Euro Area Research: The road to recovery

Aila Mihr
Senior Analyst
+45 45 12 85 35
amih@danskebank.dk

14 May 2020

Summary: Europe's road to recovery

- *Reopening has begun but not yet business as usual*
  Nascent signs of a revival have emerged but we expect the euro area economy to run below full capacity for some months still.

- *Consumers: to spend, or not to spend? That is the question*
  European consumers worry about rising unemployment but increased savings seem largely 'involuntary' rather than 'precautionary', leaving room for pent-up demand.

- *Labour market: job losses accelerate, despite help from short-time working schemes*
  Short-time working schemes have acted as an important circuit breaker but we still expect the unemployment rate to rise to around 10% in coming months.

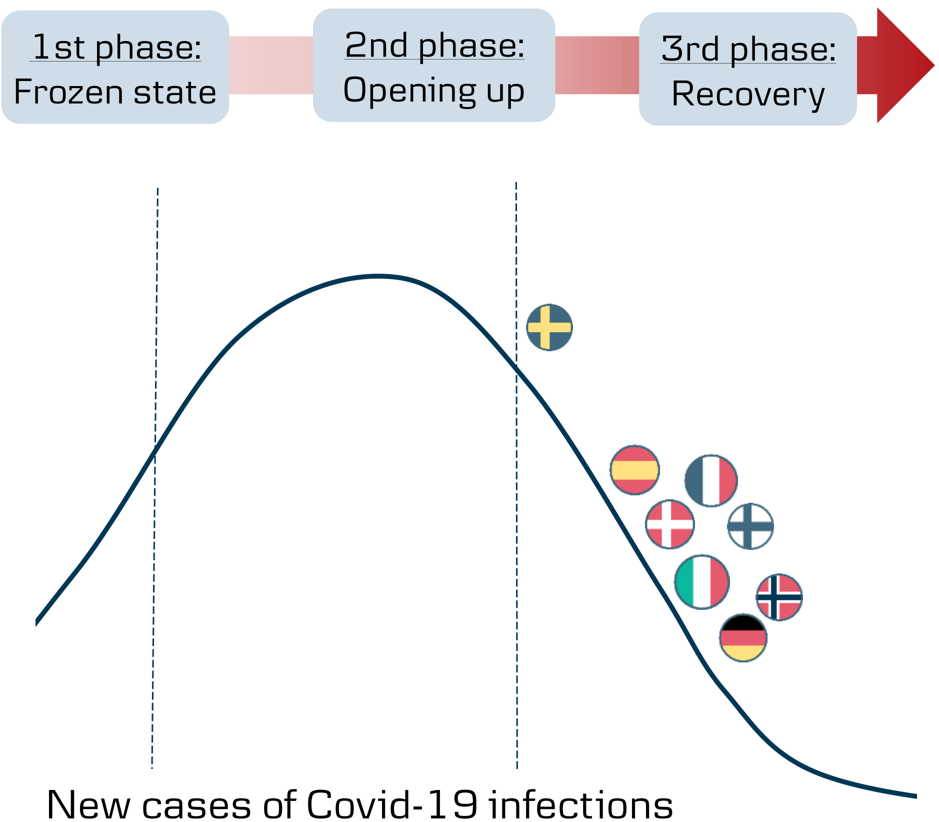
- *COVID-19 recovery: from symmetric shock to asymmetric recovery*
  Differences in fiscal capacity and tourism exposure set the scene for a two-speed recovery, in which southern Europe lags behind northern Europe. Greater global trade dependency for northern countries could mitigate the asymmetry.

- *Recovery fund: mind the (investment) gap*
  The recovery fund is set to be an important goalpost in the future of the EU, not only when it comes to channelling financial support to countries with less fiscal space but also in stemming the risk of a renewed wave of anti-EU sentiment.

- *Inflation: short-term pain, long-term gain?*
  Disinflationary pressures from falling oil prices and discounting campaigns maintain the upper hand in the near term. However, unprecedented monetary/fiscal easing and cost push inflation in some industries leave room for a reflation spiral eventually emerging.

Reopening has begun…

European countries have started to exit their lockdowns and the crucial opening up phase has begun.



Important factors from here

Virus development

- What happens to the **reproduction rate (R)** when we open up?
- Will we get a **second wave** that requires a return to lockdown measures?
- Will we get effective **medical treatment**?

→ For regular updates on these, see our *COVID-19 updates*

Economic development

- **Unemployment** – how many jobs come back?
- **Savings** – What do people do with the money they saved during lockdown?
- **Bankruptcies** – how bad will it get?
- Development in **the rest of the world** – long or short recession?

Source: Danske Bank

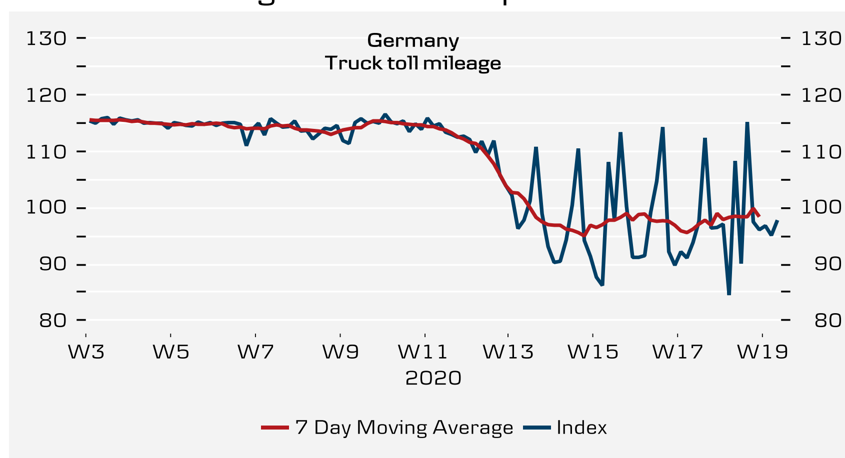
...but not yet business as usual

- As European countries have started to exit their lockdowns, early signs of revival have been visible in some high frequency data.
  - Weekly figures of retail trade in textiles in Germany have come off the trough, after shops up to 400 sq m were allowed to open again in week 17.
  - German truck toll mileage (which reports the mileage covered by trucks on German motorways) has started to show a mild uptick. As there is a strong connection between truck mileage and industrial production, this leaves hope that after a -9.2% m/m decline in March and likely an even sharper contraction in April, industrial activity will regain some ground in coming months.
  - Following the lockdowns, electricity demand has fallen as much as 20% in parts of Europe. However, since mid-April, electricity consumption shows signs of increased activity in Germany, Italy and Spain, while in France it is still at depressed levels in comparison with historical norms (see overleaf).

Textile sales have recovered some ground with the opening of shops in Germany

Source: TextilWirtschaft, Macrobond Financial, Danske Bank

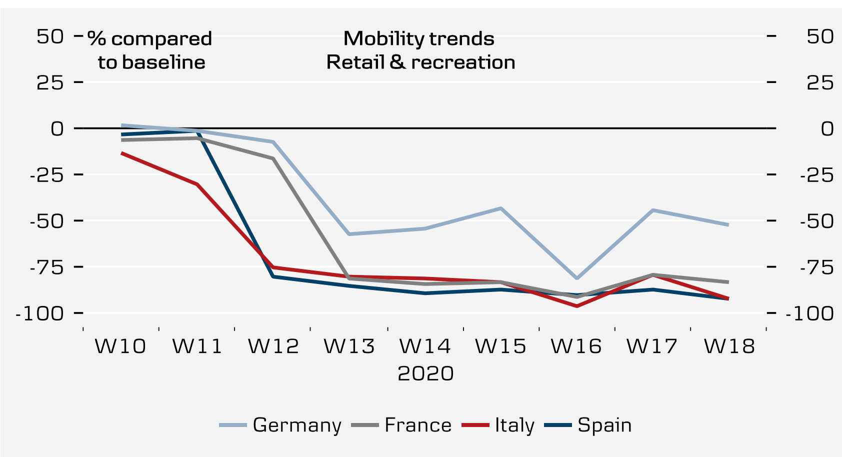
Truck toll mileage has ticked up



Source: Destatis, Macrobond Financial, Danske Bank

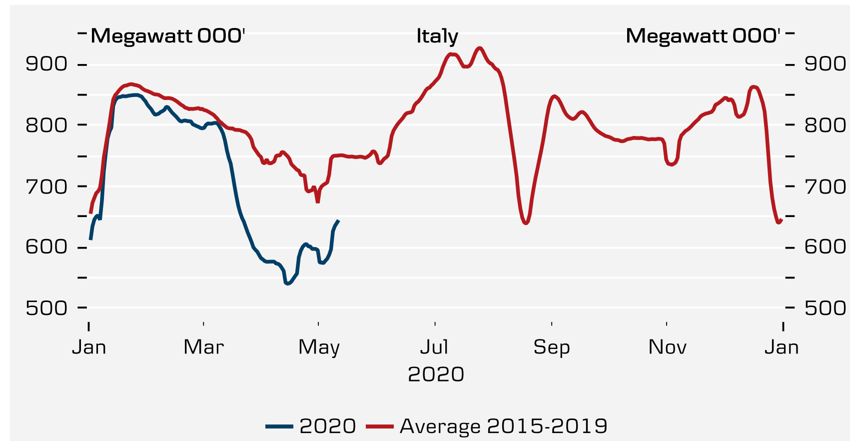
...but not yet business as usual

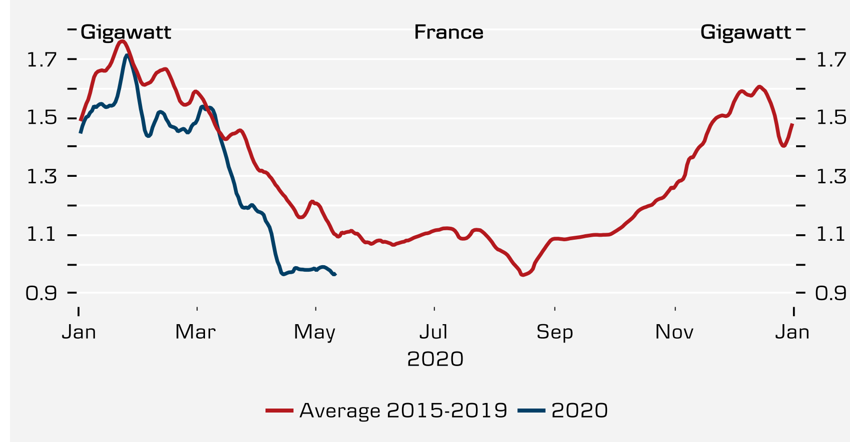
- Overall, the nascent signs of revival in the data is encouraging. However, even as economies across Europe open up again, there will be differences across sectors and we expect the euro area economy to run below full capacity for some months still. Data on Google mobility trends show that European consumers remain very cautious and that activity in retail and recreation in particular remains far below pre-lockdown levels. Ultimately, the recovery pace and the temporary versus permanent nature of the crisis will crucially depend on consumer behaviour and labour market dynamics in our view.



Note: The above shows mobility trends for places such as restaurants, cafes, shopping centres, theme parks, museums, libraries and cinemas
Source: Google Mobility, Danske Bank

Increased electricity consumption measured in Italy after easing of the lockdown but not yet in France



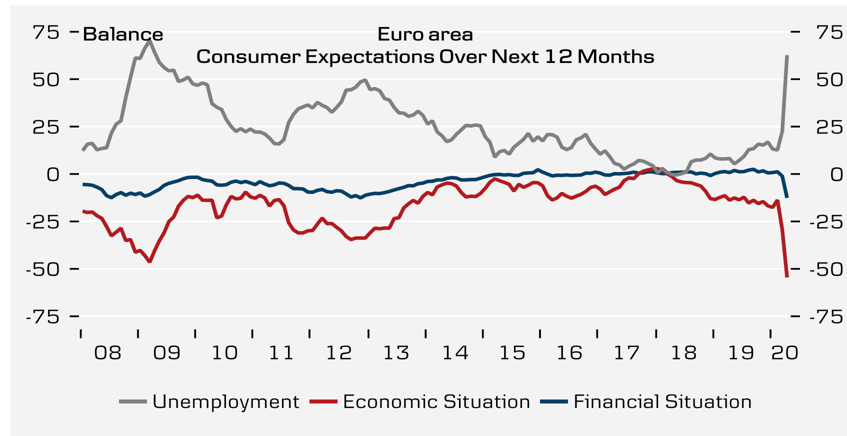


Source: ENTSO-E, Macrobond Financial, Danske Bank

Consumers: to spend, or not to spend? That is the question

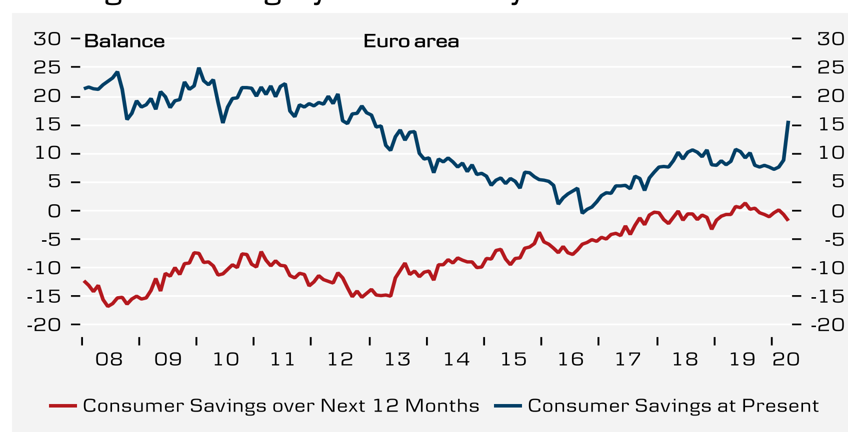
- Signals from European consumer surveys are somewhat ambiguous in terms of what they imply about the length of the crisis.
- On one hand, worries about rising unemployment have shot up and as job losses are accumulating (see next pages), this is set to leave more permanent marks on households' finances and spending power even after lockdowns are lifted.
- On the other, it seems that a large part of the increase in savings observed at present has been involuntary and not necessarily of a precautionary nature, as consumers still see their savings largely unchanged on a 12M horizon.
- In summary, we still see a case for a rebound in private consumption in H2 20. Here also differences are set to prevail, with spending on travel-related services taking longer to recover than a couple of months. In our view, how fast and to what degree current job losses will be reversed in H2 20 is crucial for developments in precautionary savings and the resumption of household consumption.

Unemployment worries have spiked



Source: EU Commission, Macrobond Financial, Danske Bank

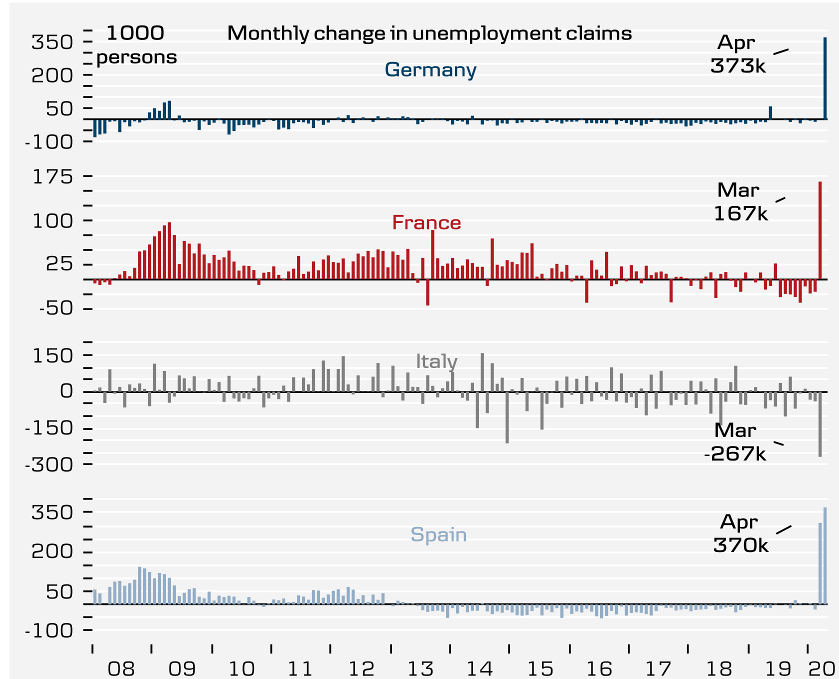
Savings still largely 'involuntary'

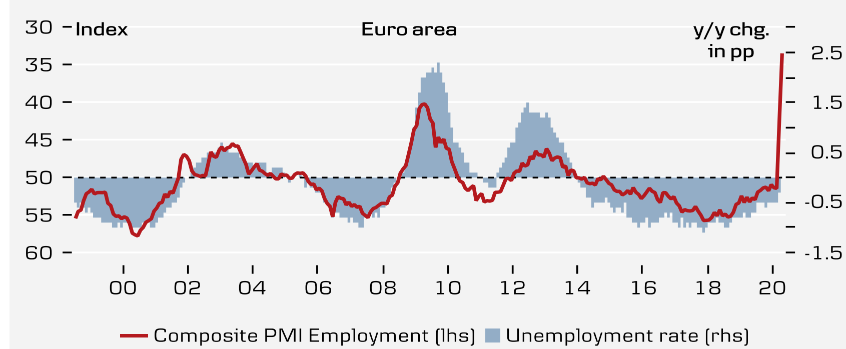


Source: EU Commission, Macrobond Financial, Danske Bank

Labour market: job losses accelerate…

- Employment losses across the euro area have gathered speed recently but remain on a much smaller scale than in, for example, the US. European countries have been quick to expand access to short-time working schemes (see overleaf), which we view as an important circuit breaker for a prolonged crisis.
- Unemployment rates rose in Germany, France and Spain in March. Italy seemed to defy the trend but the unexpected decline in the unemployment rate was due to a sharp fall in the activity rate, as people gave up on actively looking for a job on the back of the confinement measures or were no longer available for work as they had to take care of children.
- The latest PMI signals imply a rise in the euro area unemployment rate to around 10% from 7.4% currently (i.e. +4.3m unemployed) but lower participation rates and short-time work schemes might mitigate some of this effect.
- Although we expect a large part of job losses to be reversed once the economy recovers, we see an increased risk that a cautious reopening pace and a new wave of bankruptcies, especially in the travel and tourism industry, renders some of these temporary employment losses permanent.



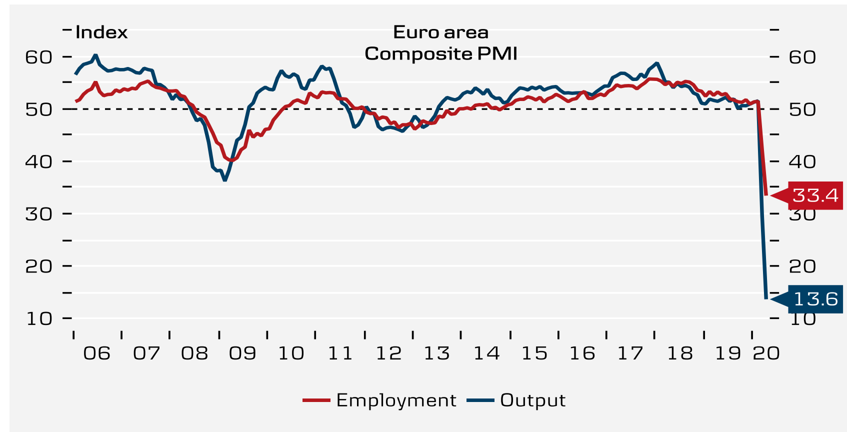


Source: Markit, Eurostat, Macrobond Financial, Danske Bank

...despite help from short-time working schemes

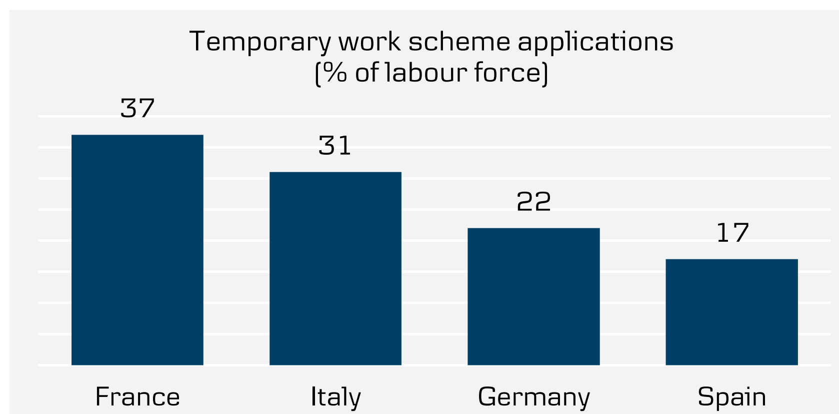
- More than 33m workers in Germany, France, Italy and Spain have applied for public support from short-time working schemes. The policy is one of the most expensive measures introduced by European governments in response to the pandemic and is expected to cost the euro area's four largest economies some EUR80bn according to government announcements.
- To help countries lift the financial burden of such safety nets for workers, the EU Commission has launched a short-term unemployment reinsurance scheme (*SURE*), whereby it will grant up to EUR100bn in favourable loans to member states that face a sudden and severe rise in spending on short-time work schemes. We view the scheme as a step in the right direction to alleviate the financial burden of the likes of Italy and Spain but time will tell whether it can be brought into action swiftly and whether the committed funds are adequate.
- Anecdotal evidence suggests short-time working schemes have helped mitigate job losses. Without them, the euro area unemployment rate would be around 20pp higher. The PMI employment index also fell much less than output in April. However, slow implementation and bureaucratic hurdles in some countries could limit the positive effect.

Short-time working schemes helped mitigate job losses: employment fell less than output in April



Source: Markit, Macrobond Financial, Danske Bank

Over a third of French workforce affected by short-time work



Source: Various government sources, Macrobond Financial, Danske Bank

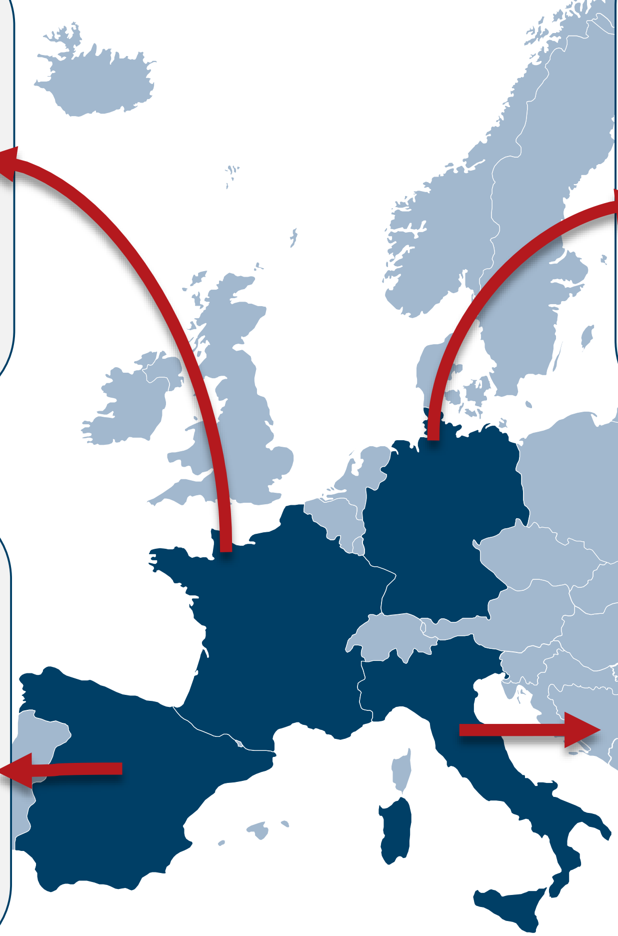
European short-time working schemes

France

- 84% of full-time salary paid by state at an estimated cost of EUR20bn
- Currently, 11.3m temporarily unemployed workers (37% of labour force) covered by *chômage partiel*

Germany

- 60-87% of full-time salary paid by the state at an estimated cost of EUR30bn
- 751,000 *Kurzarbeit* applications so far (almost every third company)
- Could potentially apply to up to 10.1m people (22% of total labour force)



Spain

- 70% of full-time salary paid by state at an estimated cost of EUR17bn
- Currently, 4m temporary unemployed workers (17% of labour force) registered under ERTE *(expediente de regulación temporal de empleo)*

Italy

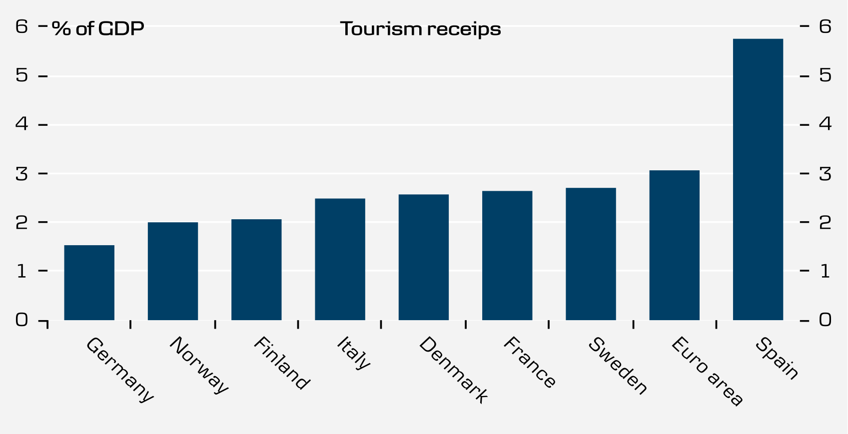
- Support through wage guarantee fund *(cassa integrazione guadagni)* → up to EUR1,400 for workers at zero hours for 9 weeks at estimated cost of EUR10bn
- Currently, 7.8m temporarily unemployed workers (31% of labour force) → due to slow implementation only 5m have so far received any benefits from INPS

Source: Various government sources, Danske Bank

COVID-19 recovery: from symmetric shock to asymmetric recovery

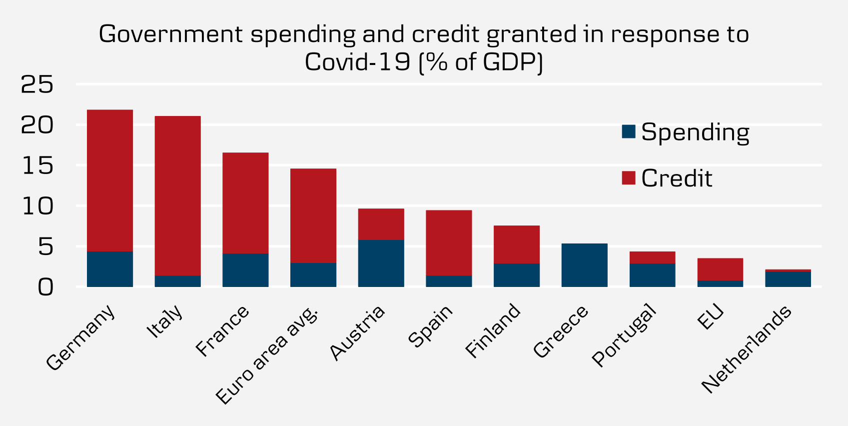
- What will the recovery from the 'great lockdown recession' look like? While policymakers have been at pains to stress that the health crisis is a symmetric shock that requires all EU governments to pool together, the danger of a two-speed recovery, in which the south badly lags behind the north, remains tangible due for several reasons.
- **Reopening pace and tourism exposure:** countries such as Italy and Spain have not only pursued a much more gradual reopening strategy than, for example, Germany and some of the Nordic countries but their economies also rely heavily on the tourism sector. Hence, there is a greater risk of permanent (and larger) employment losses and a longer time before pre-crisis GDP levels are reached.
- **Policy space:** Governments have pledged an unprecedented amount of fiscal easing in response to the COVID-19 crisis, amounting to 15% of euro area GDP on average (of which 3% are spending measures and 12% are liquidity and credit guarantees). However, its magnitude and composition vary significantly across countries.

Sluggish recovery in tourism set to hit Spain



Source: World Bank, Macrobond Financial, Danske Bank

Euro area countries have pledged fiscal measures of the magnitude of 15% of GDP on average

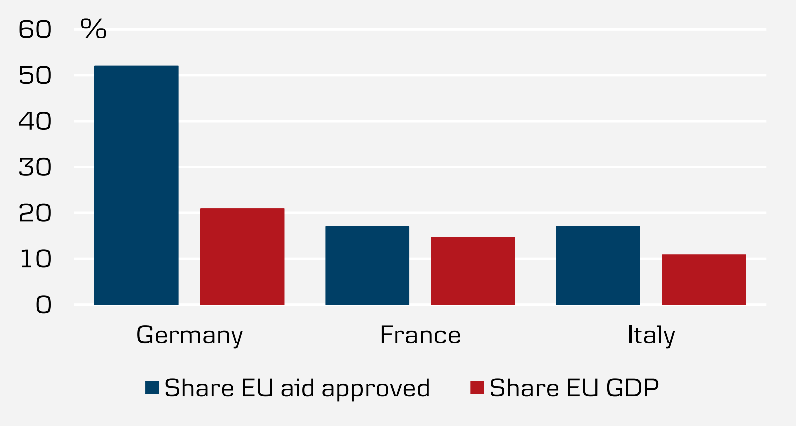


Source: Various government sources, Danske Bank

COVID-19 recovery: from symmetric shock to asymmetric recovery

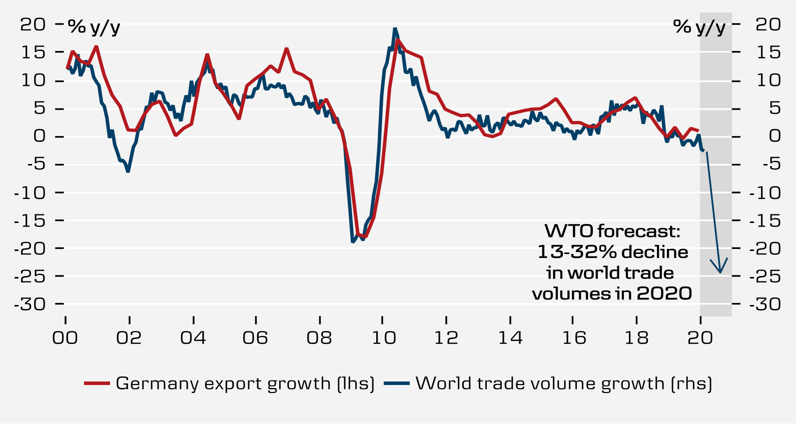
- Funding issues also extend to the important short-time work schemes. While Germany's Federal Employment Agency has ample reserves of EUR26bn to fund 'Kurzarbeit' well into 2021 and has implemented direct cash handouts of EUR9,000 to the self-employed, Italy's scheme is limited to a relatively short duration of nine weeks and covers a maximum of c.57% of average salary.
- **State aid:** Deep-pocketed countries such as Germany account for a disproportionately large share of state aid approved by the EU Commission compared with its share of the EU economy. This has triggered criticism from less well-off countries, such as Spain, about creating unfair advantages in the single market.
- **Bankruptcies:** Discretionary policy responses are set to leave their mark on the number of corporate bankruptcies ensuing in 2020, again with southern countries more exposed according to credit insurer *Coface*. Preliminary data from *Germany* suggest that the number of insolvency proceedings remained low in April due to policy steps.
- **Exposure to global trade:** One mitigating factor could stem from northern countries' larger exposure to global trade. With the *WTO* expecting a fall in world trade volumes of 13-32% in 2020, export-dependent nations such as Germany will have a tough time ahead.

Northern countries benefit disproportionately from relaxed state aid rules



Source: EU Commission

Export-dependent nations set to have a tough time ahead

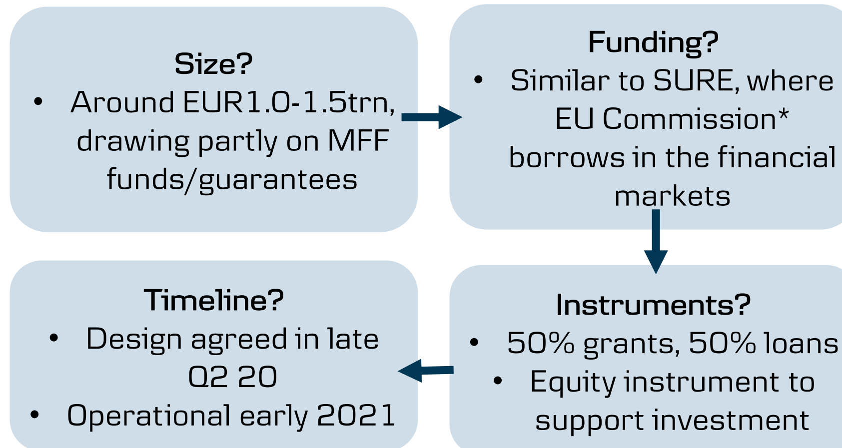


Source: Eurostat, CPB, WTO, Macrobond Financial, Danske Bank

Recovery fund: mind the (investment) gap

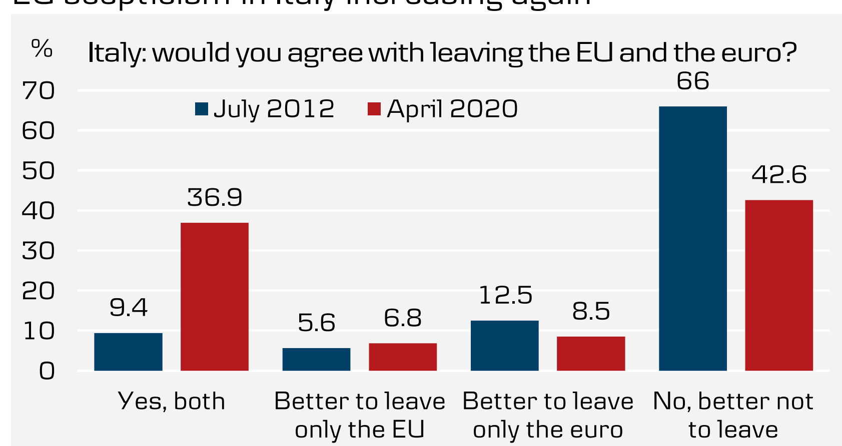
- The risk of economic divergence, paired with the uncertainty that the German constitutional court ruling has cast on the ECB's crisis fighting power, makes the need for a sizable EU recovery fund – in the form of grants rather than loans – all the more clear. Although we have previously made the case for 'corona bonds' (see *FI Research: The case for 'corona bonds' and other policy options*, 3 April), we believe they are unlikely to see the light of day at the current stage. Rather, it seems the funding of the recovery fund will be achieved in a similar model to *SURE*. Additionally, an equity instrument, which would directly or indirectly support investment, is currently also under discussion at the EU Commission.
- We expect EU leaders to make a final decision on the recovery fund in late Q2 at the earliest. Negotiations will be fraught, not only with the traditional north-south divisions but also with respect to eastern European countries which are keen to avoid seeing their EU budget funds redirected to southern Europe. All this could see the recovery fund up and running only in early 2021.
- We believe the recovery fund will be an important goalpost in the future of the EU, not only when it comes to channelling financial support to countries that have less fiscal space but also in stemming the risk of a renewed wave of anti-EU sentiment, that has, for example, already been visible in Italy.

What the recovery fund could look like



** EU institutions such as the EIB and the Commission have the power to borrow on the open markets as long as lending is guaranteed by member states*
Source: Danske Bank

EU scepticism in Italy increasing again

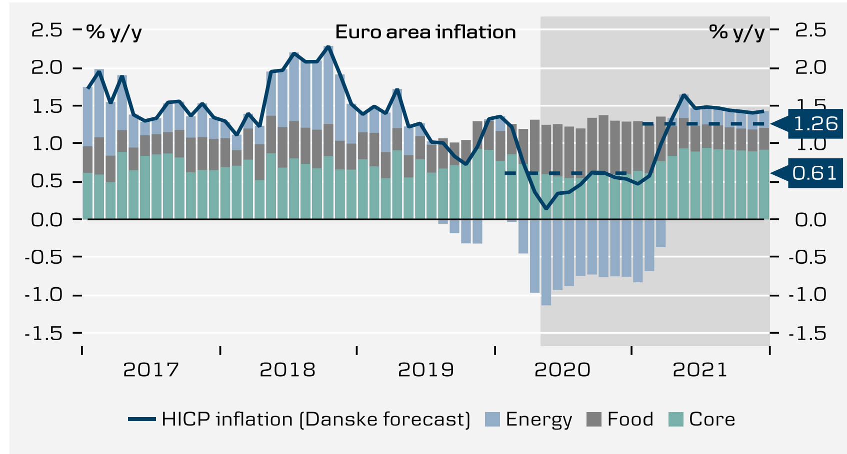


Source: Termometro Politico

Inflation: short-term pain…

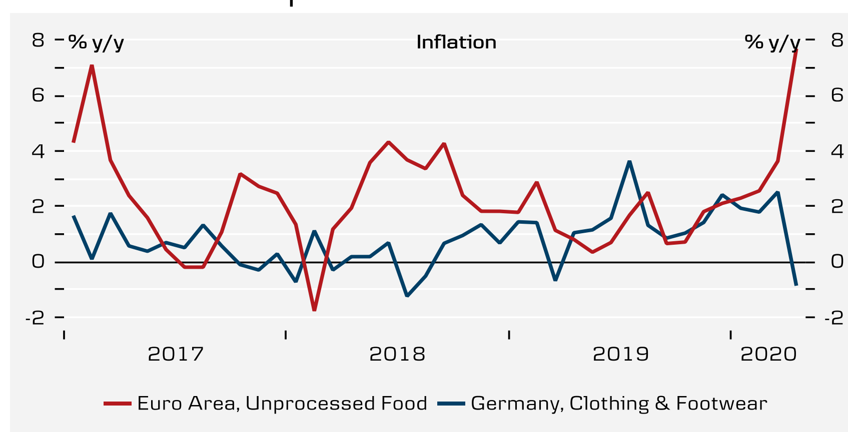
- In *Euro Area Research – Euro inflation in the coronavirus maelstrom*, 1 April, we discussed how the corona crisis was affecting the euro inflation outlook.
- In general, the implications of the coronavirus for inflation are not clear cut in theory, as it constitutes both a demand- and a supply-side shock. However, in the short term, the disinflationary effects of the demand shock seem to dominate, as discounting campaigns and the collapse in energy prices are already taking their toll on inflation dynamics.
- However, not all categories are weighing on inflation. Food prices accelerated sharply in April, driven by greater demand and more prevalent supply chain disruptions within the *agricultural sector*. Imputations applied to some services that are not currently traded (air fares, package tours, etc.) have also created an upward bias in core inflation, although this artificial boost will wane in coming months as price collection resumes after the lockdowns.

Disinflationary forces again in the driver's seat…



Source: Eurostat, Macrobond Financial, Danske Bank

…but not for food prices

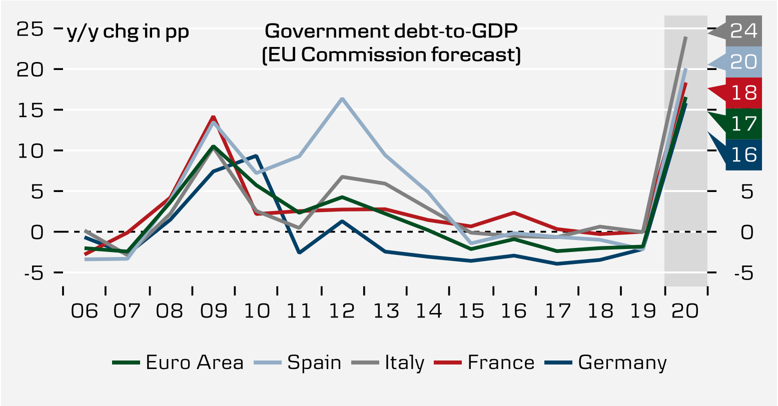


Source: Eurostat, Macrobond Financial, Danske Bank

...long-term gain?

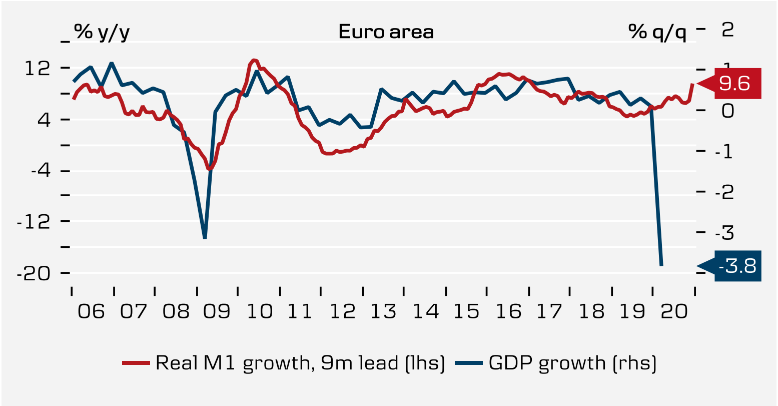
- Given the current deterioration in labour market conditions, we expect less price pressure from wages ahead. Still, this could be mitigated by the balance of bargaining power swinging back to workers if deglobalisation trends are reinforced in coming years (see also discussion *here*).
- Further, there is reason to believe that pro-inflationary forces from supply chain disruptions will at some stage come to the fore. Marked price increases are already visible for fruit and vegetables and anecdotal evidence of this is also reported in the *car sector* and *airlines*.
- Furthermore, in light of the unprecedented scale of monetary and fiscal easing, the uncertainty about a reflation spiral eventually emerging cannot be completely dismissed. As former IMF Chief Economist Olivier Blanchard argues in a recent *article*, the combination of (1) skyrocketing government debt-to-GDP ratios, (2) subsequent increases in the neutral rate above the growth rate and (3) fiscal dominance of monetary policy could lead to central bankers becoming more reluctant to counteract emerging cost-push inflation. This is particularly true in the case of the eurozone, where a lack of political will for (fiscal) risk sharing has essentially strong armed the ECB into doing monetary financing through the backdoor via its various crisis support tools.
- The argument of a reflationary boost from QE has been heard before in the aftermath of the global financial crisis but, in contrast to 2008/09, when a large part of the monetary boost simply ended up in excess liquidity, the recent uptick in money growth suggests easier financing conditions are this time starting to filter through to the real economy and consequently inflation.

Government debt levels set to rise even more sharply than after the global financial crisis



Source: EU Commission, Macrobond Financial, Danske Bank

In contrast to 2008/09, monetary stimulus is filtering through to the real economy as uptick in money growth shows



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Aila Mihr, Senior Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Danske Bank is not registered as a Credit Rating Agency pursuant to the CRA Regulation (Regulation (EC) no. 1060/2009); hence, Danske Bank does not comply with nor seek to comply with the requirements applicable to Credit Rating Agencies.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from and do not report to other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Danske Bank is a market maker and liquidity provider and may hold positions in the financial instruments mentioned in this research report.

Danske Bank, its affiliates and subsidiaries are engaged in commercial banking, securities underwriting, dealing, trading, brokerage, investment management, investment banking, custody and other financial services activities, may be a lender to the companies mentioned in this publication and have whatever rights are available to a creditor under applicable law and the applicable loan and credit agreements. At any time, Danske Bank, its affiliates and subsidiaries may have credit or other information regarding the companies mentioned in this publication that is not available to or may not be used by the personnel responsible for the preparation of this report, which might affect the analysis and opinions expressed in this research report.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual fixed income asset.

We base our conclusion on an estimation of the financial risk profile of the financial asset. By combining these risk profiles with market technical and financial asset-specific issues such as rating, supply and demand factors, macro factors, regulation, curve structure, etc., we arrive at an overall view and risk profile for the specific financial asset. We compare the financial asset to those of peers with similar risk profiles and on this background, we estimate whether the specific financial asset is attractively priced in the specific market. We express these views through buy and sell recommendations. These signal our opinion about the financial asset's performance potential in the coming three to six months.

More information about the valuation and/or methodology and the underlying assumptions is accessible via *http://www.danskebank.com/en-uk/ci/Products-Services/Markets/Research/Pages/researchdisclaimer.aspx*. Select *Fixed Income Research Methodology*.

Risk warning

Major risks connected with recommendations or opinions in this research report, including a sensitivity analysis of relevant assumptions, are stated throughout the text.

Completion and first dissemination

The completion date and time in this research report mean the date and time when the author hands over the final version of the research report to Danske Bank's editing function for legal review and editing.

The date and time of first dissemination mean the date and estimated time of the first dissemination of this research report. The estimated time may deviate up to 15 minutes from the effective dissemination time due to technical limitations.

See the final page of this research report for the date and time of completion and first dissemination.

Validity time period

This communication as well as the communications in the list referred to below are valid until the earlier of (a) dissemination of a superseding communication by the author, or (b) significant changes in circumstances following its dissemination, including events relating to the market or the issuer, which can influence the price of the issuer or financial instrument.

Investment recommendations disseminated in the preceding 12-month period

A list of previous investment recommendations disseminated by the lead analyst(s) of this research report in the preceding 12-month period can be found at *http://www.danskebank.com/en-uk/ci/products-services/markets/research/pages/researchdisclaimer.aspx*. Select Fixed Income Trade Recommendation History.

Other previous investment recommendations disseminated by Danske Bank are also available in the database.

See *http://www.danskebank.com/en-uk/ci/products-services/markets/research/pages/researchdisclaimer.aspx*. for further disclosures and information.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 14 May 2020, 08:06 CEST
Report first disseminated: 14 May 2020, 08:15 CEST