

# Week Ahead Economic Preview

## Global overview

- This quarter growth signals sought from industrial production and trade updates
- Policy decisions in the eurozone and Malaysia
- UK, Japan, eurozone and Russia GDP data
- US inflation and jobless claims in focus

After signs from the [latest business surveys](#) that the [global recovery](#) accelerated in August as economies continued to open up after COVID-19 lockdowns, confirmation of solid starts to the third quarter will be sought from industrial production numbers for the UK, Germany, Italy and Spain, as well as trade numbers for China, Taiwan, Germany and the UK. New estimates of GDP data for Japan, Russia and the eurozone are meanwhile expected to confirm second quarter woes.

In the US, inflation data are updated alongside labour market indicators in the form of jobless claims and job openings. There have been some signs of input cost inflation starting to pick up in the US PMI surveys, though policymakers have shifted their focus away from price stability towards sustaining the recovery, meaning it will be the labour market that likely holds most attention. The weekly jobless claims numbers in particular will be eyed for the ongoing impact of lockdowns, which were tightened on average across the US in August but are now easing again ([page 3](#)).

In terms of policy action, the latest ECB monetary policy decision will be eagerly awaited for clues as to the possibility of further stimulus later this year amid signs of falling prices and hints of a [stumbling recovery](#) as Italy and Spain tightened lockdowns. In the UK, July's GDP data will likely show the economy surging, though [recent survey data](#) have hinted that growth could fade after the initial rebound (see [page 4](#) plus our special eurozone inflation report on [page 6](#)).

In Asia Pacific, the import and export data published for China and Taiwan will be in particular focus as recovery hopes for the region are dependent on trade flows picking up, having been curbed by pandemic supply chain disruptions and weak demand. China's inflation data, Japan's machinery orders and Indian industrial production are also notable releases. Malaysia central bank watchers meanwhile have mixed views on whether further stimulus will be announced at the forthcoming monthly meeting ([page 5](#)).

## Special reports

**Asia Pacific tourism:** A look at how the region's travel and tourism industry has been devastated by COVID-19 ([page 6](#)).

**Eurozone inflation:** How renewed deflationary forces are posing new challenges to policymakers at the European Central Bank ([page 9](#)).

## Upcoming PMI releases

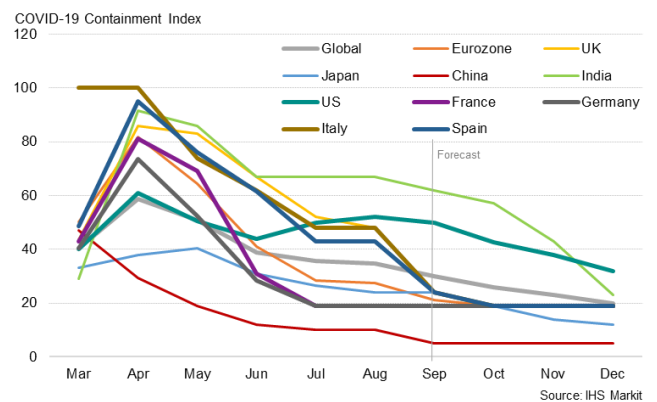
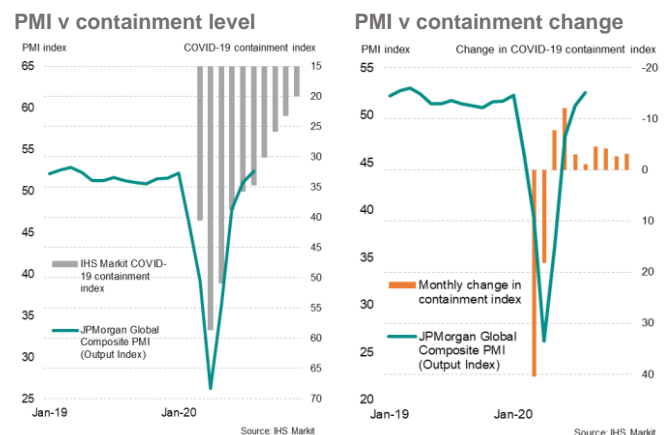
**22<sup>nd</sup> September:** Flash PMIs (US, UK, Eurozone, Japan & Australia)

**1<sup>st</sup> October:** Final Global Manufacturing PMIs

**5<sup>th</sup> October:** Final Global Services PMIs

**6<sup>th</sup> October:** Detailed global sector PMIs

**The global PMI has risen as COVID-19 containment measures have eased, but resurgent infections dampened growth in some countries in August**



**Chris Williamson**

Chief Business Economist

IHS Markit

Email: [chris.williamson@ihsmarkit.com](mailto:chris.williamson@ihsmarkit.com)

## Key diary events (UTC)

### Monday 7 September

China trade (Aug)  
Thailand inflation (Aug)  
Germany industrial output (Jul)  
UK Halifax house price index (Aug)  
Taiwan trade (Aug)  
Japan GDP (Final, Q2), current account, household spending and earnings (Jul)

### Tuesday 8 September

Australia business confidence (Aug)  
Indonesia consumer confidence (Aug)  
Japan Eco watchers survey outlook (Aug)  
Germany trade (Jul)  
France trade balance (Jul)  
Italy retail sales (Jul)  
Taiwan inflation (Aug)  
Euro area GDP, employment change (3<sup>rd</sup> Est, Q2)  
US IBD/TIPP economic optimism (Sep)  
South Korea unemployment rate (Aug)

### Wednesday 9 September

Australia consumer confidence (Sep)  
China inflation (Aug)  
Japan machine tool orders (Aug)  
Brazil inflation (Aug)  
Russia GDP (Final, Q2)  
US JOLTs job openings (Jul)  
Japan machinery orders (Jul) 23:50 UTC

### Thursday 10 September

Philippines trade (Jul)  
France and Italy industrial output (Jul)  
Malaysia interest rate decision  
ECB monetary policy decision  
Brazil retail sales (Jul)  
US jobless claims (5-Sep), wholesale inventories (Jul)

### Friday 11 September

Malaysia industrial output, jobless rate (Jul)  
Germany and Spain inflation (Final, Aug)  
UK trade balance, industrial output (Jul), monthly GDP (Jul)  
India industrial production (Jul)  
US inflation, monthly budget statement (Aug)  
China new yuan loans, total social financing, M2 (Aug)

#### For further information:

If you would like to receive this report on a regular basis, please email [economics@ihsmarkit.com](mailto:economics@ihsmarkit.com) to be placed on the distribution list.

For more information on our products, including economic forecasting and industry research, please visit the Solutions section of [www.ihsmarkit.com](http://www.ihsmarkit.com)

For more information on our PMI business surveys, please visit [www.ihsmarkit.com/products/PMI](http://www.ihsmarkit.com/products/PMI)

[Click here](#) for more PMI and economic commentary.

For all further information, please visit [www.ihsmarkit.com](http://www.ihsmarkit.com)

The intellectual property rights to the report are owned by or licensed to IHS Markit. Any unauthorised use, including but not limited to copying, distributing, transmitting or otherwise of any data appearing is not permitted without IHS Markit's prior consent. IHS Markit shall not have any liability, duty or obligation for or relating to the content or information ("data") contained herein, any errors, inaccuracies, omissions or delays in the data, or for any actions taken in reliance thereon. In no event shall IHS Markit be liable for any special, incidental, or consequential damages, arising out of the use of the data.

Purchasing Managers' Index® and PMI® are either registered trade marks of Markit Economics Limited or licensed to Markit Economics Limited. IHS Markit is a registered trademark of IHS Markit Ltd.

# United States Week Ahead

Inflation, labour market data and inventories

By Siân Jones

Economist, IHS Markit, London

Email: [sian.jones@ihsmarkit.com](mailto:sian.jones@ihsmarkit.com)

Key US economic data releases include updates to inflation and labour market data, which will be keenly watched ahead of the upcoming FOMC meeting in mid-September.

## Inflation

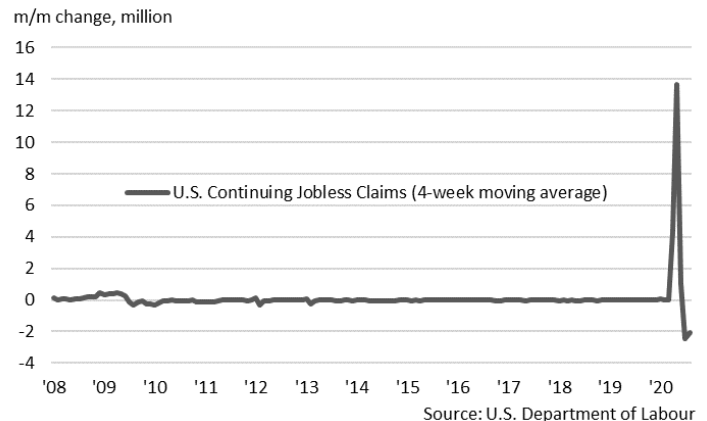
The Fed has moved to a new policy framework which will allow it to tolerate overshoots of the 2% inflation target, but this is unlikely to be tested by the next batch of official data. Although the rate of inflation picked up slightly to 1.0% in July, with core inflation up for a third month to reach 1.3%, price pressures are set to remain relatively subdued in August. According to [August PMI data](#), private sector firms moderated their increases in output charges, soaking up higher costs as firms sought to compete to further boost sales. While the Fed will continue to monitor price pressures, their focus will likely be on the outlook for the domestic and global economy.

## Employment data

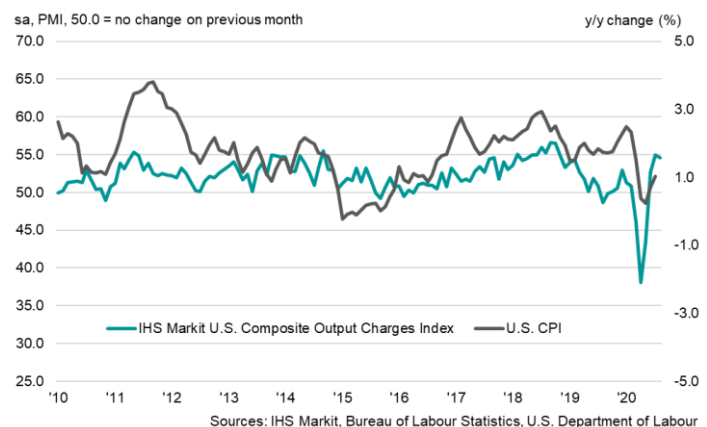
As many states continued to tighten lockdown restrictions in August – IHS Markit’s US COVID-19 Containment Index (which measures a basket of lockdown indicators) rose from 50 to 52 between July and August, up from a low of 44 in June – a key focus will be employment, especially as government support schemes are closing. The release of July JOLTs data and August continuing jobless claims data will therefore give a fresh insight into the health of the labour market. Although the latest job openings data continued to suggest an annual fall in demand for employees, on a monthly basis jobless claims have fallen. Importantly, this includes continuing jobless claims (those claiming unemployment payments for two weeks or more) where claimants fell to the lowest level since early April.

Meanwhile, updates to business and economic optimism, and wholesale inventories data are also released, the latter likely to show signs of recovery on the basis of recent PMI data.

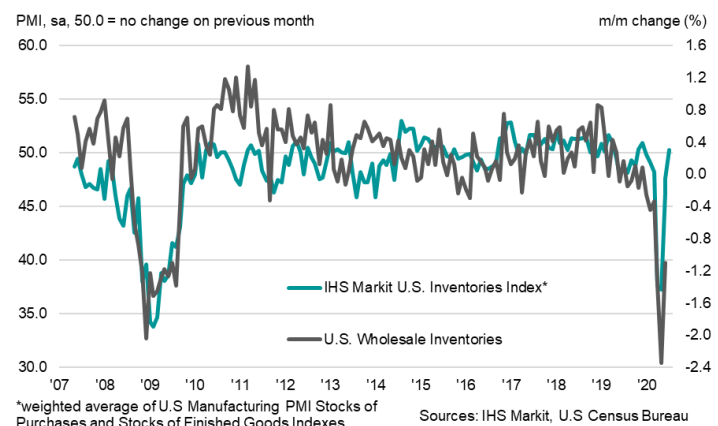
### Continued jobless claims have fallen amid a gradual reopening of the economy



### Inflationary pressures have risen but remained muted in August



### Firms have moved towards building inventories amid stronger client demand



# Europe Week Ahead

## ECB, industrial production and UK GDP

By **Paul Smith**

Economics Director, IHS Markit, London

Email: [paul.smith@ihsmarkit.com](mailto:paul.smith@ihsmarkit.com)

Next week's focus will be on the European Central Bank's monetary policy decision, especially against the backdrop of negative inflation and signs of a faltering economic recovery. Trade and industrial production data across several European countries will also be updated, with the focus at the end of the week switching to the UK, which releases July GDP numbers.

### ECB rate decision, industrial production

The ECB will meet for the first time after the summer break amid rising concerns of deflation in the single currency area following the news of negative headline inflation and a record low core rate in August. With unemployment set to rise further in the coming months, and signs of faltering growth in the region's service sectors, pressure on the central bank to provide an even greater accommodative policy stance is mounting. See our [Special Report](#) for further analysis.

Whilst hopes of a broad 'v-shaped' recovery have been punctured somewhat by the [loss of momentum in overall growth](#), PMI data have shown manufacturers experiencing improving performance over the summer. France, Germany and Italy separately report industrial productions figures for July next week, and all are expected to confirm the positive survey trends.

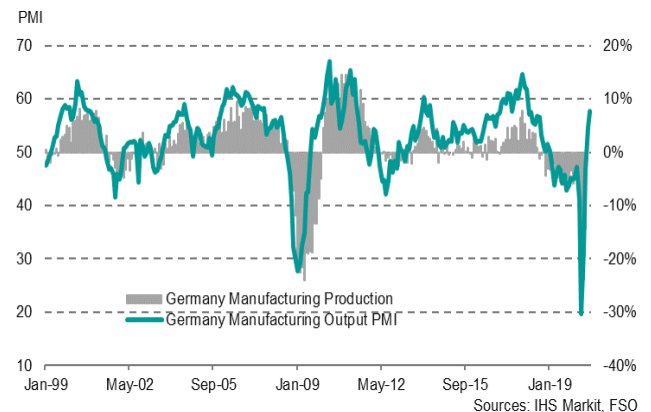
### UK GDP, house prices, jobs

Over in the UK, official figures related to trade, industrial production and services industries will provide plenty of additional colour to July's monthly GDP figures. With [August PMI data](#) indicating the best rise in output since mid-2014, official data should follow suit and signal strong growth.

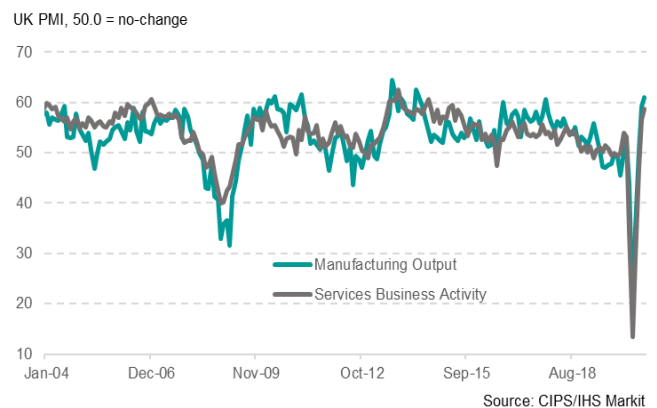
One area of the economy firing on all cylinders is housing, amid widespread reports that pent-up demand, the emerging structural shift to greater home working and a cut in stamp duty supercharging the market. Halifax's house price index will provide details on how this is feeding through to agreed prices.

Whether momentum in the housing market – and the wider economy – can be sustained depends greatly on employment and income developments. Next week's August KMPG/REC Report on Jobs data will therefore provide a timely update on the labour market.

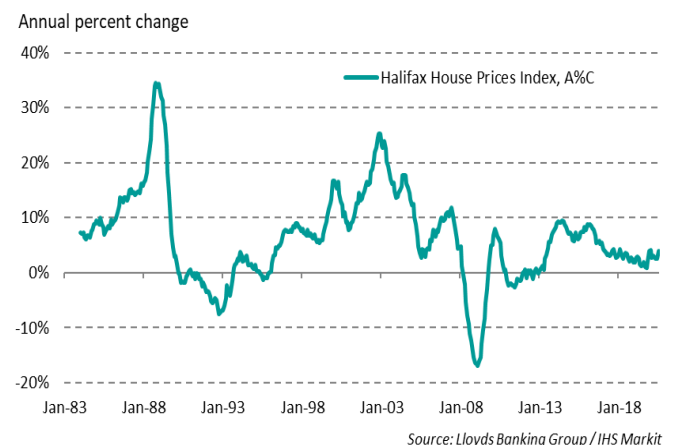
### German manufacturing has helped to drive growth of the recovery in the euro area's industrial sector



### The UK has experienced especially strong growth across the manufacturing and service sectors



### The UK housing market has defied expectations in recent months, with prices rising 1.7% on the month in July and by 3.8% year-on-year



# Asia Pacific Week Ahead

China data, Asia trade figures and Malaysia monetary policy

By **Bernard Aw**

Principal Economist, IHS Markit, Singapore

Email: [bernard.aw@ihsmarkit.com](mailto:bernard.aw@ihsmarkit.com)

Further clues on the health of China's economy will be gleaned from the forthcoming Chinese economic data releases next week. These follow the Caixin PMI surveys showing a sustained recovery in August, with export growth evident for the first time this year. Trade figures for Taiwan and the Philippines will also be closely monitored for signs of improvements in regional trade conditions. Malaysia will meanwhile decide on monetary policy.

Other key Asian highlights include inflation figures in China, Taiwan and Thailand, as well as Japan's machinery orders and sentiment surveys in Australia and Indonesia.

## China data and Asia trade

With [Caixin PMI](#) indicating renewed growth in China's manufacturing export orders in August, analysts will look to the August official update for trade where, apart from export figures, import performance will also provide indication of Chinese demand for commodities and intermediate goods across the region. Meanwhile, credit and inflation numbers will provide more insights into the durability of recovery momentum from the COVID-19 downturn.

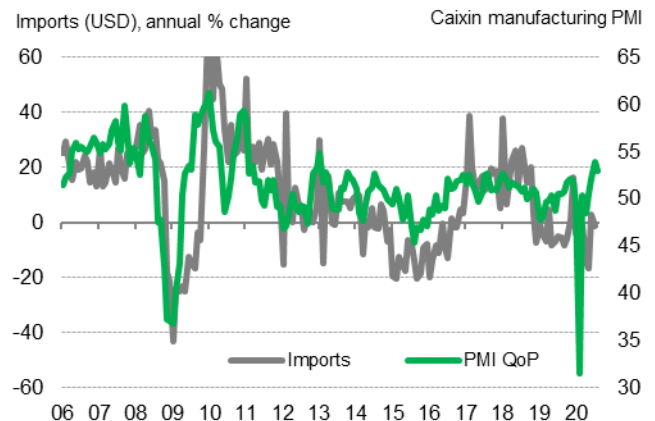
Taiwan's export data, widely considered a barometer for regional trade, will provide further clues into Asian trade conditions. [Taiwan PMI](#) data indicated a further improvement in manufacturing conditions during August, with export growth reported for the first time since January.

## Close call on further Malaysia rate cut

Monetary policymakers meet in Malaysia, with market expectations mixed towards prospects of a further rate cut. The Bank Negara Malaysia maintained the policy rate at 1.75% in August and had reduced rates four times so far this year, with the last rate cut seen in July. Deflationary pressures and prospects of further economic uncertainties have led to increasing calls for more rate reductions to support the economy.

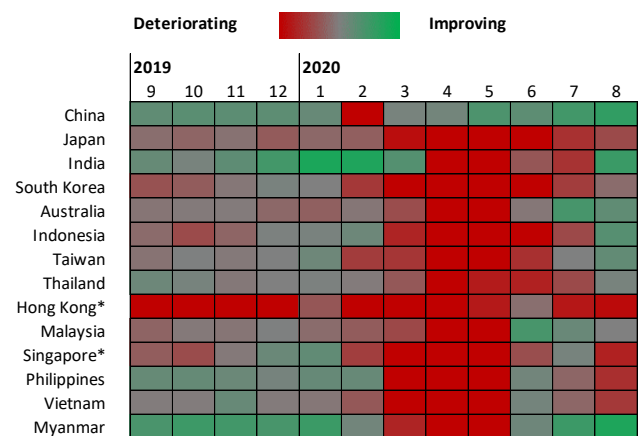
Recent PMI data showed a sustained recovery from the COVID-19 downturn, although [August survey data](#) signalled an easing in manufacturing output growth and continued softening of order book volumes. Factory jobs were also reduced at a survey-record rate.

## August Caixin PMI surveys signal further rise in purchasing activity, hinting at import growth



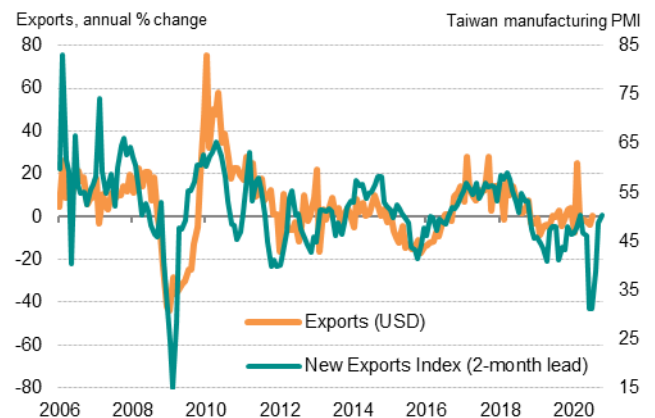
Sources: IHS Markit, Caixin, China Customs

## PMI (Output Index) heatmap shows recovery rates continue to vary across Asia Pacific in August



\*Represented by Whole Economy PMI. Non-asterisk are shown with manufacturing PMI  
Sources: IHS Markit, Caixin, au Jibun Bank, Commonwealth Bank

## Taiwan PMI and export growth



Source: IHS Markit, DGBAS

## APAC Special Focus

### Covid-19 shockwaves devastate the APAC tourism industry

By **Rajiv Biswas**

Asia Pacific Chief Economist, IHS Markit

Email: [Rajiv.biswas@ihsmarkit.com](mailto:Rajiv.biswas@ihsmarkit.com)

*After years of buoyant growth driven by rapidly increasing Asian tourism and business travel, the Asia-Pacific tourism industry has been devastated in 2020 by the massive economic shockwaves from Covid-19 lockdowns and travel bans that have swept across the Asia-Pacific region.*

### The economic impact on the global international tourism industry

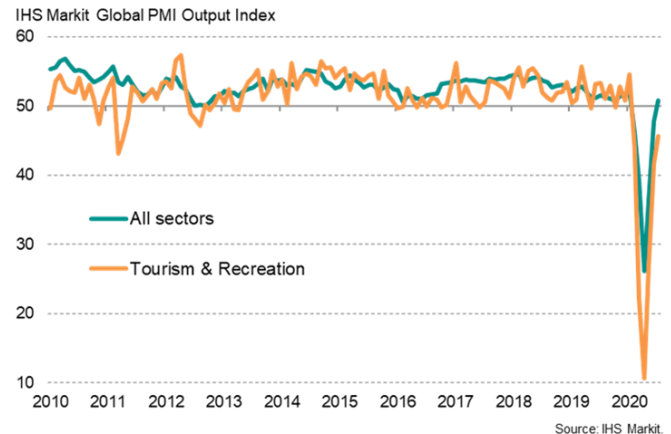
The world tourism industry, which accounts for an estimated 10% of global GDP after including indirect output and employment effects, has been extremely badly hit by lockdowns and travel bans during the first half of 2020. The United Nations (UN) has estimated that in the January to May 2020 period, international tourism dropped by 56%, or around 300 million fewer tourists, with USD 320 billion of lost tourism revenue globally.

A range of scenarios developed by the UN World Tourism Organisation (UNWTO) for the world tourism industry indicate that international tourist numbers could decline by between 58 per cent to 78 per cent in 2020. This would result in a decline of tourism spending from a level of USD 1.5 trillion in 2019 to a range of between USD 310 and USD 570 billion in 2020. The UNWTO has estimated that this could put over 100 million direct tourism jobs at risk worldwide. UNCTAD has estimated that depending on the severity of the scenario that transpires, the total economic impact from the international tourism slump would be 1.5% to 2.8% of world GDP.

The IHS Markit Global PMI Output Index for the Tourism and Recreation sector shows that world tourism sector business conditions collapsed during March to May 2020. However, as lockdowns were eased in June, notably in Europe, tourism and recreation activity rebounded, albeit at a slower pace than the broader global output index for 'All Sectors'.

However, the latest Tourism and Recreation index reading still continues to signal that global tourism sector business conditions are contracting, albeit at a moderating pace.

### IHS Markit Global Tourism & Recreation PMI



### The collapse of international tourism in APAC

The Covid-19 pandemic has become an extreme "Black Swan" event for the Asia-Pacific tourism industry, with international tourism travel across the Asia-Pacific having collapsed since March 2020 due to travel bans on foreign tourist arrivals by most Asia-Pacific governments. Domestic tourism travel within many Asia-Pacific economies has also been heavily disrupted during 2020 by lockdowns that have been implemented in various countries. With the travel and tourism sector accounting for an estimated 10% of the Asia-Pacific region's GDP, the deep slump in both the tourism sector and in the commercial aviation industry has had a severe negative impact on many APAC economies.

With large gatherings for conferences and events also banned by most governments, this important segment of the APAC tourism industry has also collapsed in 2020. Due to the ongoing pandemic, Japan was forced to postpone the Tokyo 2020 Olympics with the intent to hold it in 2021, which was a significant blow to Japan's tourism industry this year.

Furthermore, plans to reopen international tourism in various Asian countries have also been postponed indefinitely, as second waves of Covid-19 cases have hit a number of countries, including Japan, Australia and South Korea. Unlike the European Union (EU), which reopened its internal borders for tourism travel within the EU since mid-June and have also gradually allowed resumption of travel from selected other

nations worldwide, no international tourism travel of significance has resumed yet in the Asia-Pacific region. Most APAC governments have continued to keep their borders closed to international visitors except for essential purposes.

Severe travel bans by many APAC countries have brought international tourism travel in the region to a halt since late March, with many countries restricting entry to their own citizens and residents. Australia even banned travel by their own citizens, restricting their own citizens from leaving the country since March 2020, except in exceptional circumstances with government approval. Malaysia had also imposed severe travel restrictions on their citizens leaving the country, although these have been gradually eased. India had banned all international flights in and out of the country for several months during the first phases of its lockdown measures, although flights have gradually restarted since July.

For example, total international visitor arrivals in Singapore fell to 2,918 persons in July 2020, compared with a high of around 1.4 million international visitors in the month of August 2019 and an annual total of 19.1 million visitors in calendar 2019. In Australia, total short-term international visitor arrivals fell to just 5,400 persons in June 2020, compared to 766,000 in January 2020 and an annual total of 9.5 million visitors in the year to January 2020. With borders closed in Thailand, international tourist visits were zero in June 2020, for the third successive month. This compares with 3.1 million international visitors in the month of June 2019 with an estimated tourism revenue of USD 4.1 billion. In Japan, international visitors in June 2020 fell to just 2,600, down 99.9% year-on-year.

At present, unlike the EU, there seems to be no co-ordinated roadmap or strategy in place in the APAC region for reopening their international tourism sectors, except to wait until a Covid-19 vaccine is eventually approved by regulatory authorities and mass immunization has been carried out. With most APAC countries requiring a 14-day quarantine period for all arrivals, this is also a severe deterrent to any potential revival of the international tourism sector in the APAC region. A number of countries had been discussing creating safe “travel bubbles”, including discussions between Australia and New Zealand for a bilateral safe travel corridor, but a second wave of new Covid-19 cases in the state of Victoria combined with a number of new cases reported in New Zealand has delayed progress on that plan.

## APAC domestic tourism industry

Faced with the complete collapse of international tourism in the APAC region, the role of domestic tourism is becoming a key pillar for the survival of the tourism sectors in some Asia-Pacific countries. The gradual resumption of domestic tourism travel after lockdowns have ended has provided some revenue flows for the tourism industries of certain Asian economies. As domestic pandemics have been contained in economies which normally have substantial domestic tourism expenditure like mainland China, Japan, South Korea and Thailand, the rebound in domestic tourism is helping to mitigate the economic shocks from the collapse of international tourism.

Mainland China has seen a considerable recovery in domestic tourism since May 2020, as the severe lockdown measures and internal travel restrictions imposed during February and March were eased and daily new Covid-19 cases fell to very low levels from April onwards. Domestic tourism activity during the May Labour Day holidays was estimated at around 50% of normal levels, although actual tourism revenue was only 30% of the previous year due to more cautious spending patterns. Nevertheless, this represented a major recovery from the zero levels of tourism recorded in February.

In Japan, the domestic tourism sector is estimated to account for around 80% of total tourism spending in 2019, which substantially limits the vulnerability of the Japanese tourism industry to the slump in international tourism.

In Vietnam, the National Administration of Tourism reported that during the first six months of 2020, domestic tourism trips were about 50% below the same period of 2019. In the 2019 calendar year, there were around 85 million domestic tourism trips, accounting for around two-thirds of Vietnam's total tourism revenue. Due to the ban on international tourist arrivals due to the Covid-19 pandemic, average occupancy at hotels during the first six months of 2020 was around 20%. As lockdown restrictions were eased in during Q2 2020, domestic air travel resumed in late April and total domestic air travel has gradually rebounded during May and June. However, the collapse in international tourism is a very large negative shock to the tourism industry, with international tourist visitors having reached 18 million in 2019, whereas for most of this year international tourism has ceased. International tourism accounted for an estimated USD 9 billion of revenue in 2019, compared with USD 21 billion revenue from domestic tourism. Consequently, domestic tourism is acting as an important pillar for Vietnam's tourism industry

during the pandemic, albeit the negative economic shocks are still very severe.

In Australia, international tourist arrivals have been banned since late March. In 2018–19, both domestic and international tourism, combined together, contributed AUD 61 billion to Australian GDP and provided employment for 666,000 workers, equivalent to 5.2% of Australia's total workforce. As the impact of travel bans and lockdowns within Australia has restricted both international tourism arrivals as well as travel between most Australian states, the overall negative shock to the entire tourism industry has been devastating. In Australia, three-quarters of tourism consumption is attributable to domestic tourism. However due to strict restrictions on the movement of people between the Australian states, the domestic tourism sector has also been hit hard, although tourism travel intrastate provides some support for the tourism industry.

However, for some countries where the domestic tourism segment is relatively small compared to international tourism, such as Singapore, the ability of domestic tourism to mitigate the collapse of international tourism is very limited. For the Pacific Island states, the overall economic impact from the collapse of international tourism is particularly severe due to the dominant role of international tourism in overall tourism expenditure as well as the very high share of tourism and travel in overall GDP, including multiplier effects on output.

## Near-term outlook

International tourism travel in the APAC region has collapsed since March 2020, with no early end to the tourism industry crisis in sight. Considerable uncertainties about the future duration and potential new waves of the Covid-19 epidemic continue to cloud the near-term outlook for the Asia-Pacific tourism and travel industry. The situation for the APAC tourism industry contrasts considerably with that in the EU, where EU internal borders were largely reopened for tourism travel in mid-June 2020. In the APAC region, there has been no resumption of international tourism until the end of August 2020. However, domestic tourism has rebounded in a number of APAC economies which have successfully contained their domestic pandemics, providing the only mitigation for the severe economic shocks that have hit the tourism industry.

The economic consequences of the collapse in APAC tourism are becoming more severe as the duration of the ban on international tourism becomes increasingly

protracted. The international travel bans and collapse in air travel in the Asia-Pacific region has hit the APAC airline industry very severely, with several airlines having gone into voluntary administration and a number of others facing substantial financial restructuring or requiring state aid. Many hotels have been closed for long periods of time during national lockdowns. For those that have reopened, they have to rely on domestic tourism revenue. This has imposed severe financial costs on the APAC hotel industry as well as resulting in large-scale job losses or pay reductions.

The broader economic impact on the collapse of international tourism on various APAC economies varies significantly, depending on the share of tourism in overall GDP, as well as the relative importance of domestic tourism vis-à-vis international tourism.

At present, the most likely pathway out of the protracted collapse in APAC tourism will be the rollout of mass immunization programs with a Covid-19 vaccine. Meanwhile the economic costs to the tourism industry and tourism sector jobs will continue to escalate.



# Europe Special Focus

Eurozone: Deflation risks back in the spotlight

By Ken Wattret

Chief European Economist, IHS Markit

Email: [kenneth.wattret@ihsmarkit.com](mailto:kenneth.wattret@ihsmarkit.com)

Flash HICP data for August showed a sub-zero headline inflation rate for the first time in over four years, and not just due to energy price effects. Underlying inflation rates surprised significantly to the downside again in August, with core goods and services both decelerating to record lows. While the weakness is partly due to distortions from COVID-19, IHS Markit's measure of deflation vulnerability in the eurozone has also been picking up.

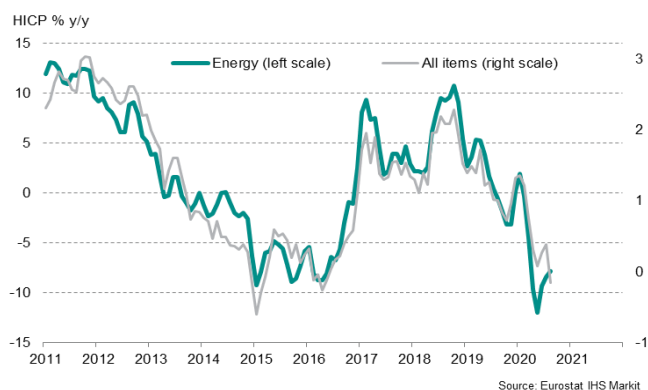
While the ECB will highlight the transitory influences on August's negative inflation rate in the press conference on 10 September, pressure for further stimulus will continue to build.

## Headline inflation falls below zero

Eurostat's flash August estimate for HICP inflation in the eurozone showed an unexpected plunge from 0.4% to -0.2%, an exceptionally large 0.4 percentage points below the market consensus expectation.

The headline inflation rate fell below zero for the first time since May 2016 and, unusually, this was not due to a swing in energy prices. Rather, the recent gradual upward pressure on the inflation rate for energy continued (from -8.4% to -7.8% year-on-year (y/y)), reflecting the lagged impact of higher oil prices and base effects (Chart 1).

Chart 1: Energy price drag on eurozone inflation easing

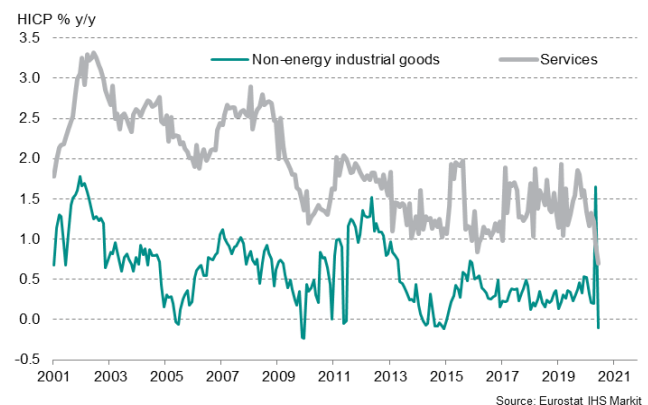


## Core rates collapse

The key reason for the downward surprise in August's HICP release was the magnitude of the falls in underlying inflation rates. The rate excluding food, energy, alcohol and tobacco prices, for example, plunged from 1.2% in July to just 0.4% in August, a record low.

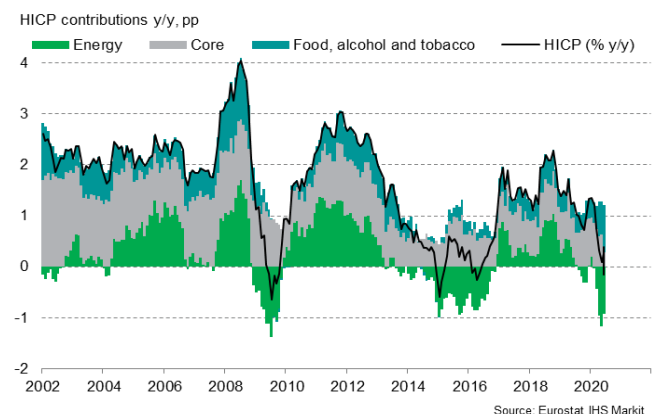
We had expected that July's record acceleration in non-energy industrial goods inflation would reverse in August, which indeed it did, plus a bit more (Chart 2). The y/y rate tumbled from 1.6% to -0.1%, well below the average rate of 0.2% between April and June. The recent volatility reflects delays to the timing of seasonal price reductions in some member states.

Chart 2: Near-term volatility in eurozone core goods inflation rate



At the same time, services inflation decelerated again in August, from 0.9% to just 0.7%, also a record low. National details already released suggest that weakness in the HICP items hit hardest by the effects of COVID-19, such as recreation and culture prices, continued to weigh. Unprocessed food prices have also contributed to the downward pressure on headline inflation, with August's y/y rate of 2.3% well down on April's 7.6% peak (Chart 3).

Chart 3: HICP contributions, diminishing euro area inflation contributions broad-based



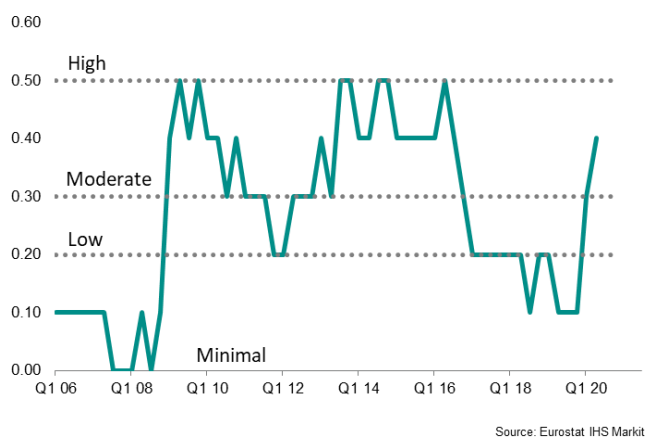
A full breakdown of August's HICP by component will be released on 17<sup>th</sup> September, which will illustrate in more detail the items driving the weakness. Looking ahead, we expect a partial rebound in both core goods and services prices in September as the effects of seasonal price discounting wane, though headline and core inflation rates will remain very subdued and well below the ECB's aim of "below but close to 2%".

Distortions from the impact of COVID-19, seasonal price changes and VAT reductions in Germany all complicate the assessment of recent HICP data. Still, separating trend from noise, underlying inflation pressures will remain muted, in line with the challenging economic environment and the negative headline inflation rate in August, and plunging core rates, will further fuel speculation about deflation in the eurozone, a risk which we have been highlighting for some time.

## Deflation vulnerability index increasing

While we see August's sub-zero headline rate as partly due to seasonal effects, IHS Markit's index of deflation vulnerability (the DVI) has increased markedly in recent quarters (Chart 4).

**Chart 4: Eurozone deflation vulnerability index rose in H1 2020**



The most recent value, for Q2 2020, is 0.4, up from 0.1 in Q4 2019 and 0.3 in Q1 2020 and the highest level since Q3 2016. While this implies only a "moderate" risk of deflation still, given the typical lags between adverse economic shocks and the full impact on the DVI, there is a significant risk of further increases into the "high" risk bracket.

As Chart 4 illustrates, the DVI rose to slightly higher levels than currently in the aftermath of the two previous major adverse shocks to hit the eurozone, the Global Financial Crisis (GFC) from 2008-9 and the subsequent eurozone crisis from 2011-12.

## Lagged effects on the DVI

During the GFC, the DVI started to rise significantly from Q3 2008, peaking at 0.5 five quarters later in Q4 2009: that is, on the cusp of entering the "high" risk category. During the subsequent eurozone crisis, the DVI started to increase from Q3 2011 and peaked again at 0.5, just short of the "high" risk threshold. It then remained elevated for three years, from Q3 2013 to Q3 2016.

In both episodes, the DVI reached its peak several quarters after the respective crises reached their maximum intensity. There were significant lags between the shocks occurring and the full pass through into inflation and the factors which determine it, suggesting that the DVI for the eurozone is likely to remain elevated in the coming quarters.

In Q2 2020, there were four positive contributions to the DVI: one related to monetary growth, one by low inflation and two related to the output gap. Positive contributions to the DVI from the two output gap components are likely to continue for a long time yet given the unprecedented magnitude of the GDP losses during the first half of 2020. While we expect the initial rebound in GDP in Q3 2020 to be pronounced, growth momentum is likely to fade and we do not expect eurozone GDP to exceed its pre-COVID-19 level until 2023 in our baseline forecast.

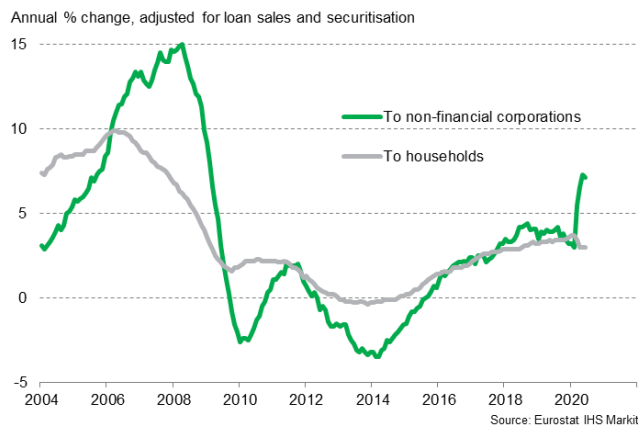
Other areas to monitor going forward include the appreciation of the exchange rate. The criterion stipulates an appreciation in real terms of over 4% versus a year earlier which does not look such a tall order given the euro's recent strength against the US dollar and trade-weighted.

## Some differences, including credit growth

The positive news is that the impressively swift response of monetary and fiscal policy to the COVID-19 shock could prevent some of the other criteria in the DVI exceeding their thresholds, assuaging some of the concerns over deflation. Contracting credit, for example, contributed to the increases in the DVI after the GFC and the eurozone crisis but this has not been evident recently.

In fact, credit growth to enterprises picked up markedly in the wake of COVID-19 (Chart 5). The ECB's extensive long-term liquidity provision to banks, alongside the ramping up of its asset purchase programmes, appears to be having a much more positive effect on credit supply and credit conditions for loans to enterprises compared to the two prior shocks.

**Chart 5: Eurozone credit, post-COVID-19 surge in bank lending to NFCs**



## Close monitoring required

For various reasons, the eurozone appears to be relatively susceptible to deflation and its pernicious consequences. The latest update of IHS Markit's deflation vulnerability index for the eurozone suggests the risk of deflation is increasing.

While it remains only a "moderate" threat according to the framework we are using, given the lags associated with the fallout from a severe economic shock, the index is likely to remain elevated and we will need to continue to monitor its evolution closely.

Deflation concerns are likely to feature prominently in the Q&A session of the upcoming ECB press conference on 10<sup>th</sup> September. While we expect President Lagarde to highlight the transitory role played by seasonal factors and other developments in August's negative headline rate, the likelihood of continued muted underlying rates going forward is one of the key reasons why we expect additional ECB stimulus to be announced, most likely in December.