ZURICH®

Stimulus measures ramp up in the Eurozone

But even more is needed as recession could be severe

We are finally seeing aggressive monetary and fiscal action in the Eurozone in response to the COVID-19 pandemic. However, even more is needed, as downside risks remain high in what could be as large or larger a decline in Eurozone GDP than was seen during the Global Financial Crisis. However, it should be shorter in duration and we anticipate a rebound in activity in H2 provided there is the correct policy response.

Source: iStock

"There are no limits to our commitment to the euro. We are determined to use the full potential of our tools, within our mandate."

Christine Lagarde, ECB President, March 19

The outbreak of the COVID-19 pandemic is primarily a human tragedy and our thoughts are with everyone affected. However, here we focus on the economic and financial market impact.

We highlighted the fragility of the Eurozone economy in our paper last year *("The Eurozone heads towards recession",* September 6, 2019), in which we emphasised that growth was already weak and the region extremely vulnerable to either an external or internal shock.

Last year, our base case was that in 2020 weakness in the US economy would transmit to the Eurozone as well, pushing it into a mild recession sometime around the middle of the year. Unfortunately, the COVID-19 pandemic has highlighted the region's vulnerabilities and pushed the Eurozone into recession in Q1.

What's more, instead of being a mild recession, it is likely to be severe. The region contracted almost 6% peak to trough during the 2008/09 Global Financial Crisis (GFC) with five consecutive quarters of shrinking GDP. We expect the peak to trough decline in this downturn to be similar, but there is considerable uncertainty around this estimate with risks to the downside that it could be significantly higher. However, where we have more confidence is that this downturn should be shorter in duration than in 2008/09, lasting two to three quarters we expect.

This assumes that the aggressive measures now being deployed against the virus outbreak contain it within the next few months. It also assumes an aggressive and unprecedented economic stimulus response in the Eurozone, which we are now beginning to see, though even more is needed in our view (see below).

ECB acts just in time to contain periphery spread widening

Source: Bloomberg

The ECB fires its "bazooka"

After initially disappointing at the Thursday, March 12 regular ECB monetary policy meeting by announcing a relatively modest response (an extra EUR 12 billion a month of QE and easier liquidity terms for banks), the ECB got ahead of expectations the following

week. After an emergency meeting late on Wednesday March 18, it announced a EUR 750 billion QE "Pandemic Emergency Purchase Programme (PEPP)" to buy public and private sector debt.

This brings the total size of monthly QE asset purchases to around EUR 110 billion a month, even more than the EUR 80 billion that the ECB was buying at the peak of the previous programme in 2016 following the Eurozone debt crisis. The range of eligible assets will also be widened to include non-financial commercial paper, as well as the usual purchases of government bonds and corporate debt.

The optionality the ECB has left itself is also wide-ranging and unprecedented, with ECB President Lagarde saying, "We are fully prepared to increase the size of our asset purchase programme and adjust their composition, by as much as necessary and for as long as needed."

In particular, the ECB gave a strong indication that it would show flexibility with respect to its 33% issuer limit (a self-imposed cap that means the ECB only buys up to 33% of any particular bond issuance) and will increase this limit if needed to continue with asset purchases of sovereign bonds. (In a legal document released this week the ECB confirmed that the 33% issuer limit cap was being waived for PEPP purchases.) Overall, this was a much more aggressive response than the previous week's decision and was needed to stabilise periphery bond markets, where spreads had been widening sharply in recent days.

Fiscal response is also ramping up

The response on the fiscal side has ramped up in the Eurozone as well, though even more needs to be done. Various governments have announced fiscal packages, including extra healthcare spending and subsidies to companies to continue paying workers who are temporarily experiencing reduced working hours or not being able to work at all.

In total, these various direct fiscal packages represent around 1-2% of Eurozone GDP for 2020. Large government credit and loan guarantee programmes have also been announced to underwrite either directly or indirectly loans made to companies.

Germany takes off the breaks

Significantly, the German government announced on Monday March 23 a supplementary budget for 2020 worth around 4.5% of GDP, (including around two percentage points of GDP of discretionary fiscal spending). This is particularly noteworthy both because of Germany's size within the overall Eurozone economy (around 30% of GDP) and because it has previously been reluctant to embrace large fiscal stimulus packages. It also came on top of an already announced EUR 600 billion stabilisation fund to take equity stakes and provide loans and credit guarantees for companies either directly or via the state development bank, KFW.

An exemption to the so-called "debt brake" was passed in parliament this week. Enshrined in the constitution since 2009, it commits Germany to a structural deficit that does not exceed 0.35% of GDP in any one year, unless there are exceptional circumstances.

The coalition government's commitment to a black zero ("Schwarze Null"), an annual budget balance of zero or higher (i.e. not running a budget deficit), has therefore finally been abandoned, correctly in our view. Germany has the fiscal capacity to spend significantly more as its debt to GDP ratio was only around 60% in 2019, much lower than the US, UK or rest of the Eurozone.

ESM and Euro/Corona bonds also needed

Given the size of decline in GDP we are now expecting in 2020, it is our opinion that even more stimulus and government spending, of the order of a few more percentage points (pp) of GDP, is likely to be needed. To enhance the resilience of the Eurozone, some form of common bond issuance and debt mutualisation is probably also needed as well.

A mechanism that could be activated to increase spending further includes the European Stabilisation Mechanism (ESM), which has around EUR 400 billion (around 3% of Eurozone GDP) of capacity to borrow. This could be done in conjunction with all Eurozone countries applying to the fund in order to avoid the stigma of just one or two countries applying for funding, and with the issuance of common Eurobonds (which may be even named coronabonds).

If announced in the next few days or weeks this would be an encouraging and necessary development in our view that would also make the region more resilient to future shocks. Such measures are currently being discussed, though so far there does not appear to be agreement amongst all the Eurozone member countries on the way forward.

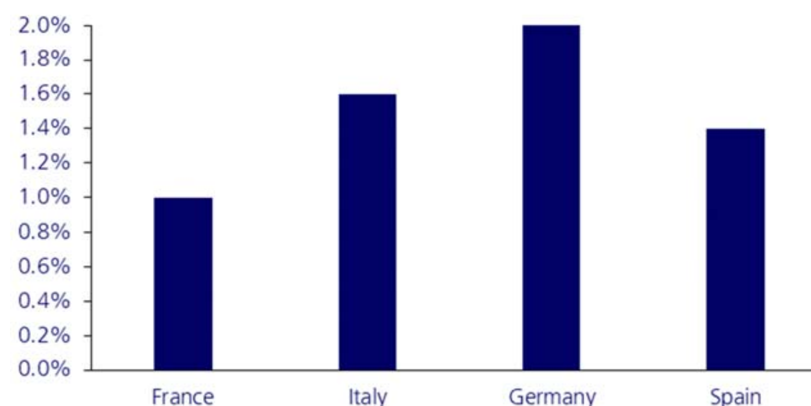
Conclusions

The monetary and fiscal response to the COVID-19 crisis has ramped up significantly in recent days in the Eurozone, with the EUR 750 billion QE programme announced by the ECB last week, and Germany's commitment this week to embrace deficit spending and make an exception to its constitutionally enshrined debt brake.

However, even assuming the outbreak is contained over the next few months, more stimulus and policy support will be needed, especially on the fiscal front, while the banking sector also remains a significant weak link in the Eurozone.

Whilst there is considerable uncertainty, our base case is that after a severe contraction starting in the first half of the year, the Eurozone will return to growth sometime in the second half of the year. However, the monetary and fiscal landscape in the region will have been transformed forever by the COVID-19 outbreak and the extraordinary policy response to it.

Discretionary fiscal stimulus in 2020 (% of GDP)



Source: National governments, Zurich MSME own estimates

Disclaimer and cautionary statement

This publication has been prepared by Zurich Insurance Group Ltd and the opinions expressed therein are those of Zurich Insurance Group Ltd as of the date of writing and are subject to change without notice.

This publication has been produced solely for informational purposes. The analysis contained and opinions expressed herein are based on numerous assumptions concerning anticipated results that are inherently subject to significant economic, competitive, and other uncertainties and contingencies. Different assumptions could result in materially different conclusions. All information contained in this publication have been compiled and obtained from sources believed to be reliable and credible but no representation or warranty, express or implied, is made by Zurich Insurance Group Ltd or any of its subsidiaries (the 'Group') as to their accuracy or completeness.

Opinions expressed and analyses contained herein might differ from or be contrary to those expressed by other Group functions or contained in other documents of the Group, as a result of using different assumptions and/or criteria.

The Group may buy, sell, cover or otherwise change the nature, form or amount of its investments, including any investments identified in this publication, without further notice for any reason.

This publication is not intended to be legal, underwriting, financial investment or any other type of professional advice. No content in this publication constitutes a recommendation that any particular investment, security, transaction or investment strategy is suitable for any specific person. The content in this publication is not designed to meet any one's personal situation. The Group hereby disclaims any duty to update any information in this publication.

Persons requiring advice should consult an independent adviser (the Group does not provide investment or personalized advice).

The Group disclaims any and all liability whatsoever resulting from the use of or reliance upon publication. Certain statements in this publication are forward-looking statements, including, but not limited to, statements that are predictions of or indicate future events, trends, plans, developments or objectives. Undue reliance should not be placed on such statements because, by their nature, they are subject to known and unknown risks and uncertainties and can be affected by other factors that could cause actual results, developments and plans and objectives to differ materially from those expressed or implied in the forward-looking statements.

The subject matter of this publication is also not tied to any specific insurance product nor will it ensure coverage under any insurance policy.

This publication may not be reproduced either in whole, or in part, without prior written permission of Zurich Insurance Group Ltd, Mythenquai 2, 8002 Zurich, Switzerland. Neither Zurich Insurance Group Ltd nor any of its subsidiaries accept liability for any loss arising from the use or distribution of publication. This publication is for distribution only under such circumstances as may be permitted by applicable law and regulations. This publication does not constitute an offer or an invitation for the sale or purchase of securities in any jurisdiction.

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001631 (01/16) TCL