Economic Preview: Week of 15 June 2020

Publication date: 12 June 2020

Week Ahead Economic Preview

Global overview

- **Industrial production and retail sales updates for the US and China**
- **Central bank meetings in the UK, Japan, Brazil and Russia**

Key releases in the coming week include industrial production and retail sales for the US and China, helping to gauge manufacturing and consumer trends as the world's two largest economies eased lockdowns. Jobs data are meanwhile issued in the US, China and the UK, while inflation numbers are updated in the Eurozone, Japan and UK.

It's also a busy week for central banks, with markets looking for views from policymakers on expected recovery speeds and whether any new tools might be deployed to help ease downturns. Policy decisions are due in the UK, Japan, Brazil, Russia, Indonesia and Taiwan. Minutes from prior meetings are meanwhile published in Japan and Australia.

Industrial production and retail sales data for the US are updated for May, and will be eagerly awaited for confirmation that the worst of the economic downturn from the pandemic has passed. IHS Markit PMI surveys, which fell into contraction back in February, look to have bottomed out in April, rising in both manufacturing and services in May. Other US data releases include the current account, housing starts, business inventories, surveys from the Empire State and Philly Fed, plus weekly jobless claims (page 3).

In Asia, the focus is on China with production and retail sales data eagerly awaited to assess the extent to which economic activity may be recovering after the relatively early relaxation of virus restrictions. Surveys show domestic demand driving the rebound in China, with trade dragging. Fresh trade data from Japan, Singapore and Taiwan will therefore also draw scrutiny to help gauge global trade. Two sets of monetary policy meeting minutes will be released: while Japan's central bank offered new support for smaller firms, the RBA turned the focus to fiscal stimulus (page 5).

In Europe, markets will be expecting the Bank of England to announce more asset purchases and will seek clues as to policymakers' appetite for negative interest rates. The Monetary Policy Committee meeting is preceded by updates to inflation and labour market data, and followed by retail sales numbers. A relatively quiet week for Eurozone economics sees the release of final inflation, construction and trade data (page 4).

Special reports

Asia Pacific: COVID-19 Assessing the Impact on Manufacturing and Services in the Asia-Pacific (**page 6**).

Europe: No easy way out for eurozone public finances after COVID-19-virus shock (**page 10**).

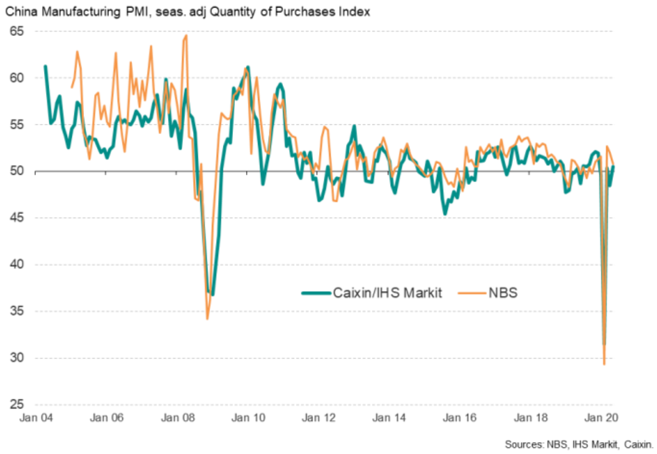
Upcoming PMI releases

23rd June: US, Eurozone, Japan, UK and Australia flash PMIs

1st July: Final Global manufacturing PMIs

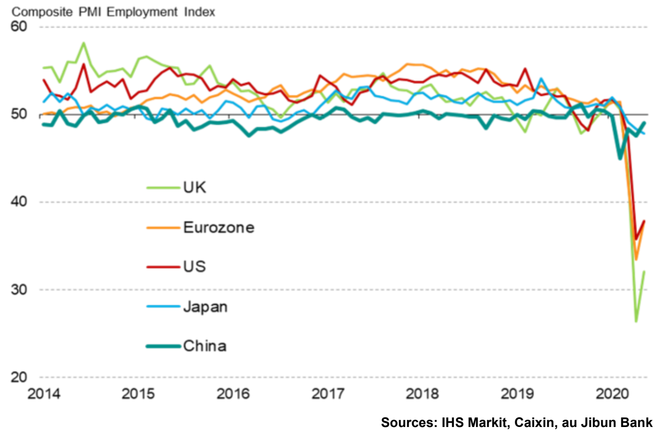
3rd July: Final Global services PMIs

PMI surveys in China suggest official production data will show an improving trend, but growth of purchasing activity remains worryingly subdued



Sources: NBS, IHS Markit, Caixin.

Labour market data will be watched closely as job trends are likely to lead to differing economic recovery speeds



Sources: IHS Markit, Caixin, au Jibun Bank

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Key diary events (UTC)

Monday 15 June

China fixed asset investment, industrial output, retail sales, house price index, jobless rate (May)

Indonesia trade (May), business confidence (Q1)

Malaysia unemployment rate (Apr)

India WPI (May)

Italy inflation (Final, May)

Euro area trade balance (Apr)

US Empire State manufacturing index (Jun)

Tuesday 16 June

RBA meeting minutes (Jun)

BoJ interest rate decision

Germany inflation (Final, May)

UK claimant count change (May), unemployment rate, average earnings (Apr)

IEA oil market report

Hong Kong SAR unemployment rate (May)

Euro area and Germany ZEW surveys (Jun)

US retail sales, industrial output (May) business inventories (Apr), NAHB housing market index (Jun)

Japan trade (May) 23:50 UTC

Wednesday 17 June

Visa's UK consumer spending index (May)

Australia new home sales (May)

Singapore NODX (May)

UK inflation (May)

Euro area inflation (Final, May), construction output (Apr)

US building permits, housing starts (May)

Russia GDP (Final, Q1)

New Zealand GDP (Q1)

Brazil interest rate decision

Thursday 18 June

Australia employment change, jobless rate (May)

Indonesia and Taiwan interest rate decision

BoE monetary policy meeting

US jobless claims (13-Jun), Philadelphia Fed manufacturing index (Jun)

Japan inflation (May) 23:30 UTC

BoJ meeting minutes (22 May) 23:50 UTC

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Friday 19 June

Germany wholesale prices (May)

UK retail sales (May)

Taiwan export orders (May)

Russia interest rate decision

India current account (Q1)

US current account (Q1)

Brazil business confidence (Jun)

European council meeting

Saturday-Sunday 20-21 June

20/6: Japan all industry activity index (Apr)

United States Week Ahead

Retail sales and industrial production

By Siân Jones

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Following the surprise non-farm payroll rise in May, the upcoming economic releases centre on jobless claims, retail sales and industrial production for additional signs that the worst of the downturn is behind us, barring a second wave of infections. Meanwhile, updates to regional business surveys for June are published, alongside May housing starts data.

Retail Sales

April data signalled an unprecedented fall in retail sales across the US, as stay-at-home measures and store closures partially stymied spending. Also driving the decline was an historic rise in unemployment, as temporary and permanent lay-offs swept the private sector.

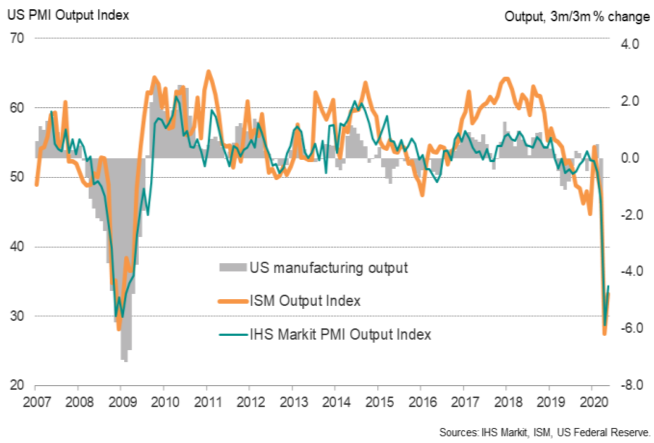
Uncertainty in the labour market for those seeking employment and for those who retained their jobs is expected to have once again suppressed sales well below a year ago again in May, though markets will be looking for a month-on-month increase from April's low. Despite the rate of unemployment dropping 1.4% on the prior month in May, largely due to the end of temporary lay-offs, the extra $600 stimulus given to those claiming unemployment benefits is currently due to cease at the end of July, adding to fears of further damage to the retail sector in coming months.

Industrial production

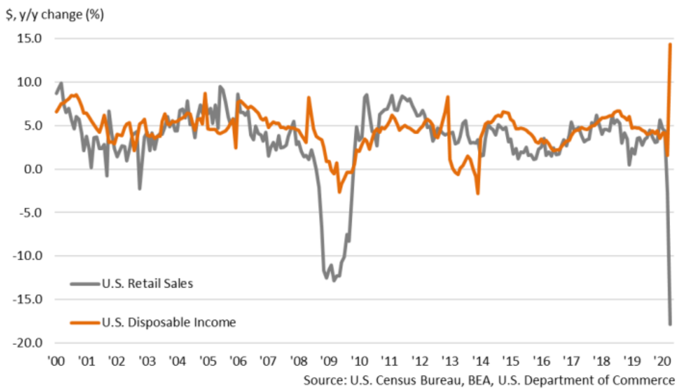
Due to the escalation of the COVID-19 pandemic, April proved a very challenging month for manufacturers as many factories shut down temporarily following emergency public health measures. May saw the reopening of many goods producers, with adaptations made to adhere to social distancing protocols. Given the reopening of production facilities in May, an increase in output looks likely, though the latest PMI data indicate that many companies continued to struggle amid collapsing demand, highlighting how output is likely to remain far below levels seen at the start of the year.

More up to date data on the health of the manufacturing sector will meanwhile be gleaned from June updates to the Philly Fed and Empire State surveys.

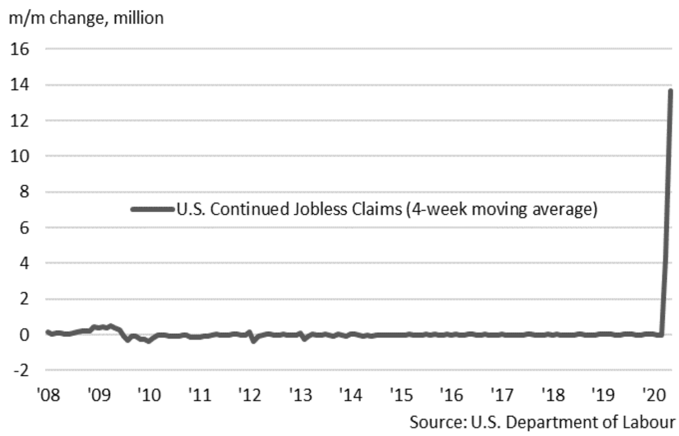
The US manufacturing downturn looks to have bottomed out in April



Retail sales declined steeply in April and look set to remain well below levels of a year ago in May



Continuing jobless claims remain historically high despite the return of those temporarily laid off



Europe Week Ahead

Bank of England, European Commission, UK employment and retail sales

By Joe Hayes

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In Europe, the focus of attention turns to the UK in the coming week as expectations grow for further policy action from the Bank of England. Analysts are widely expecting the Monetary Policy Committee (MPC) to expand its asset purchasing programme, albeit merely to sustain its current pace of bond purchasing. Retail sales and claimant count numbers for May will also garner interest to see if the gradual reopening of the economy has led to an improved picture. Elsewhere, we will be keeping a close eye on the outcome of the EU Council meeting following the Commission's proposed recovery plan.

Bank of England

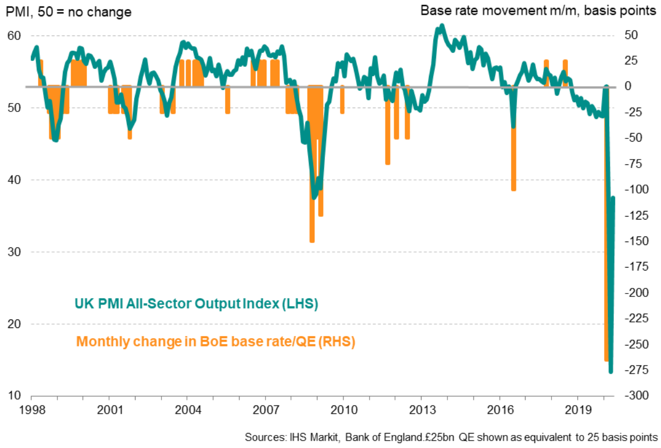
At the MPC's last meeting, it was revealed that the additional £200bn of quantitative easing announced in March in response to the COVID-19 pandemic would be exhausted by the beginning of July at the current pace of purchases. We therefore expect an expansion in the Bank's asset purchasing next week in order to meet the Treasury's aggressive borrowing plans and support the economy, ensuring the current pace of Asset purchases can continue until the MPC next meets in August. Certainly, given the severity of the economic decline expected in the second quarter, and the fact the UK still lags behind the other major Western economies in easing lockdown measures, further support from the central bank seems inevitable.

There is also plenty of UK data for markets to digest, starting with employment figures. The extent to which the unemployment rate rises (and how quickly it can come back down) will be crucial in determining the shape of the recovery. Retail sales data will also be watched for signs of an improvement after volumes sank to a level not seen in 15 years during April.

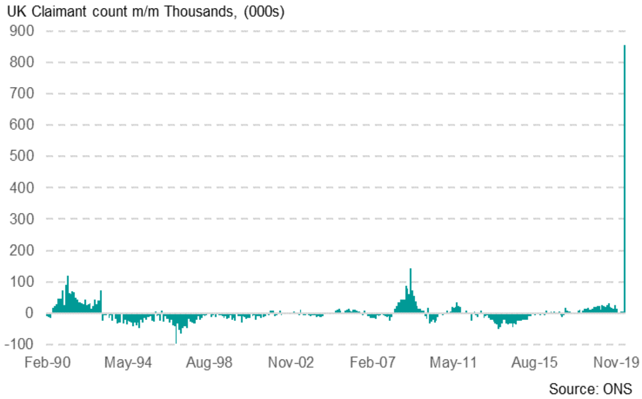
European Commission

In an otherwise quiet week for the rest of the continent, the EU Council meets, with the focus on the proposed recovery fund. It needs unanimous backing by all member states, so the approach of the sceptics – Austria, the Netherlands, Sweden and Denmark – will be a focus of attention.

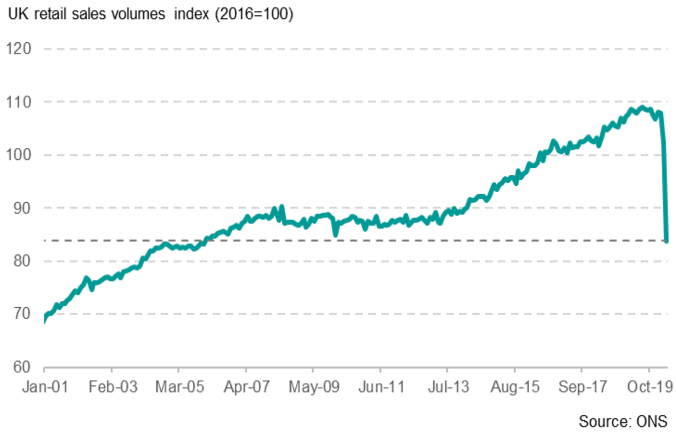
Bank of England is widely tipped to up its asset purchasing again in June



UK claimant count surged in April at the height of COVID-19 pandemic



UK retail sales volumes sank to a level not seen since 2005 in April



Asia Pacific Week Ahead

China data, Asia monetary policy and trade numbers

By Bernard Aw

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Markets will continue to assess the prospect of economic recovery next week as an increasing number of countries around the world re-open their economies. Therefore, data releases in mainland China and trade figures from Japan, Singapore and Taiwan will draw particular scrutiny after May PMI surveys having indicated a further sharp contraction in global business activity, accompanied by continued job losses.

Policy action will come from Japan, Taiwan and Indonesia, while RBA meeting minutes from Australia will also be closely watched.

New Zealand will meanwhile report its first quarter GDP. Other key Asian data highlights included job and housing data in Australia, as well as inflation figures in India and Japan.

China data and Asian trade

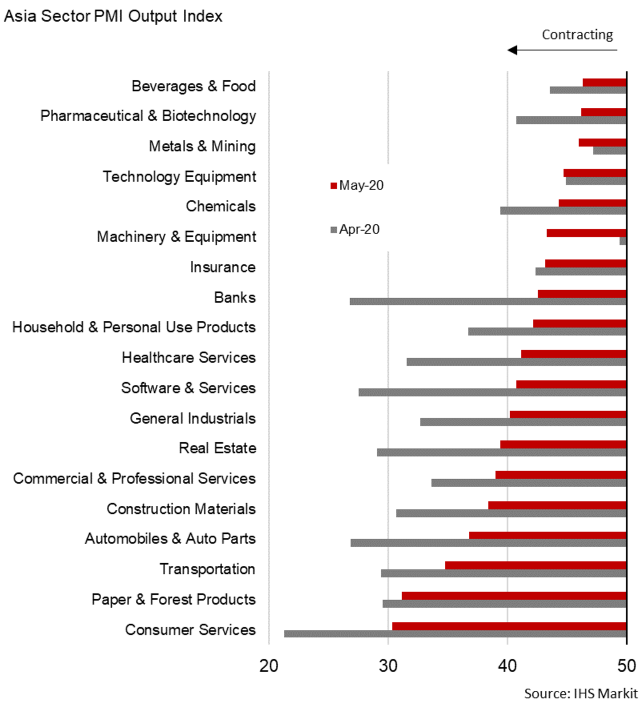
China watchers will keenly anticipate May data updates to fixed asset investment, industrial output and retail sales for signs of further progress in recovery. This will come on the heels of May PMI surveys having signalled a rise in overall business activity (covering both manufacturing and services) for the first time since January. China's data will be especially interesting as a potential guide to output for other countries in coming months as China relaxed its lockdown measures earlier and has now seen both manufacturing and services return to growth, fuelled by rising domestic demand.

Trade figures in Japan, Singapore, Taiwan and Indonesia will be eagerly monitored for wider Asian trade performance, and are likely to show slumping sales amid global demand weakness.

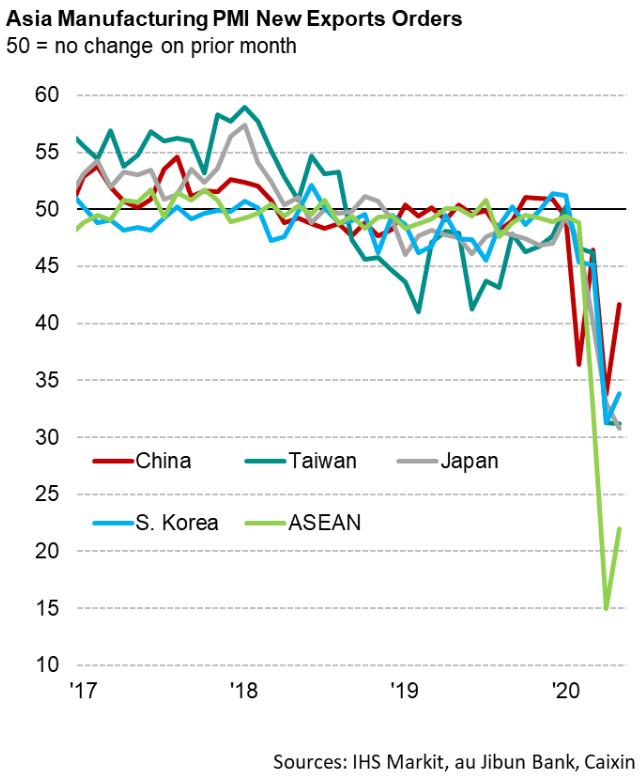
Monetary policy

Monetary policy meetings in Japan, Taiwan and Indonesia will be convened in the coming week, whereby the post-decision press conferences may provide clues as to future policy direction and whether any new measures may be deployed to support economies. Taiwan and Indonesia last reduced interest rates in March. Analysts will scrutinise the BoJ minutes from an unscheduled policy meeting during May in particular to gauge views on recovery prospects.

Asia Sector PMI continued to show a broad-based decline in output across all monitored sectors, with consumer services the worst performing



PMI data signalled further declines in export orders across Asia



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Asia Pacific Special Focus

COVID-19: Assessing the Impact on Manufacturing and Services in the Asia-Pacific

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The Asia-Pacific (APAC) region has been badly hit by the impact of the coronavirus disease 2019 (COVID-19) pandemic during the first half of 2020, with lockdown measures and travel bans in many Asian economies having triggered sharp contractions in GDP. Industrial production and consumer spending were disrupted in many Asian economies, with the APAC tourism industry having collapsed since March 2020.

However, with the number of new COVID-19 cases slowing to very low levels in many APAC economies during May, lockdown measures are being eased in a growing number of nations. PMI data indicated an accelerated rise in mainland China's business activity during May, while PMI surveys also signalled easing manufacturing downturns in some other APAC economies, including Malaysia and Thailand. Improving APAC economic growth momentum is expected in the second half of 2020, as domestic demand gradually recovers from lockdowns while export orders from key markets in Europe and North America improve. By 2021, with the pandemic expected to be contained, a stronger economic rebound in expected in the APAC region, led by buoyant growth in China.

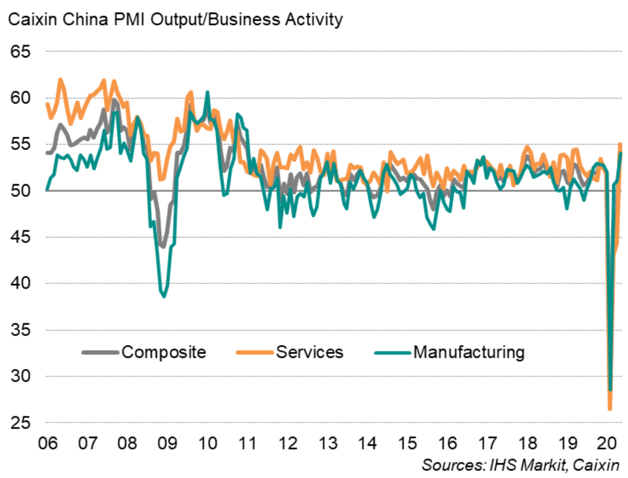
China leads APAC economic recovery

As the COVID-19 pandemic escalated in China during the first quarter of 2020, it created severe disruptions of industrial production due to the strict lockdown imposed on industries and households. The normal annual shutdown of China's industrial production during the Chinese New Year holiday period, which occurred in late January, was followed by a nationwide lockdown that extended until mid-February.

As a result of the lockdown, industrial production halted for a protracted period of time, disrupting production and shipments of industrial materials, intermediate goods and finished products from the world's largest manufacturing hub for many weeks. Restrictions on the movement of workers within mainland China also created further delays to the process of restarting factories once the lockdown was gradually lifted.

However as Chinese factories ramped up output during April and May, industrial production recovered rapidly. By April, industrial production was up 3.9% year-on-year, while production of high technology goods rose by 10.5% year-on-year. While the recovery in consumer demand has been relatively more gradual, with retail sales in March down 15.8% year-on-year, this had improved significantly by April, with the decline narrowing to 7.5% y/y. China's vehicle sales rebounded during April, rising 4.4% y/y, helped by a strong surge is sales of commercial vehicles. This compared with a 42% y/y decline in vehicle sales during Q1 2020.

Caixin China PMI points to growth in business activity



The May Caixin PMI data (compiled by IHS Markit) indicated growth in overall Chinese business activity for the first time since January this year, fuelled by a rebound in services activity and faster expansion in manufacturing output. Business sentiment also improved, with the Future Output Index, a measure of confidence, rising to a four-month high. The Caixin survey also brought signs of further restoration of the supply chains in China. Delivery delays were not reported for the first time in nearly one-and-a-half years during May as the resumption of production continued to help rebuild the distribution network.

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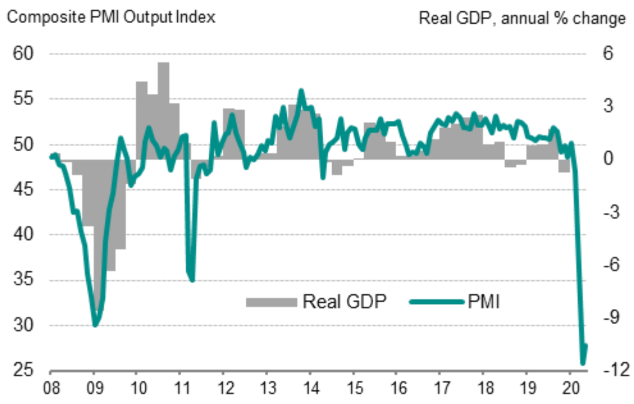
China's recovery remained reliant on the domestic market, however, amid current global trade weakness, as reflected by a rise in total new orders and a continued contraction of export orders.

Japan slides into a deeper recession

Japan's GDP contracted by an annualised 2.2% in Q1 2020, registering the second consecutive quarter of GDP decline and thereby pushing the Japanese economy into recession for the first time in four-and-a-half years. Recent PMI surveys point to [a deepening downturn] in the second quarter, with the economic contraction in Q2 2020 likely to be even more severe due to the State of Emergency measures that were initially announced by Prime Minister Abe on 7th April, which applied to certain prefectures, and were later extended to the whole of Japan on 16th April. The State of Emergency ended on 25th May as the number of new cases fell to very low levels during most of May. Due to this protracted period of weak consumer spending, both domestic manufacturing new orders and services sector activity were badly impacted.

Meanwhile, the global slump in economic activity during Q2 2020 has also hit Japanese new export orders. Provisional export data from the Japanese Ministry of Finance show that exports during the first 20 days of May contracted by 26% y/y. This followed a 22% y/y contraction in exports for the month of April.

Japan PMI points to further slump in business activity during May amid emergency measures



Sources: IHS Markit, au Jibun Bank, Cabinet Office

The latest PMI results showed the Japanese economy suffering a further substantial decline in business activity during May. The downturn reflected not only the extension of emergency measures taken to contain the COVID-19 pandemic but also the collapse in global demand. The curbs on social and business activities weighed heavily on sales across manufacturing and service sectors. Consequently, jobs were cut at a rate unsurpassed for a decade as firms faced dwindling sales. Business expectations of output over the next 12 months remained negative. Forward-looking survey indicators therefore suggest a recovery in economic activity remains far off.

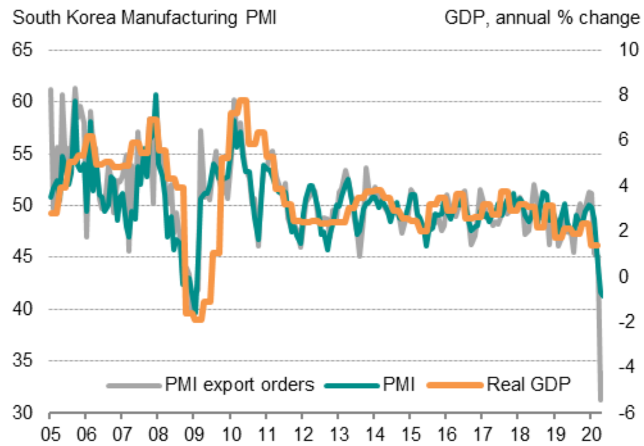
South Korean domestic demand improves but exports slump

South Korea's success in containing the escalation in new COVID-19 cases during March has allowed South Korean domestic demand to improve during April and May, with the number of new cases remaining low. According to data from the Ministry of Trade, Industry and Energy based on surveys of major retailers, South Korea's retail sales in April rose 3.9% compared to the same period last year, with online retail sales having jumped 16.9%.

However South Korea's export sector has been hit hard by the impact of lockdowns in key markets such as the US and EU. The Ministry of Trade, Industry and Energy data show that South Korea's exports in May saw a year-on-year decrease of 23.7% to USD 34.9 billion. Auto exports dropped 54% to USD 1.8 billion, due to the falling global demand in major markets, notably the United States and Europe. In May, South Korean merchandise exports to the US fell by 29%, while exports to the EU were down 25% and shipments to ASEAN fell 30%, impacted heavily by lockdown measures in these markets.

PMI data meanwhile showed a fourth straight monthly contraction in new export orders during May, with the rate of decline the second quickest in the 16-year survey history, albeit easing from April's record.

South Korea PMI shows manufacturing deeply affected by weak external demand



Sources: IHS Markit, Bank of Korea

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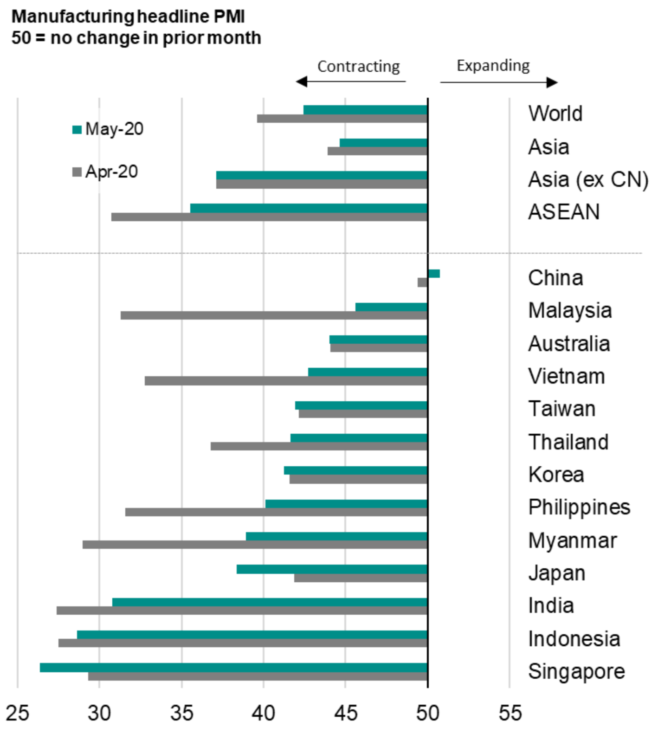
ASEAN economies hit by lockdowns

The economic impact of the COVID-19 pandemic across the ASEAN region has been mixed, with some nations such as Vietnam having largely avoided any significant domestic epidemic, while other nations such as Indonesia and Singapore have suffered more severe economic shocks.

Indonesia, which is the largest economy in ASEAN, is still facing a high level of daily new COVID-19 cases, increasing the uncertainty about how long and protracted the impact of the domestic epidemic will be on the national economy. In Singapore, the protracted lockdown is expected to result in a severe contraction in Q2 GDP, plunging the economy into a severe recession for 2020.

Malaysia and Thailand experienced a rising number of new COVID-19 cases during March and early April, but were able to control the number of new cases significantly during May, allowing the easing of lockdown measures. Nevertheless, both nations are expected to experience recessions in 2020, reflecting the slump in consumption spending in recent months as well as the decline in exports to key global markets. The collapse in international tourism is also a significant negative factor for both economies. The latest PMI surveys for Malaysia and Thailand point to a notable easing in the rate of deterioration in manufacturing conditions during May.

AsiaPac Manufacturing PMI rankings

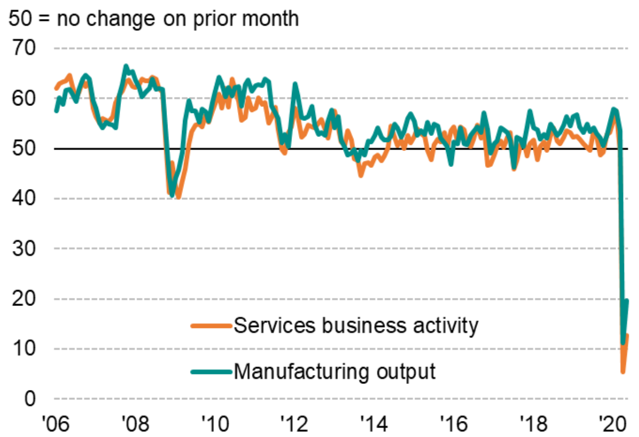


Sources: IHS Markit, JPMorgan, Caixin, au Jibun Bank, CBA

India faces recession due to lockdown

In India, a national lockdown began on 25th March and has continued in various phases into the month of June, albeit with significant easing of restrictions since early May. This protracted lockdown has resulted in the severe disruption of industrial production and consumer spending, with GDP growth forecast to contract sharply during Q2 2020, pushing Indian GDP growth for the 2020-21 financial year into a deep recession. April PMI data, reflecting the full impact of the lockdown measures, indicated a collapse of business activity, with the Composite Output Index plummeting to 7.2 in April, a record low in the 14½-year survey history and one that was extreme overall. While both manufacturing and service sectors were severely battered by the COVID-19 responses, the latter posted the sharper reduction of business activity.

India PMI signals further substantial falls in both factory output and services activity during May



Sources: IHS Markit

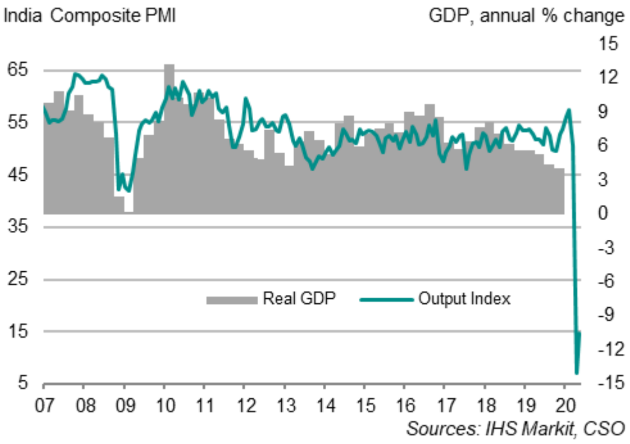
Unlike many other countries which have eased lockdown measures, India has faced continued escalation in the number of daily new COVID-19 cases, which reached a daily level of 9,987 new cases on 8th June. Consequently, the future path of lockdown measures remains highly uncertain, particularly if new daily cases continue to escalate.

As a result of the lockdown measures, Indian industrial production was heavily disrupted during late March and during April, although a limited restart of certain industries has gradually occurred since 22nd April. In the auto sector, production largely shut down when the lockdown commenced in late March, with large automakers as well as two-wheeler makers having temporarily closed their plants for most of April before lockdown conditions started to be gradually eased. Firms manufacturing auto components also had shut down temporarily due to the lockdown. The Society of Indian Automobile Manufacturers (SIAM) have estimated that the daily turnover lost for India's auto manufacturing sector for each day of closure amount to around USD 300 million per day.

Consequently, the COVID-19 pandemic intensified the recessionary conditions in India's auto industry, which had already experienced severe conditions in 2019, with a 12.7% y/y decline in passenger vehicle sales, while commercial vehicle sales were down 15.0% y/y.

The services sector has also been badly hit by the impact of lockdown measures on retail trade and the collapse of domestic travel and tourism. The May PMI data showed a further severe decline in services business activity despite easing from April's record contraction. New business plummeted further from April, reflecting the extent to which the COVID-19 restrictions had impacted the service sector. Business sentiment also turned negative for the first time since 2015, according to the latest PMI survey.

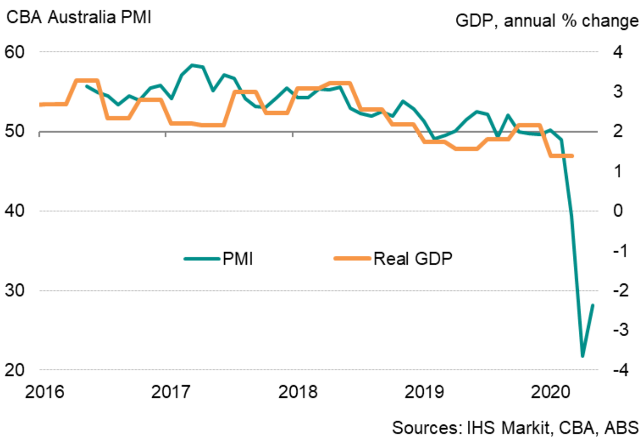
India PMI and economic growth



Australia faces first recession in 29 years

Although Australia has managed to rapidly contain its COVID-19 epidemic, the impact of lockdown measures and travel bans is expected to push the economy into its first recession in 29 years.

Australia PMI points to recession



GDP growth in Q1 2020 already recorded a contraction of 0.3% quarter-on-quarter, with lockdown measures only having impacted on the economy in late March. However, with severe lockdown measures and travel bans in place during much of Q2 2020, the economic contraction in the second quarter will be much more severe. With COVID-19 restrictions starting to be gradually eased in May and June, a gradual improvement in economic growth momentum is expected during H2 2020.

Outlook

The significant moderation in the number of new COVID-19 cases in many major economies in the APAC region during April and May has created the platform for a gradual recovery of domestic demand during H2 2020.

China, the world's second largest economy, is leading the world recovery, with economic activity reviving for both manufacturing and services. A key strength supporting China's rapid economic rebound is the large size of the domestic consumer market, which has helped offset falling external demand.

Japan has lifted the state of emergency completely, as the number of new COVID-19 cases has slowed significantly since April. South Korea has also contained its daily new cases, and has avoided imposing any strict lockdown so far.

Australia continues to contain new COVID-19 cases to very low daily levels. Domestic economic lockdown restrictions are being relaxed, which will allow domestic demand to recover. Meanwhile in New Zealand, no new COVID-19 cases have been reported for one month and the domestic lockdown has been completely lifted.

In the ASEAN region, Malaysia, Thailand and Vietnam have eased lockdown conditions, with Vietnam having had very few recorded COVID-19 cases to date.

However, new COVID-19 cases are still escalating in India and remain high in Indonesia due to large populations and dense urban areas, as well as very weak healthcare systems. This poses further downside risks to the economic outlook for both countries.

Overall, GDP growth momentum is expected to gradually improve in the APAC region during H2 2020, helped by improving domestic demand and an upturn in new export orders from key global markets, notably the US and EU. In 2021, renewed positive growth is forecast for APAC as the pandemic fades, with regional growth momentum buoyed by a strong economic rebound in China.

Europe Focus

No easy way out for eurozone public finances after COVID-19-virus shock

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A combination of collapsing economic activity, automatic stabilisers and fiscal stimulus will lead to a significant deterioration of public finances across the eurozone. Although the European Central Bank's support will help to keep borrowing costs low, extremely high public debt levels in many eurozone economies will leave them vulnerable to shocks. IHS Markit presents an overview of the financing requirements, actions taken and options available.

Scale of eurozone governments' funding needs in 2020

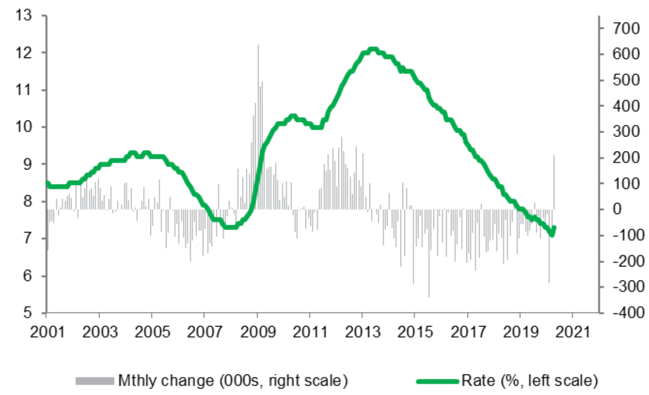
The coronavirus (COVID-19) pandemic struck after several years of improving budget balances across the Eurozone (Chart 1). However, public debt levels remain elevated in some economies (Chart 2).

Eurozone's governments need to roll over just under EUR1.9 trillion of debt in 2020. Around half of this debt is short dated with original maturities of less than a year. However, over EUR900 billion consists of longer-term debt that is maturing in 2020. This may be an area of concern if longer term yields on government bonds in weaker economies rise and result in higher debt-servicing burdens.

IHS Markit expects fiscal deficits in the eurozone to reach EUR1.1 trillion (for announced fiscal support measures, see **COVID-19: Government response**). Furthermore, in line with the experience from the financial crisis and the extensive liquidity support measures announced during the crisis, we expect another EUR600-billion of financing need (deficit-debt adjustment) on top of the deficit. This includes bailouts for specific companies, such as airlines, preferential loans for most targeted sectors, and loan guarantees, some of which are likely to be converted into expenditure because of company defaults. The scale of debt issuance in 2020 will be unprecedented (Chart 3).

Chart 1: Eurozone general government balance

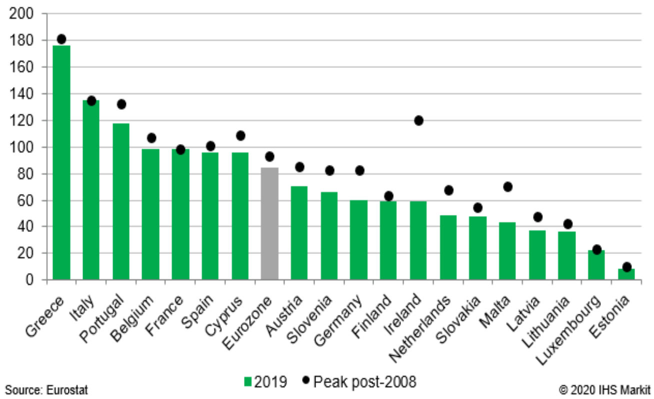
% of Eurozone GDP



Source: Eurostat

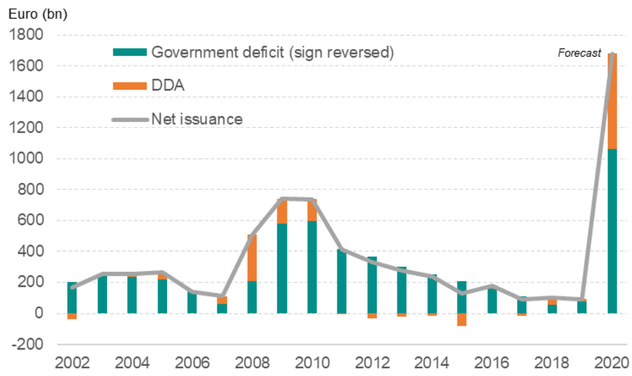
Chart 2: Public debt

% of GDP



Source: Eurostat © 2020 IHS Markit

Chart 3: Change in Eurozone public debt



Source: IHS Markit, Eurostat.

The ECB will be instrumental in absorbing a large share of bond issuance in 2020

The ECB has been active in introducing measures to contain the fallout from the COVID-19-virus crisis. The Pandemic Emergency Purchase Programme (PEPP), announced by the central bank on 18th March, has been instrumental in limiting the impact of the higher deficits on borrowing costs, particularly after its envelope was expanded in early June (see chart 4). The PEPP has now a total envelope of EUR1.350 trillion and is expected to be in place at least until the end of June 2021. This is in addition to the EUR240-billion open-ended asset purchase programme (APP) for 2020 and additional envelope of EUR120 billion announced on 12th March. The expanded asset purchases equal most of this year's net issuance (Tables 1 & 2).

Chart 4: Bond spreads vis-a-vis German Bunds

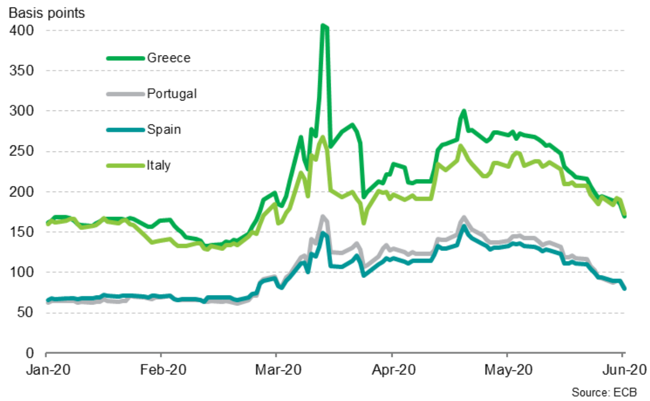


Table 1: Eurozone government financing needs in 2020 (EUR bil.)	
Total debt to roll over in 2020	**1,869**
Currency and deposits	361
Short-term loans & debt securities (<1 year)	589
Other loans & debt securities maturing in 2020 (>1 year)	919
Net issuane in 2020	**1,678**
Deficit in 2020	1,059
Deficit-debt-adjustment	619
Total financing needs in 2020	**3,547**

Source: ECB, IHS Markit calculations

Table 2: ECB purchases of government debt in 2020 (EUR bil.)	
Redemptions in 2020	**201**
APP total	**360**
Sep'19 open-ended QE	240
Mar'20 additional envelope	120
PEPP total	**1,350**
Purchases in 2020, at current pace	1,000
Purchases in 2021, at current pace	350
Total purchases of government debt (75% for APP & PEPP)	**1,221**

Source: ECB, IHS Markit calculations

Are high public-debt levels necessarily a problem?

In principle, higher debt levels should not be a problem as long as sovereigns can refinance this debt at reasonable rates. The swift action by the ECB suggests that refinancing risks should be low in 2020. However, substantially higher debt levels make countries more vulnerable to shocks, with sudden increases in borrowing costs or political events that could have a negative impact on investors' appetite for debt of a particular country. Moreover, high debt levels mean that interest burden could rise substantially if interest rates increase from their current historically low levels.

While monetary policy helps to finance debts at affordable costs, eurozone countries have limited options when it comes to lowering their debt levels. In principle, debt ratios can decline as a result of one or a combination of economic growth, inflation, and primary surpluses or, failing that, debt restructuring. Given the weak growth prospects and the expected deflationary impact of the COVID-19 shock, the first two options seem to be out of reach for most eurozone countries.

Primary fiscal surpluses could also lead to lower debt ratios over the period of time. Positively, low interest rates reduce the size of the primary balances needed to stabilise debt levels, but these balances would have to be sustained over a long period of time to lead to a sizeable decline in debt levels. In a low growth environment, this prolonged period of fiscal surpluses will be difficult to maintain.

Options ahead

There are several options for making the combination of large contractions of economic activity (with permanent output losses) and large increases in public debts manageable for governments.

- **Debt monetisation via the ECB.** The ECB's series of easing measures and announcements of large APPs that can be scaled up have had the largest impact so far on calming the bond markets. However, the ECB can currently only purchase government bonds on the secondary market and these still present a liability for the government. The room for manoeuvre is constrained by a previous ruling by the European Court of Justice, while a ruling of the German Constitutional Court points to potential clashes between European and national legal frameworks.

- **Debt mutualisation via fiscal transfers and common debt instruments.** Although it is established that, for a currency area to function smoothly, it should have more extensive fiscal transfers and common debt instruments, the politics of the eurozone have presented a serious obstacle to implementing this in any meaningful form. Several northern eurozone countries, who would be net contributors, are against debt mutualisation, while most southern eurozone countries are against ceding sovereignty on fiscal matters, which such any form of fiscal integration would entail. Using the next EU budget to scale up transfers is unlikely to be enough to meet the needs across much of the eurozone, while the politics of agreeing it is no less difficult.

- **Debt reprofiling via the ESM or other loan mechanisms:** Although repurposed for this crisis, the ESM is perceived as toxic because of its legacy from the eurozone's sovereign debt crisis among the potential recipients of its funds. Its current available lending capacity of just over EUR400 billion, which pales in comparison to the ECB's balance sheet, would also need to be scaled up. Alternatively, the European Commission has temporarily (initially until the end of 2022) made available ESM credit lines for up to 2% of members' GDP with minimum conditionality to be used to support domestic financing of direct and indirect COVID-19-virus-related healthcare, cure and prevention costs.

- **Debt write-down:** While alleviating some or most of the burden, domestic residents, including banks, own large shares of government debt, especially in Italy. Any write-down would be likely to precipitate a banking crisis and be opposed by politically powerful domestic constituents. It would also lead to widespread contagion, as investors sell eurozone debt in anticipation of more defaults. Moreover, the lack of an established process for sovereign debt restructuring within the eurozone presents another obstacle.

- **Helicopter money:** As recently described in one of our special reports, helicopter money could theoretically be an option in extreme circumstances The main difference between helicopter money and debt monetisation is that with helicopter money, rather than holding government bonds to maturity or selling them later, the ECB would cancel them, thus lowering public debt. This would face strong opposition from some member states, while the EU treaties explicitly forbid direct monetary financing of public bodies.

This analysis suggests that, in the absence of a restructuring, highly elevated public debt levels will remain a characteristic of several eurozone economies. If interest rates remain sufficiently low across the eurozone and the economies return to growth, a debt crisis could be avoided. However, this would be a very fragile equilibrium, and there are several triggers which that could lead to a more unstable outcome, including:

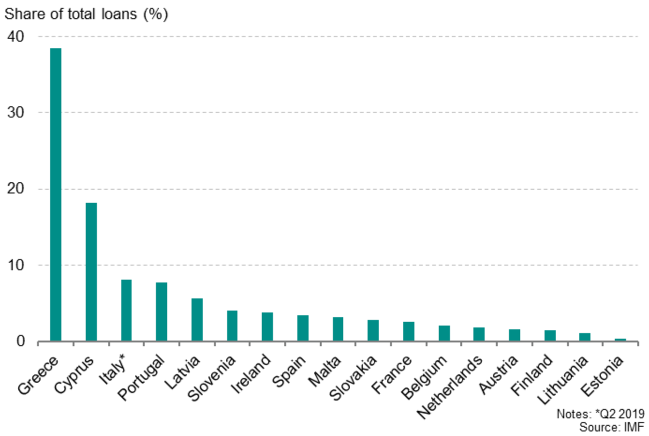
- **A longer and deeper recession than currently expected.** The debt burden can quickly deteriorate if nominal GDP contracts for a prolonged period of time, or if it grows by less than the effective borrowing costs.

- **Deflation becoming entrenched in the eurozone.** Under a deflationary spiral, the relative size of the debt grows, while the capacity of the government to service it diminishes.

- **Markets' repricing of redenomination risks.** Increasing perception that a country may decide to leave the eurozone may lead to substantially large borrowing costs and cause contagion.

- **Increasing signs of stress in the banking sector, which could lead to bailouts**. The severe decline in economic activity may lead to large increases in non-performing loans, as banking sectors in many eurozone countries are still dealing with legacy issues from the financial crisis and have poor asset quality (see Chart 5). Bad debts can end up on the sovereign's balance sheets with negative implications for debt sustainability.

Chart 5: Non-performing loans ratio - Q3 2019



Outlook

Our baseline scenario is that, while the ECB remaining a large buyer in the secondary market will help to limit the increases in borrowing costs, central banks' asset purchases alone will not be enough. Given the huge new net issuance and rollover needs this year, the expected declines in GDP and apparent constraints on the ECB, eurozone governments will be forced by markets to choose one or a combination of the options presented above. It is most likely that reprofiling debts via the ESM would be the next step, given that it is available immediately, is preferred by the member states with fiscal space, and is the default fall-back option if a government is unable to finance itself via the markets. However, this could be done in combination with some elements of the other options. The main risk of making the ESM a central tool of the response is its toxic legacy from the eurozone debt crisis, when it became associated with strict conditionality, such as harsh austerity and reforms. Using the ESM would require a major climb-down for the governments in some potential recipient countries, who have all rejected it, and fuel euro scepticism, which would be detrimental for the integrity of the eurozone.