

Europe monitor



Pandemic uncertainty
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Macroeconomic Update Europe
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Pandemic uncertainty

More than ten years after the Global Financial Crisis we are again dealing with great uncertainty, due to the Coronavirus or COVID-19 pandemic. These are extraordinary times, because since the 1918 Flu Pandemic, the global community has not been confronted with an epidemic of this size, while the world has become a very different place in the past decades.

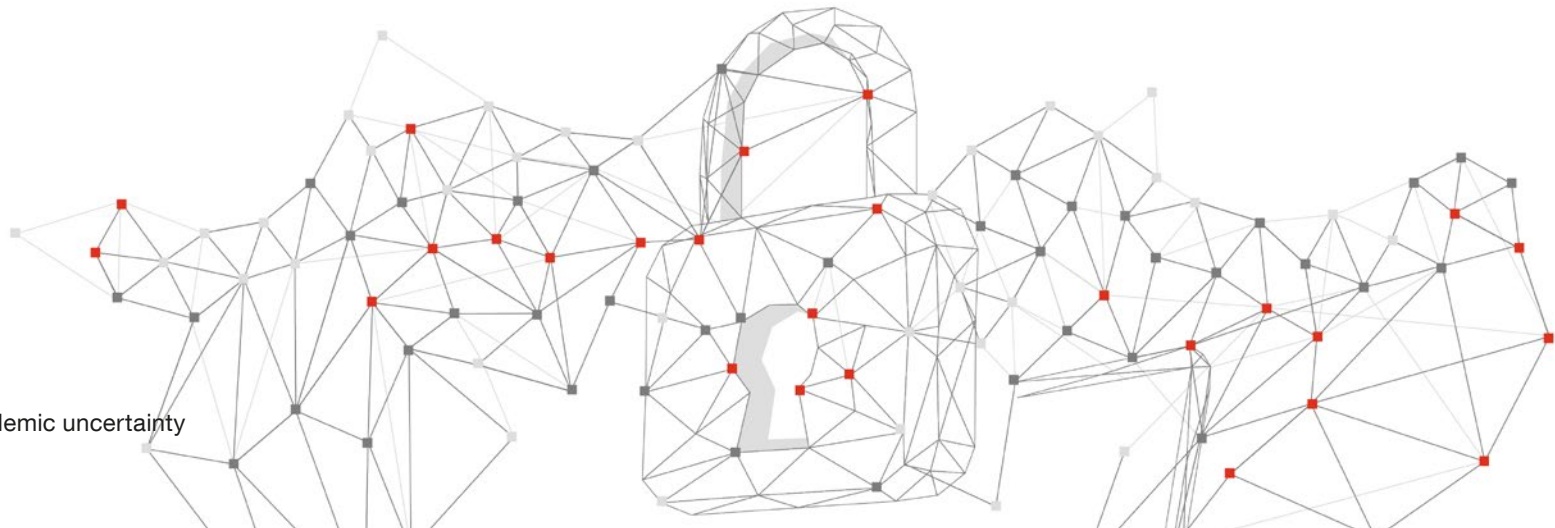
At the time of writing, developments follow each other very quickly, the pandemic is spreading, and subsequent measures are being taken by governments, central banks and organisations. Like most crises and in case of the current pandemic, events are unpredictable, and this makes it almost impossible to foresee what is in store next, especially in the short term.

Regardless of this unpredictability, we will highlight the most recent economic conditions, based on available so-called 'hard data', which is the starting point from where we will go through this crisis. In the current turbulence, this can help us to assess in a structured way the magnitude of changes and their impact, that lie ahead of us. We will further present three scenarios, and already look beyond the current crisis by considering the potential longer-term impacts of the COVID-19 pandemic. This will help to discuss and consider the post-crisis world.

Potential COVID-19 scenarios

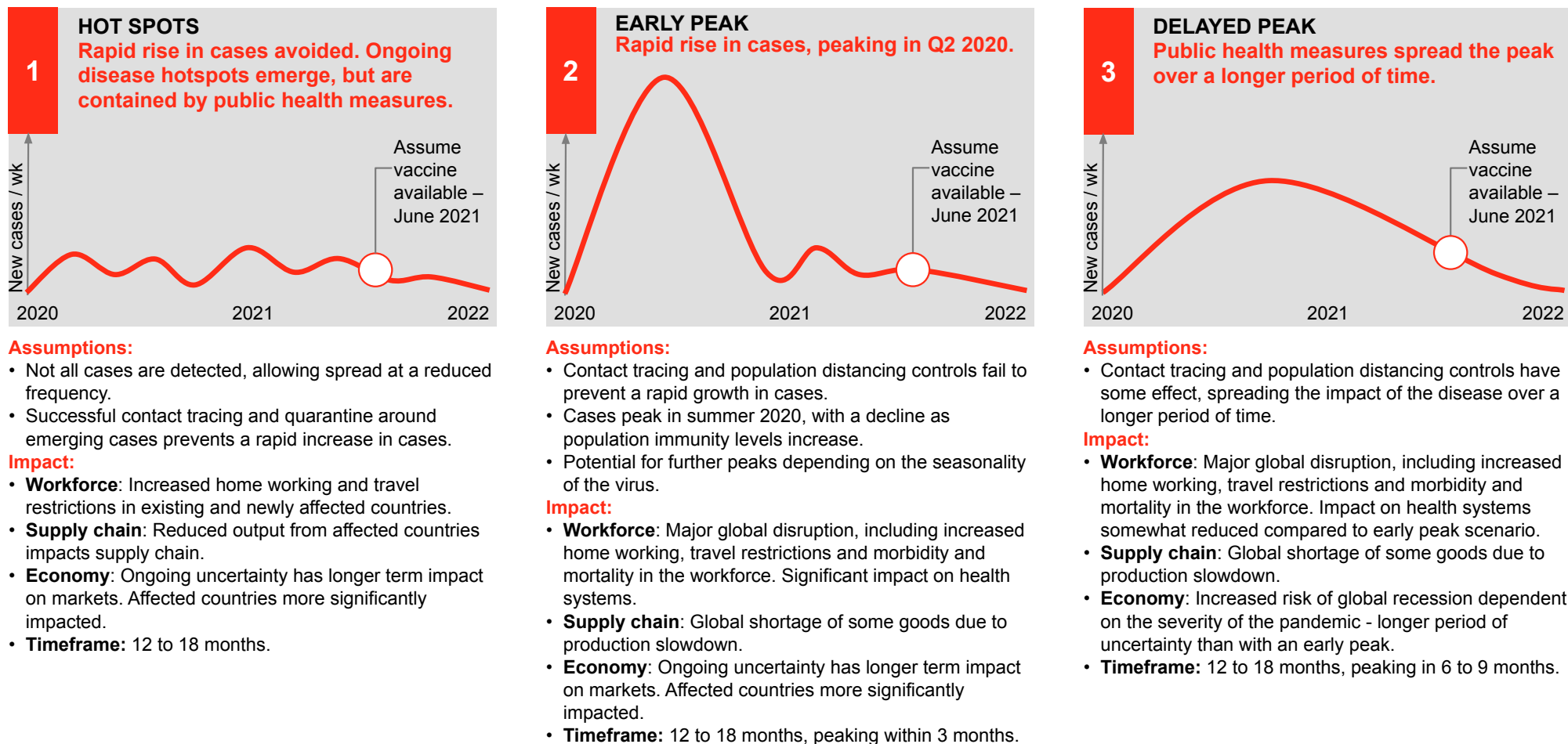
The impact that the COVID-19 pandemic will ultimately have on the economy, depends very much on its duration, the number of people affected, and the amount of disruption caused. The course of the pandemic may also differ per country.

A great unknown now is when the virus will disappear. We could see an increase of infections again in the future, after a period in which the number infections declined or even ended. Obviously, this would lead to new disruptions. Fortunately, across the world many bright researchers are frantically working on the development of a vaccine. However, even if an effective vaccine is discovered, it will take approximately one year before it can become available to the wider public. Even taking into account that a great effort and many resources will be allocated to the development of such a vaccine. The significance of this is that a true and lasting containment of the Coronavirus outbreak is probably at least a year or so away.



Currently, we distinguish three scenarios with different developments in the pandemic and related impacts (Figure 1):

Figure 1 Potential COVID-19 scenarios



Source: PwC analysis

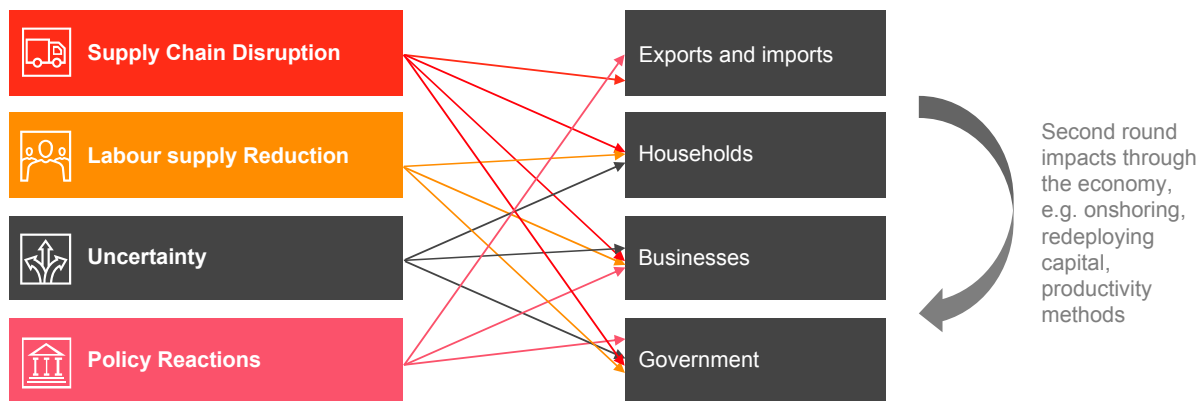
Scenario 1 “Hot spots”

This scenario assumes a less severe pandemic in terms of the number of people affected. This could be because of swift actions taken to prevent a further spread of the virus, e.g. by means of immediate travel restrictions or effective contact tracing. Hong Kong and Taiwan seem to follow this path, and it could apply to countries in Eastern Europe. The impact on the economy is comparatively small, as less people are infected, but can be more prolonged, as fear remains that cases could peak as soon as measures are lifted.

Scenario 2 “Early Peak”

Here we see a strong increase in the number of new infections in the early stages of the pandemic. A smaller peak could follow once some measures are withdrawn, and people start to come into closer contact again, or because of seasonal factors. In order to address the strong rise in infections, stringent measures are taken that have a proportionally deep impact on economic activity. China is an example of how this scenario plays out. In Europe, a country like Italy now seems to be following this path, although it is yet unclear whether the measures taken there will also lead to a comparatively strong reduction in new cases as we saw in China .

Figure 2 Overview of channels through which the economy is impacted



Source: PwC analysis

Scenario 3 “Delayed Peak”

In this case, measures are taken early to prevent a very strong increase of new infections. The pandemic is less severe within a short time frame, but lasts longer as some people continue to be infected. This can be the result of a strategy in which there’s no complete lock-down of people in cities as we saw in China, but with some restrictions in movement. The Netherlands and Germany seem to be following this strategy at the time of writing, where it is considered unavoidable that many people will ultimately be infected, and measures are taken to avoid a strong increase in infections that would strain healthcare.

An anatomy of impacts

How does the pandemic and all related developments affect economic activity? It is helpful to look at several although not exhaustive, transmission channels that PwC has identified, and to assess how these influence the components of GDP growth i.e. consumer and government expenditure, investment and net trade (Figure 2). By structuring developments in this manner, we can more easily determine how events and measures have an impact on the economy.

Supply chain disruption

Because of the pandemic, the production of goods and the provision of services is stopped or reduced. This can subsequently lead to disruptions elsewhere, when for example raw materials to produce a good are no longer available. Effects can be amplified because of interdependencies. For example, a manufacturer of car parts that relies on one supplier in an area affected by the virus outbreak, has to stop production as parts delivered from this area run out. A manufacturer of cars, that uses the parts, and the dealerships selling the cars, may then get into trouble. The demand for selected products, such as suitcases or transport services, also declines, as consumers or producers cannot buy them or lose interest due to other priorities.

Impact on the economy

- Trade flows decline or come to a standstill, as borders close and both demand and supply is disrupted.
- Household consumption of selective items falls, and businesses produce less goods, as they either have no raw materials or respond to a lower demand. This also leads to lower revenues, while costs tend to remain at regular levels.
- Companies can be forced to reduce costs by laying off employees, who will reduce consumption in response.
- Lower revenues lead to a decline in tax revenues for governments, while they spend more to support economic activity.
- A reverse response is hoarding behaviour, whereby the anticipation of shortages lead to an increase in purchases and greater general shortages, that could drive up prices too.

Labour supply

Some people are unavailable for work, because they must stay at home, for instance to look after their children, are made redundant or fall ill.

Impact on the economy

- Loss of production and income, as workers can no longer make contributions. Some businesses fail as a result, which reduces productive capacity.
- Employees lower their expenditure when they are confronted with dwindling incomes.
- Government institutions can function less effectively, because some of the people they employ are not available for work.

Uncertainty

Continuously changing conditions and a lack of clarity about what can or will happen, lead to uncertainty among consumers and producers. Consumers and producers alike may become less effective in their actions, start to avoid risk, take protective measures that may negatively impact others, and reduce expenditure to build buffers against setback.

Impact on the economy

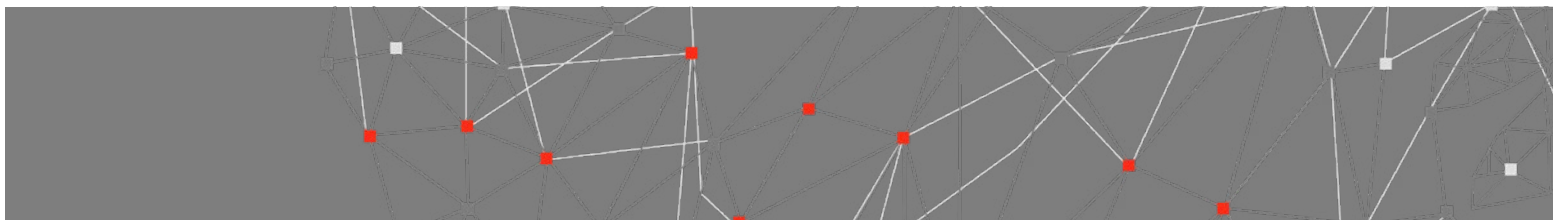
- Consumption and investment declines, as outcomes are unclear and priorities shift. This means less income for the providers of goods and services, prompting them to cut back on expenditure too.
- Reallocation of resources by means of stockpiling or building buffers.
- Both consumers and businesses may be more reluctant to engage in transactions, due to higher perceived risks.

Policy response

Governments respond to the crisis with measures to battle the pandemic, for example by introducing emergency legislation, providing financial support and tax relief. Emergency measures can range from a forced cessation of activities, as in case of air travel, restaurants and events, to labour cost subsidies in order to support continuation of employment. Central banks reduce interest rates, provide liquidity, purchase assets such as government bonds, and take other measures that facilitate financial transactions or the provision of loans against low costs.

Impact on the economy

- Fiscal policy can alleviate the negative impacts of the pandemic. For instance, loans or tax relief provided to companies can replace the loss of revenue, allowing companies to continue paying wages, rent, raw materials etc.
- Intervention by authorities can also reduce fatalities or damaging behaviour, benefiting economic activity. However, the forced shut down of business activities will negatively affect economic growth, especially if compensation for losses is not provided.
- The asset purchases of central banks can help governments to issue debt more easily, allowing them to raise money for support.
- At some point in the future, government debt needs to be reduced, for example by higher taxes or diminished expenditure, this will slow down future growth.



Potential long-term effects of the COVID-19 outbreak

Added to the human drama, the crisis has made clear how interdependencies lead to vulnerability. A positive aspect is that, despite the tragic loss of lives, so far little productive capacity is permanently destroyed, as often is the case with natural disasters like earthquakes and floods. This means that once the threat of a further spread of the virus has diminished, relatively quickly activities can resume completely.

Some of the longer-term effects we can currently foresee are:

- Increased attention for organisational resilience. This would include changes in supply chains, in order to reduce risk and dependencies. Both companies and governments are likely to take measures to diversify supply chains. This includes efforts to reduce dependencies on medical supplies and pharmaceutical inputs from countries such as China and India. Organisations may need to maintain better buffers to deal with adverse conditions. We could even see new legislation being introduced to address this for non-financial organisations, just as with banks after the Global Financial Crisis, or as a condition for receiving state aid.
- Inflation could increase, as the optimal allocation of production globally is partly reversed, and in a process of 'on-shoring' more production will take place locally, potentially against higher costs. Companies may be inclined to maintain larger stock levels with increased inventory costs as a result. Health workers and others, in what are now considered to be 'critical professions', are better positioned to ask for higher wages in the future.
- In case of a renewed outbreak of a virus, we are likely to see stronger measures earlier, leading to disruptions that can impact economic growth. We learn from the current pandemic allowing us to respond in more appropriate ways in the future. This can avoid an escalation of an epidemic or even other crisis situation, and related economic damage too.
- Depending on the duration of the pandemic, we could see lasting changes in ways of working, as many people are forced to work at home and / or cancel business related travel. This forces employees to more intensely use tools to collaborate at a distance, potentially increasing familiarity with and comfort in using such tools too in the future. This can have a more lasting impact on office use and business travel.
- Future investment could show a mixed picture, in that on the one hand it will decline as companies need to strengthen their balance sheets, but on the other hand we could see more investment in technology that enables work at a distance, including broadband infrastructure, and moving production facilities to the proximity of end markets. More investment could also be allocated to production of and research related to medicine, vaccines and medical equipment.
- Current policy measures will be reversed in the future, and this can lead to lower growth contributions. Governments will have higher debt levels due to emergency expenditure, forcing them to reduce spending later and/or to increase taxes. In case of very high debt levels, we can witness higher interest rates or yields for government debt. As the benchmark for risk free assets, this can also signify higher borrowing costs for other lenders. Central banks will have to shrink their expanded balance sheets, this can lead to repricing on capital markets as well.

A rethink of monetary policy

The new economy is one of slower growth, aging population, digitization, and declining confidence in the institutions that underpin our society, as captured in PwC's ADAPT framework . Added to this are ever looser monetary policy stances, with continually lower interest rates and asset purchase programs. These expansionary stances have given rise to critiques of negative interest rates being potentially applied to small retail depositors, calls for the use of expansionary fiscal policies in budgetary surplus countries, low profitability of financial service sector entities, potential housing bubbles, and financial stability concerns.

Against this background, a fierce debate of current monetary policy has ensued. The debate has put central banks at crossroads in deciding what they should do in the future. Calls for a greener monetary policy, the exploration of central bank digital currencies, a rethink of the inflation target, and the adoption of unconventional expansionary policies as normal policy tools, are a few future alternatives.

To all of this is currently added the economic pressures from the COVID-19 pandemic, which has prompted many central banks to significantly ease monetary policy at a time when many of them, at the brink of the virus outbreak, were expected to tighten it. Below we review the current monetary policy arsenal of the European Central Bank (ECB), and highlight the tools that central banks are now using to counter the economic and financial impact of COVID-19.

Figure 3 Inflation (HICP) in the eurozone, 2000 to 2020



Source: ECB

What are central banks for?

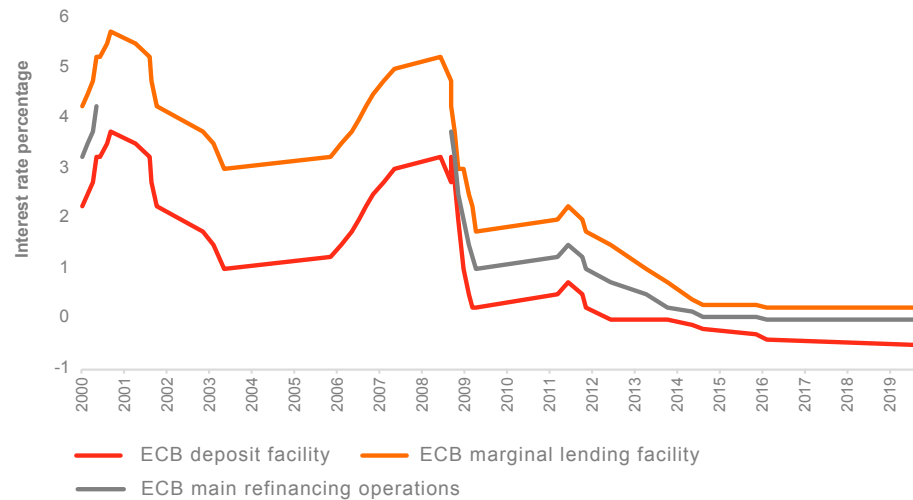
The primary objective of the Eurosystem, which comprises the ECB and the national central banks of EU Member States that have adopted the euro, is price stability. In 2003, The ECB translated this price stability goal into a quantitative definition of “a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below but close to 2 % over the medium term”. In layman’s terms, this would be an inflation target of around 2% (Figure 3). The ECB can support general economic policies in the EU only insofar as they do not pose a threat to price stability.

Why is price stability important?

Price stability is important, as it allows the economy to function smoothly by reducing uncertainty about general price developments. This facilitates transactions and decision-making.

¹ For more information regarding ADAPT, please visit our Global website: <https://www.pwc.com/adapt>.

Figure 4 ECB key interest rates, 2000 to 2020



Source: ECB

Long periods of excessive inflation or deflation have negative effects on the economy. High inflation results in people losing purchasing power. Deflation, defined as an ongoing and widespread fall in prices across the economy that is not due to improvements in production, incentivises people to postpone spending and investment, thereby depressing prices even further and bringing the economy to a slowdown.

What has inflation been like in the euro area?

In the aftermath of the global financial crisis, the ECB has mainly undershot its inflation target despite ultra-loose monetary policy. It is because of this undershooting that the ECB has used to the fullest its conventional monetary policy tools and experimented with unconventional monetary policy tools.

How do central banks ensure price stability?

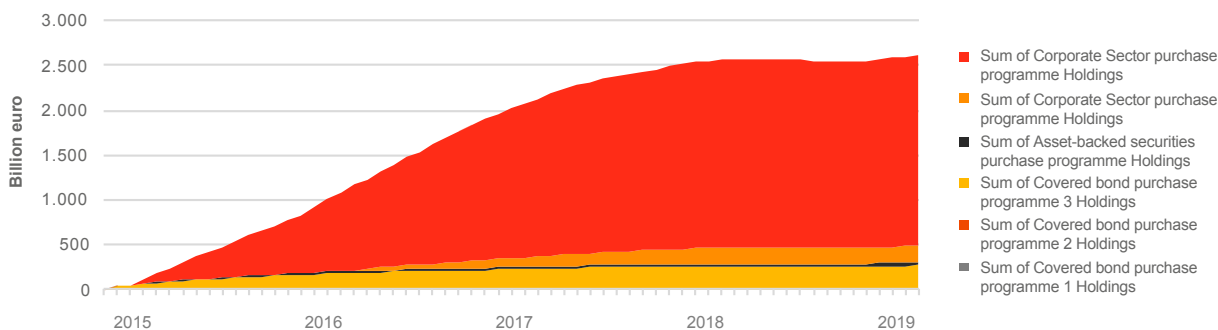
When faced with weak economic activity and stressed financial markets, central banks ease their monetary policy through their conventional monetary policy tools, such as a reduction in short-term interest rates (Figure 4). The resulting lower rates are expected to stimulate the conditions for investment and consumption.

Given that in the aftermath of the global financial crisis the interest rates were already low, central banks resorted to unconventional monetary policy tools to stimulate the economy.

Radical future states

In the upcoming publication “A rethink of monetary policy” we will shed light on what ECB monetary policy may look like in the future. An infinite central bank balance sheet, substantially negative interest rates, ‘helicopter money’, central bank digital currencies, a change in the central banking target, and a greening of monetary policy are all analysed as policy alternatives. We look at their effect on the economy in terms of central bank independence, financial stability, profitability of financial service entities, redistribution concerns, effect on savers, etc.

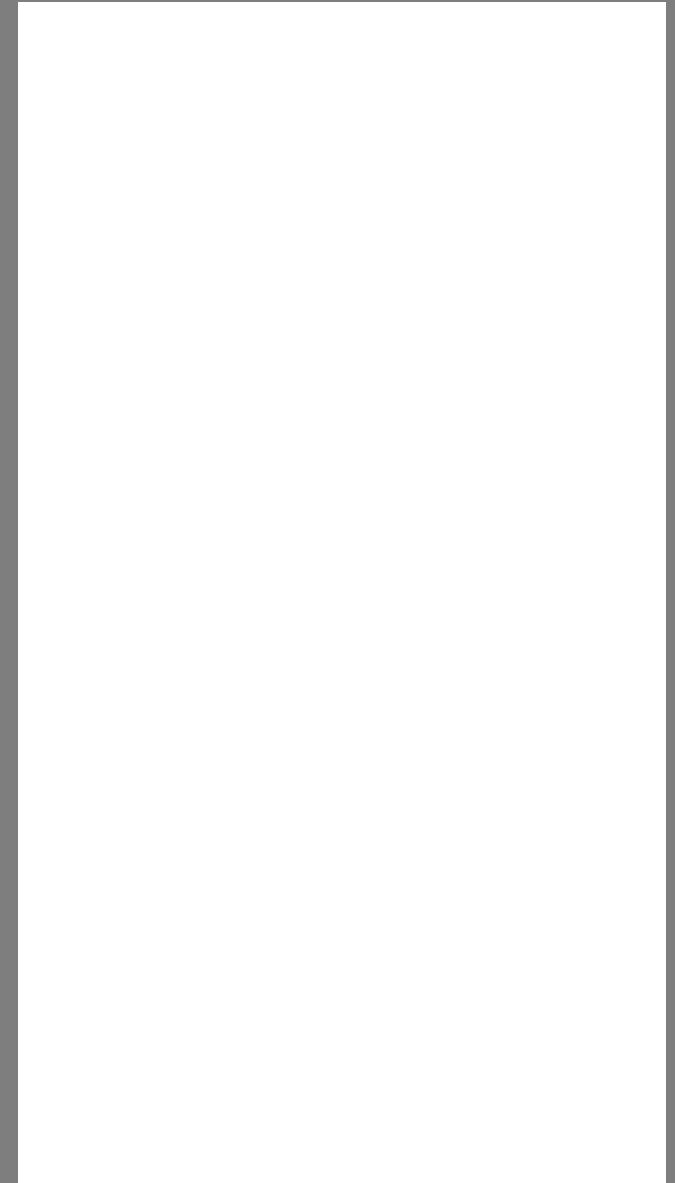
Figure 5 Asset purchase program holdings (see 2. Asset purchase programs on the next page)



Source: ECB

Monetary policy instruments

In keeping up with its task of ensuring stable prices through achieving an inflation target of below, but close to, 2% over the medium term, ECB utilizes an arsenal of monetary policy tools, both conventional and unconventional. The figure below is a condensed description of these tools. **Mouse-over the red squares to read.**



What are central banks doing in the face of the COVID-19 pandemic?

March has seen major central banks take bold monetary policy decisions in the face of the COVID-19 pandemic. These decisions consisted of further monetary easing through the use of unconventional policy tools, and have surprised many with their magnitude and immediacy.

On March 15, the Federal Open Markets Committee (Fed) decided to lower the target range for the federal funds rate to a range of 0 to 0.25%. The Committee also announced that it will increase its holdings of Treasury securities by at least US\$500 billion and its holdings of agency mortgage-backed securities by at least US\$200 billion. This move is intended to support the functioning of these markets and subsequently the flow of credit to households and businesses.

The following day, the Bank of Japan announced that it will purchase Japanese government bonds, commercial paper, and corporate bonds, while issuing loans with a maximum maturity of one year to corporates at an interest rate of 0%. Remarkable was the forward guidance provided, whereby the central bank stated that the policy rates in the future could be cut further into negative interest rate territory.

On the 18th of March, the ECB announced a €750 billion Pandemic Emergency Purchase Programme (PEPP) of private and public sector securities throughout 2020 to counter risks to the monetary policy transmission mechanism and the growth outlook. The securities purchased will include all the asset categories eligible under the existing asset purchase programme. On top of this, the ECB will expand the range of eligible assets of its existing corporate sector purchase programme to all commercial paper.

In addition to asset purchases, the ECB will conduct additional temporary longer-term refinancing operations (LTROs) to provide immediate liquidity support to the euro area financial system until the LTRO III that starts in June. Lastly, in LTRO III, the ECB will apply more favourable terms. The LTROs are intended to provide

liquidity support to the financial system and to support bank lending, especially to enterprises. The ECB has left its main policy rates unchanged.

The 19th of March the Bank of England (BoE) announced that it will engage in asset purchases, namely UK government bonds and sterling non-financial investment-grade corporate bonds worth £200 billion. The purchase of government bonds can facilitate the increase in fiscal budget, intended to alleviate the effects of COVID-19. It will also undertake other measures, among which the purchase of commercial paper to provide funding to non-financial businesses so that they can pay their suppliers, salaries, etc. It will also reduce the policy rate to 0.1%, only a week after it reduced it to 0.25%.

However, not all central banks are lowering their policy rates. The 20th of March, the Central Bank of Russia decided to keep its key rate unchanged. The decision reflects a combination of developments that affect inflation and the economic outlook. The Central Bank of Russia considered that the inflationary pressures stemming from a depreciating rouble - partly caused by the oil price war with Saudi Arabia - would to some extent offset the deflationary pressures of a waning global and domestic demand in the face of the pandemic. The People's Bank of China (PBoC), which now seems to be the country that has most recovered from COVID-19, also decided on its monetary policy meeting of the 20th of March to not ease policy further. This however follows a number of easing policy measures, including a decrease in minimum reserve requirements, that took place while the pandemic was expanding in the country.

While it is clear that central banks can indeed provide needed liquidity, none of their tools actually counter the root cause of the economic and financial turmoil, which is the pandemic itself. That is why their impact on financial markets or the economy cannot be long-lived. These monetary measures are as such only part of the solution, and much more now depends on actions taken by governments to contain the spread of the virus, to provide support and stability.

Macroeconomic Update Europe

Just as the European economy was showing some indications of an improving economic momentum, the COVID-19 virus spread over the continent, and will disrupt economic activity in many regions, either directly or indirectly. At the time of writing it is difficult to assess what the impact will be of the pandemic, as this largely depends on its duration, as well as the regions and the number of people affected. The virus is like a 'perfect storm', as it represents both a supply as demand shock that disrupts economic activity.

GDP growth

The eurozone ended the year with a much weaker growth rate than in the first quarter. In the final quarter of 2019, GDP expanded with a growth rate of 0.1% compared to the previous quarter, while during the first quarter of last year, this quarter-on-quarter (q-o-q) growth rate was 0.5%. Economic growth was dragged down by the area's largest economies, i.e. Germany, France and Italy, which realised q-o-q GDP growth rates of respectively 0%, -0.1% and -0.3%. As the economies of these countries are already in a weakened state, a significant contraction of these economies in especially the first half of 2020 is to be expected.

The economic growth recovery in Turkey gained pace in the last three months of 2019 with GDP growth reaching 1.9% compared to the previous quarter, and 6.0% year-on-year (y-o-y). This was a considerable increase compared to the y-o-y growth rate of 1% in the third quarter of 2019. In 2020, the COVID-19 outbreak may slowdown Turkish growth indirectly via trade and tourism.

The whole of Europe is very likely to go through a recession this year, but the severance of it is still very difficult to assess, as it strongly depends on the kind of measures taken to contain the spread of COVID-19, and their duration. In Western Europe we expect a significant decline in economic growth in the first half of 2020, with a recovery in the second half, that may nonetheless result in negative growth for the whole of 2020.

Employment and private consumption

Recent employment data still shows resilience and remains a positive force, due to its significance for private expenditure. The number of people employed in the eurozone grew with 1% in the last quarter of 2019, reaching yet another record level. Unemployment in January of this year stood at 7.4% in the euro area, the same level as in the previous three months. Several countries experience tight labour markets, leading to higher wages, but also higher labour costs for companies.

Household consumption in the eurozone increased with 1.2% in the final three months of last year and compared to the previous quarter. Private expenditure continues to contribute quite strongly to economic growth in the common currency area. The question is whether this remains one of the main growth pillars, as the virus outbreak can lead to reduced consumption, especially if confidence in the future is affected. Consumer confidence data of the European Commission released in February this year, showed no signs of weakness. On the contrary, confidence increased markedly compared to the previous month, and is still well above its long-term average.

Turkish households increased their spending with 6.8% in the final quarter of 2019 and on an annual basis. This was an acceleration compared to the 1.9% y-o-y rate of the third quarter of last year. Private consumption benefited from fiscal stimulus targeted at households and central bank measures to boost consumer lending.

The upswing in growth is only gradually leading to a decline in unemployment at this stage. In December 2019 the seasonally adjusted unemployment rate shrank with 0.1 percentage point to 13.1%. Unemployment remains elevated compared to recent history, but is already lower than the 14.2% peak of July 2019.

Capital investments

Gross fixed capital formation in the eurozone contributed strongly to fourth quarter growth, as it increased with 4.2% q-o-q. Because of capacity increases, companies were able to keep up with work at hand, as IHS Markit reported a twelfth successive monthly fall in backlogs of work outstanding⁴. Steadily increasing labour shortages and related higher costs may also stimulate firms to invest in solutions to raise productivity levels. Higher capacity rates, slowing foreign demand and now the COVID-19 pandemic, are all factors that will affect future investment plans in the coming months. However, to what extent is currently too difficult to predict. Longer term, we may see investment in a diversification of supply chains, as the pandemic has laid bare vulnerabilities that need to be addressed in order to attain higher levels of resilience. Companies with comparatively high debt levels are now confronted with risk averse financial markets. This will put pressure on them to lower debt, which can impact their ability to invest in new capacity and reduce their growth rates.

Net exports

Export from the eurozone rose with 0.4% q-o-q in the fourth quarter of last year, while imports increased with 2.2%. As a result, net trade's contribution to GDP growth was negative in the last three months of 2019. Imports increased with an average annual rate of 3.8% in 2019, which was higher than 2018 when imports rose with 3.0% on average. The average export growth rate declined from 2.9% in 2018, to 2.5% in 2019.

Turkey saw its trade deficit shrink in 2019, as exports increased with 2.1%, and imports declined with 8.7% in adjusted terms last year. The depreciation of the Turkish Lira led a surge of export until the fourth quarter of 2019, while a decline in consumption and investment

brought about a decline in demand for imported goods. Higher private consumption and investment have recently led to higher imports, as imports increased with 5.6% in the last three months of 2019, while exports fell by 14.4% compared to the previous quarter and on a seasonal as well as calendar adjusted basis.

Government expenditure

Government consumption increased with 0.3% in the last three months of 2019 and compared to the third quarter of that year. The y-o-y change of 0.1% was at the same level as in the previous four quarters. Government expenditure growth and its contribution to economic growth has been small, but constant in the past year. This will change at the start of 2020, as a result of additional expenditure related to the COVID-19 pandemic. In many countries affected by the virus, governments have pledged means to deal with the outbreak's consequences, such as higher healthcare costs and compensation for people not being able to work.

In response to the pandemic, the European Commission (EC) has pledged to make €37 billion available "to fight against the Coronavirus crisis"⁵. The EC will also make it easier for member states to use a total of about €29 billion in structural funding for investments that can support economic growth. Dutch finance minister Wiebe Hoekstra commented that he is willing and able to let government debt rise to 60% of GDP, meaning €90 billion is available for fiscal spending when needed⁶. Germany decided to 'pull all the plugs' and "provide unlimited liquidity assistance to German companies hit by the pandemic"⁷. Not all European countries have similar buffers directly at hand, because of higher debt to GDP levels or budget deficits. The Turkish government followed a procyclical policy throughout the economic downturn and in 2019 its expenditure continued to grow robustly. However, in the last quarter of 2019, government expenditure growth slowed down to 2.7% y-o-y from 5.7% in the third quarter.

⁴ IHS Markit, "Eurozone Composite PMI, Final Data", 4 March 2020.

⁵ European Commission website (https://ec.europa.eu/commission/presscorner/detail/en/ip_20_459), accessed 13 March 2020.

⁶ Het Financieele Dagblad, "Hoekstra zet crisisbuffer in van €90 mrd, zo nodig meer", 13 March 2020.

⁷ Financial Times, "Germany wields 'bazooka' in fight against coronavirus", 13 March 2020.

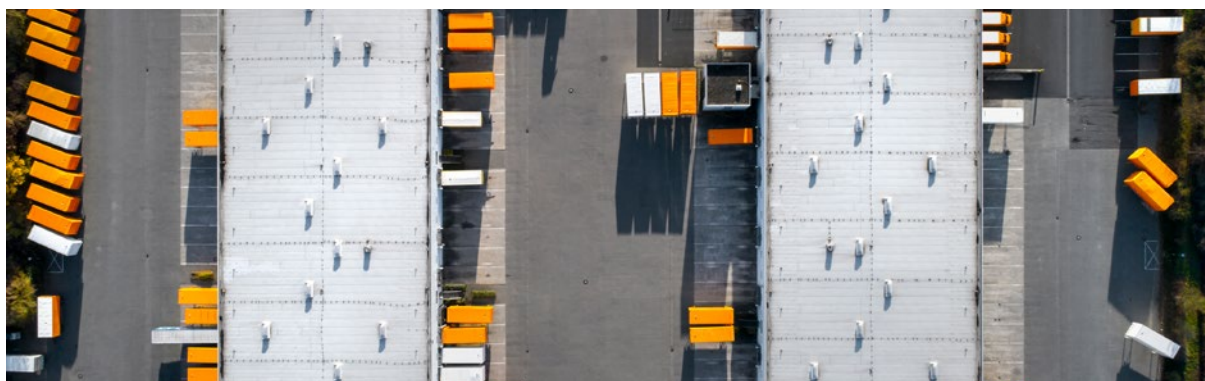


Figure 6 Key economic indicators, selected European economies

| | GDP growth (% change) | Industrial production (% change) [^] | Consumer spending (% change) | Capital investment (% change) | Unemployment rate (%) ^{^^} | Consumer prices (% change) ^{^^^} |
|----------------|-----------------------|---|------------------------------|-------------------------------|-------------------------------------|---|
| Eurozone | 1.0 | 2.3 | 1.2 | 6.3 | 7.4 | 1.2 |
| Austria | 0.9 | -1.4** | 0.9 | 1.1 | 4.3 | 2.2**** |
| Belgium | 1.2 | 4.5** | 0.8 | 0.9 | 5.3 | 1.0 |
| France | 0.9 | 1.2 | 1.3 | 3.4 | 8.2 | 1.6 |
| Germany | 0.5 | 2.7 | 2.8 | 1.0 | 3.2 | 1.6 |
| Italy | 0.1 | 3.7 | 1.3 | 1.7 | 9.8 | 0.3 |
| Luxembourg | 3.0* | 2.3 | 5.0 | 5.0 | 5.7 | 1.8 |
| Netherlands | 1.5 | 3.2 | 0.0 | 4.4 | 3.0 | 1.3 |
| Spain | 1.8 | 0.1 | 2.0 | -0.3 | 13.7 | 0.9 |
| Switzerland | 1.5 | -5.3** | 1.3 | 3.0 | 3.9** | 0.1 |
| Turkey | 6.0 | 7.9* [^] | 6.8 | -0.6 | 13.1** | 12.4 |
| United Kingdom | 1.1 | 0.0** | -1.9 | -0.9 | 3.7*** | 1.8**** |

Note: Figures are the latest available values i.e. the fourth quarter of 2019, unless specified differently. Figures are further reported quarterly, unless otherwise stated, and on basis of year-on-year change (where applicable). Consumer prices are reported according to the HICP methodology, except for Turkey, and display the year-on-year change in prices.

[^] Month-on-month change, January 2020 ^{^^} Seasonally adjusted, January 2020 ^{^^^} February 2020

* Q3 2019 ** December 2019 *** November 2019 **** January 2020 [^] Seasonal and calendar adjusted

Source: Thomson Reuters, Eurostat, Federal Statistical Office Switzerland, Turkish Statistical Institute.

Inflation

The first estimate for inflation in the month February of this year, came in at 1.2% for the eurozone. This was lower than the 1.4% rate in the previous month. Energy prices declined with 0.3% in February, after two consecutive months of increases. This component will drop further in March, due to the strong decline of oil prices recently. In the coming months, prices will likely decrease as a contraction of economic activity leads to a lower demand for products. A shortage of products could push up some prices, but this will be temporary.

A decrease of overall prices will justify a loosening of monetary policy by the ECB. However, with the deposit rate already at a negative 0.5%, it does not have many conventional instruments at hand to try to move inflation in the direction of its target of close to 2%. The ECB will likely have to resort to other means, such as a significant reboot of its assets purchase programme, also known as quantitative easing. Please see the main article of this Monitor for more information about the instruments central banks like the ECB have to influence price developments.

The rate of inflation remains challenging in Turkey, but has come down significantly after peaking at 25% in October 2018. The decline in inflation has tempted the Turkish central bank (CBRT) to continue lowering interest rates, currently at an average of 10.8% and down from an average of 24% in September 2018, in order to stimulate consumption and economic growth. In February 2020, inflation was 12.4%, with both risks to the upside and downside. The recent depreciation in the Turkish Lira raises the CBRT's appetite to cut interest rates further. However, the COVID-19 outbreak creates uncertainty about future price developments, as supply restraints could lead to higher prices, while at the same time lower oil prices, and reduced demand as a result of social distancing can put downward pressure on prices.

Country Update: Belgium

The comparatively small and open economy that Belgium is, fared quite well in 2019, despite headwinds from a slowdown in global trade, manufacturing weakness at its neighbour Germany, and uncertainty pertaining to Brexit. This year may prove to be much more challenging, as the impact of the Coronavirus epidemic will reverberate, just as economic momentum was weakening in Belgium.

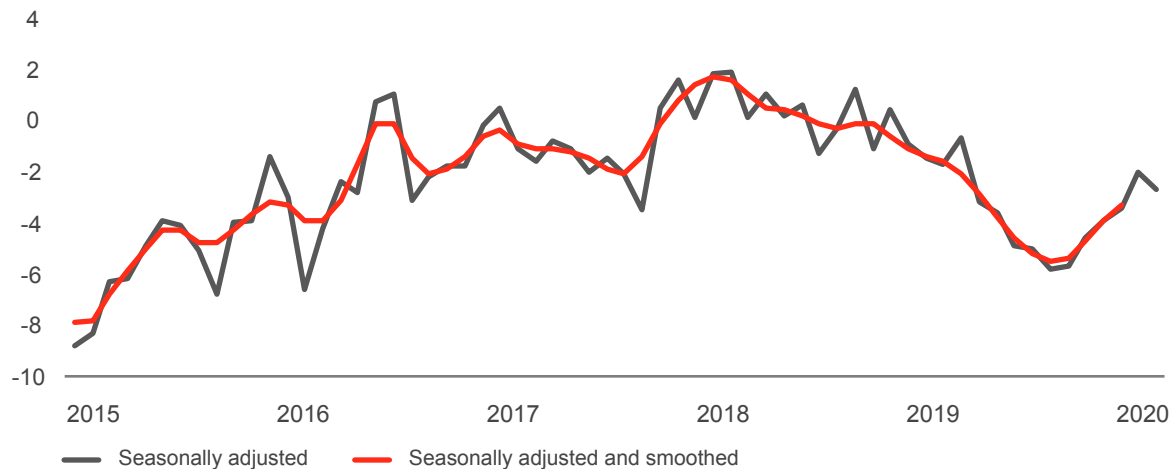
Belgium is vulnerable for disruptions in trade

At the time of writing, the impact of the COVID-19 outbreak is still very difficult to assess, but that it will have an impact on economic activity in particular the first quarter of 2020 is clear. Already around mid-February of this year, in a survey held among Belgium companies by Agoria, respondents indicated that production in China or other Asian countries went the wrong way, and two thirds experienced disruptions with the supply of parts from China⁸. Since then, the virus spread and caused disruptions in other regions as well, including Belgium itself.

Belgium's direct trade relation with China is limited at 1.8% of total export and 4.4% of total import in the first nine months of 2019⁹. This is however not representative of China's importance in global supply chains, and both the demand and supply shock resulting from the epidemic will indirectly hit Belgium via other, much more important trade partners, such as Germany, The Netherlands and Italy. Disruptions in trade will have a proportionately large effect on Belgium due to its openness. According to the National Bank of Belgium (NBB), Belgium's share of trade in goods and services averaged 80% of total GDP over the period 2016-2018¹⁰. Further, nearly two-thirds of all Belgium firms are indirectly linked to foreign trade, and therefore exposed to demand from other countries¹¹.

The disruptions caused by COVID-19, come at an inconvenient time, as international trade growth already slowed down since 2017, and turned even negative in 2019, due to trade tensions and a slump in manufacturing activity in several countries, among which Germany¹².

Figure 7 Business confidence in Belgium, January 2015 to February 2020



Source: NBB statistics

⁸ De Tijd, "Belgische bedrijven in de greep van coronavirus", 19 February 2020.
⁹ Belgium Foreign Trade Agency, "Foreign Trade Statistics 01-09/2019", page 3.
¹⁰ National Bank of Belgium (NBB), "Economic Review", December 2019, page 51.
¹¹ NBB, "Economic Review", page 62.
¹² Idem, pages 9 and 10.

This means there's less room to cushion the impact of the virus outbreak. Producer confidence was just recovering since the end of 2019, after a period of weakness from the beginning of 2018, and will come under pressure again because of the latest developments (figure 7). This in turn will likely affect business investment, a comparatively strong contributor to Belgium's economic growth in the past years (Figure 8). Particularly as investment was already weakening by the end of 2019, as costs were rising, and capacity utilisation has passed its peak¹³.

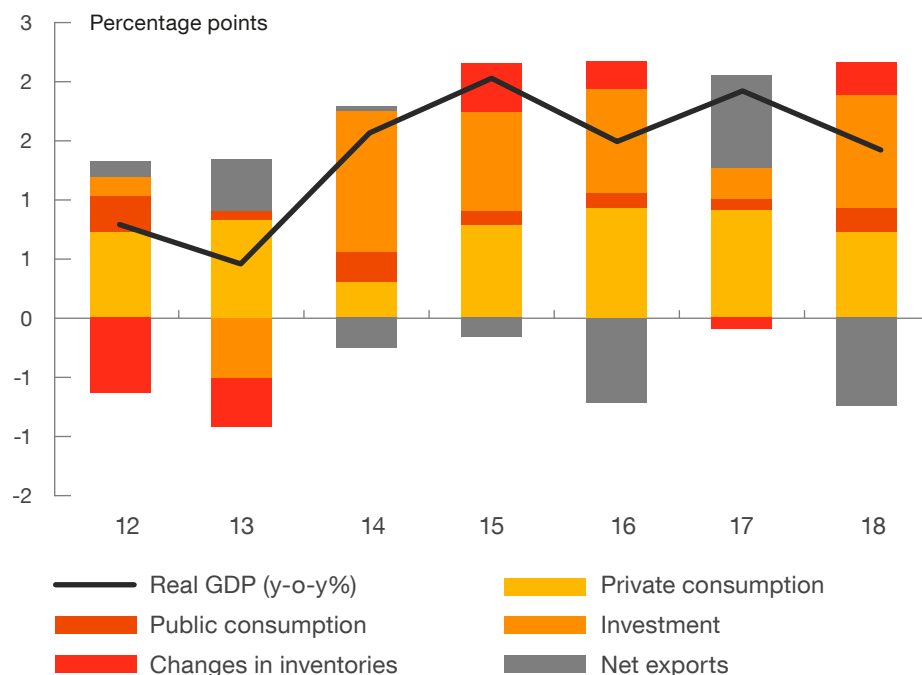
Accelerating private consumption may stop in its steps

Economic growth in Belgium held up well in 2019, partly due to the strength of private consumption. Consumption growth increased from a year-on-year rate of 0.6% in the first quarter of 2019, to 1.8% in the final quarter of 2019 according to the NBB. Consumer expenditure rose due to employment growth and higher real incomes. Disposable income also benefited from tax measures coming into play at the beginning of 2019, and a low inflation rate. However, already at the end of 2019, NBB was foreseeing a slowdown in job creation for the period 2019-2022 at a level of almost a third less than in the four years before 2019¹⁴. Considering the potential impact of the COVID-19 outbreak, employment growth may turn out much lower at least this year, affecting consumer confidence and ultimately economic growth via reduced expenditures.

Little room for government support

For the Federal Government it will be challenging to support an economy facing a slowdown due to disruption caused by the Coronavirus. One reason is that Belgium officially still does not have a new government after the general elections of 26 May 2019, and current tidings indicate it will not be able to form a new coalition government any time soon. This may make it more difficult for the government to agree upon measures to support the economy when needed. The country's fiscal position too does not offer much room to support the economy e.g. by means of higher government expenditures. Although the debt-to-GDP ratio has declined in the past years, it still stands at 100%. The budget deficit has diminished to 0.7% of GDP, but is expected to increase again to 2.8% of GDP, as the temporary factors that contributed to the shrinking deficit fade¹⁵. This leaves little room to increase government expenditure without breaking the Maastricht treaty rule of a 3% maximum deficit.

Figure 8 Real GDP growth and contributions



Source: EC, February 2020.

¹³ Idem, page 15.

¹⁴ Idem, page 16.

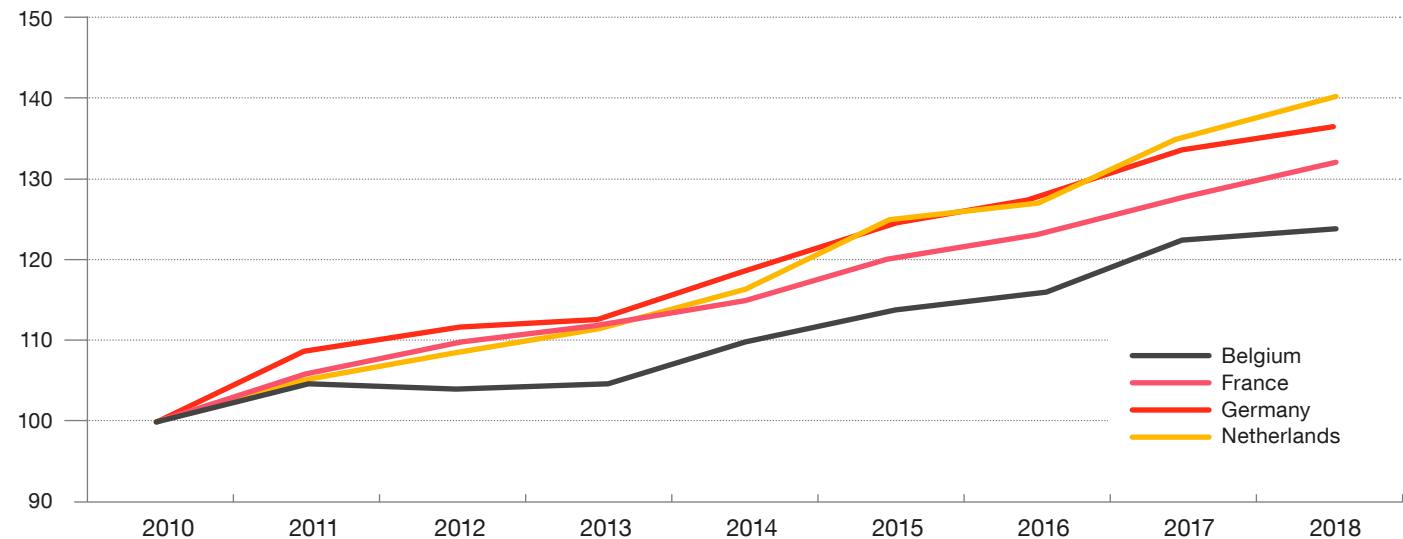
¹⁵ Idem, page 8.

Longer term opportunities

Although the first half of 2020 is likely going to be difficult, more challenges lie ahead in the longer term for Belgium. The country cannot change its openness to the world markets, as this is very much related to its small size and lack of especially natural resources domestically. Belgium needs to work on its competitive strength in the global markets, as its current position has contributed to greater vulnerability for a slowdown in global trade as mentioned earlier. This resulted in a lower growth of exports compared to neighbouring countries (Figure 9).

According to analysis by the NBB, this export performance can partly be explained by a comparatively large share of products from the manufacturing industry in total export, and a specialisation in product categories that do not generate strong growth. Belgium exporters also lost market share abroad, as gains in cost-competitiveness were not entirely passed on to export prices, but were reflected in profit margins. Factors that can contribute to higher export growth are an expansion of new transactions with other countries, or an intensification of existing relationships. Other factors are improvements in infrastructure, and the development of skills that contribute to competitive advantages.

Figure 9 Belgium's trade in goods and services compared to neighbouring countries



Source: NBB

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