

A DEEPER RECESSION WITH WIDER DIVERGENCES

The European economy entered a sudden recession in the first half of this year with the deepest output contraction since World War II. To counter the spread of COVID-19, major containment measures were introduced around the world, voluntarily shutting down large parts of the economy. A string of indicators suggests that the euro area economy has operated at between 25% to 30% below its capacity during the period of the strictest confinement. Overall, the euro area economy is forecast to contract by about 8 ¾% in 2020 before recovering at an annual growth rate of 6% next year. These projections are somewhat lower than in the spring forecast and point to an incomplete recovery as output at the end of 2021 is expected to be about 2% lower than before the crisis and about 4 ½% below the GDP level forecast in winter. Inflation prospects are little changed since the spring forecast with 0.3% expected for this year and 1.1% in 2021.

Data for the first quarter confirmed initial estimates of a sizable economic impact despite confinement measures being introduced only around mid-March in most countries. GDP contracted by 3.6% in the euro area and by 3.2% in the EU. While economic disruptions have been broad based, first quarter data also confirmed the highly asymmetrical nature of the impact across countries and industries. For the second quarter, all screened indicators suggest an acceleration of the contraction in economic activity with persisting differences across countries and industries. The main reason for that is a much longer period of 'lockdown' compared with the first quarter while the easing of containment measures as of early May has been only gradual. The GDP decline is forecast to be particularly pronounced in the second quarter, at -13 ½% q-o-q. Looking forward to the second half of the year and 2021, the European economy is expected to bounce back, but with bigger and more persistent differences across Member States than expected in spring. Signs that economic activity has already passed the trough have been visible in May as the phasing out of restrictions was progressing. In June, indicators suggest that the economy has gained further momentum, providing a favourable starting point for a further pick-up in the third quarter.

Given the unusual uncertainty surrounding economic projections, this forecast continues to be based on a number of critical assumptions. Most importantly, it is assumed that containment measures in the EU will be gradually further lifted and no major second wave of infections will trigger new generalised restrictions. However, continued social distancing measures are factored in with repercussions on sectors requiring interpersonal contact. The fiscal and monetary policy measures credibly announced up to the cut-off date are expected to support the recovery and prevent large-scale bankruptcies and layoffs. Still, insolvencies and employment losses across Member States are likely to occur. At the global level, the still rising rate of infections, particularly in the US and emerging markets, has deteriorated the global outlook and is expected to act as a drag on the European economy.

Risks surrounding the growth projections continue to be severe and interconnected, leaving the balance of risks still tilted to the downside. The major risk is a new wave of infections which would falsify one of the key assumptions of this forecast. More permanent scars from the COVID-19 induced economic shock represents another major risk as, e.g. more widespread employment destructions and corporate insolvencies would lead to a slower recovery. The absence of a deal on the relationship between the EU and the UK as of 2021 remains an important risk. On the upside, the Commission's proposal Next Generation EU, which can not be reflected in the baseline until it is adopted by co-legislators, could give a sizable impulse to the EU economy, particularly in 2021.

Table 1:

Overview - the Summer 2020 interim forecast

	Real GDP growth						Inflation					
	Summer 2020 interim forecast			Spring 2020 forecast			Summer 2020 interim forecast			Spring 2020 forecast		
	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021
Euro area	1.3	-8.7	6.1	1.2	-7.7	6.3	1.2	0.3	1.1	1.2	0.2	1.1
EU	1.5	-8.3	5.8	1.5	-7.4	6.1	1.4	0.6	1.3	1.4	0.6	1.3