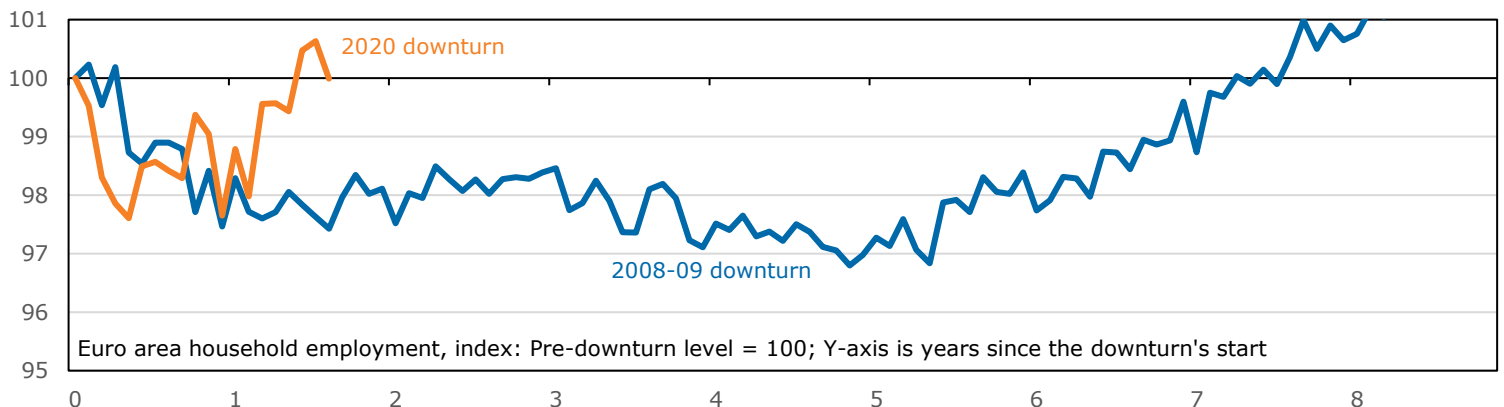
The recovery looks even stronger viewed through the labor market—employment in September was just 14,000 short of the pre-crisis peak (less than 0.1%). The Eurozone's statistics do not record furloughs as unemployment, and understated labor market slack at the bottom of the downturn. But firms are bringing back furloughed workers in 2021 as economic activity and demand recover. The Eurozone's labor protections maintained ties between employers and workers, preventing most of the dislocation experienced in the U.S. job market. Eurozone employment's quick bounce back from the Viral Recession stands in sharp contrast to the recovery after the 2009 recession, when eight and a half years passed before employment returned to its pre-crisis level (See chart 1).

Fiscal policy will tighten in 2022

Fiscal policy will provide much less support in 2022 as temporary aid programs and "automatic stabilizers" (unemployment insurance, furlough subsidies, and so forth) expire. Fiscal stimulus was a big tailwind in 2021; the EU estimates the Eurozone fiscal deficit was 8% of GDP in 2021, up from 7.2% in 2020 and 0.6% in 2019. But they forecast the deficit to fall to 4% of GDP in 2022. The deficit's shrinking share of GDP will be a net headwind to growth next year.

Against this backdrop, the Governing Council of the European Central Bank (ECB) has begun to rein in their crisis-era stimulus programs. They announced a taper of the main crisis-era quantitative easing program on September 9: Net purchases by the Pandemic Emergency Purchase Programme (PEPP) will slow to a "moderately lower pace" in the fourth quarter of 2021 than in the second and third quarters. "Moderately lower" means €65bn to €70bn per month—the ECB does not announce

CHART 1: EMPLOYMENT HAS RETRACED ITS PANDEMIC-ERA LOSSES MUCH FASTER THAN AFTER THE 2009-TO-2011 CRISIS



explicit quantitative targets for PEPP purchases. Monthly purchases averaged about €60 billion in the first quarter of 2021 and rose to about €80bn in the second and third quarters (called “a significantly higher” pace). The ambiguity leaves the ECB wiggle room to buy more if financial conditions worsen or buy less if the pandemic’s drag on the economy ends faster than expected.

The ECB’s main crisis-fighting program is set to end in March, but other QE programs will run much longer

If the recovery goes well, the ECB will wind down its stimulus programs along several different timelines. They will probably slow PEPP purchases again in early 2022 and end them in March; the ECB also is likely to shorten the tenor of negative interest rate loans they make available to Eurozone commercial banks, called Pandemic Emergency Longer-Term Refinancing Operations, a.k.a. PELTROs.

Other unconventional stimulus programs will probably continue for much longer. The ECB’s interest rate guidance commits to holding the negative deposit rate at -0.5% or lower until their three-year economic projections show inflation of 2% or more in the second and third years of the forecast, and also requires that “underlying” (core) inflation rise to be “consistent with inflation stabilizing at two per cent over the medium term.” The ECB’s projections do not expect these conditions in the next few years: Their staff economists’ projections, published in September 2021, foresee inflation of 2.2% in 2021, 1.7% in 2022, and 1.5% in 2023.

As PEPP ends, fiscal vulnerabilities could return as a catalyst of volatility for the Eurozone

Financial markets likewise price in inflation over 2% through the second half of 2022, then expect it to average below 2% for a decade. The ECB’s guidance for the Asset Purchase Programme (APP) foresees purchases continuing until “shortly before” the ECB begins raising interest rates, so it too will likely stay active for many years. The APP has bought €20 billion assets per month on an open-ended basis since November 2019 and will likely continue at this rate in 2022, and could increase it if the end of PEPP starts to send sovereign bond yields higher. Over the next few years, the ECB will change its inflation basket to incorporate owner-occupied housing costs; Eurozone house price increases have risen rapidly since the pandemic began, so this change might add a few tenths of a percentage point to Eurozone inflation if the housing market stays hot. Even so, there is no end in sight for the ECB’s quantitative easing and negative rate policies. PNC forecasts for the euro to be modestly weaker in coming years as the Federal Reserve normalizes U.S. policy more than the ECB, with targets of \$1.15 per euro for year-end 2022 and \$1.14 for year-end 2023 (See chart 2).

There are three key downside risks to the Eurozone. The first is the risk of an energy price shock if Russia throttles back natural gas deliveries during the winter. The second is from the pandemic as European weather turns colder. The third is from the sovereign bond market: spreads between the yields of bonds issued by the Eurozone’s weaker governments and its stronger ones could widen and fiscal vulnerabilities could return as a problem for the currency union after PEPP ends.

CHART 2: EURO FORECAST MODESTLY WEAKER AGAINST THE DOLLAR INTO 2022 AND 2023 AS THE FED TIGHTENS MORE THAN ECB

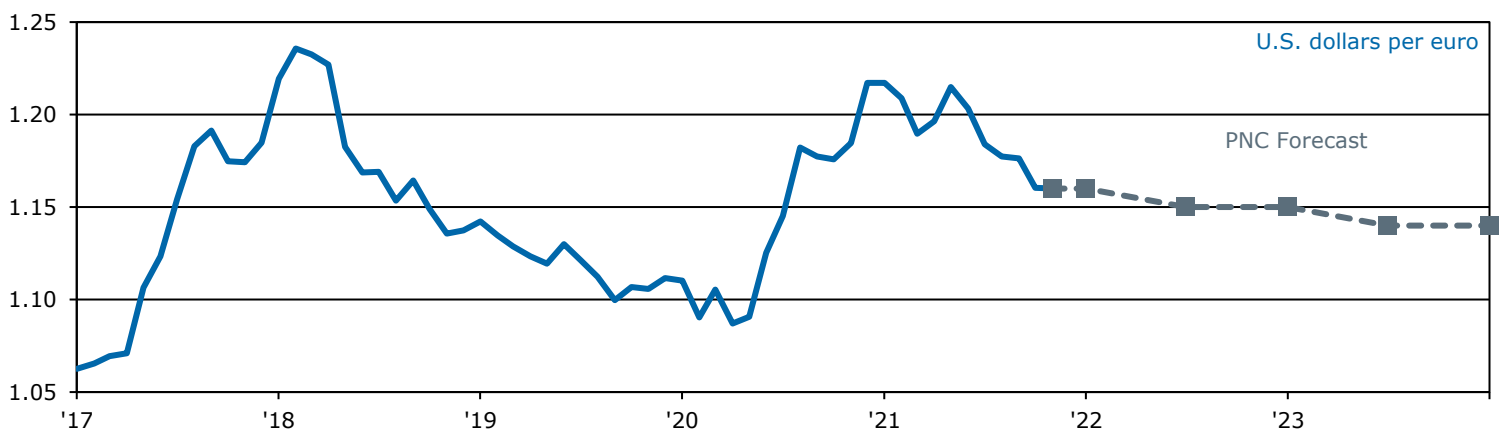


Chart sources: Bloomberg, PNC Economics forecasts

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