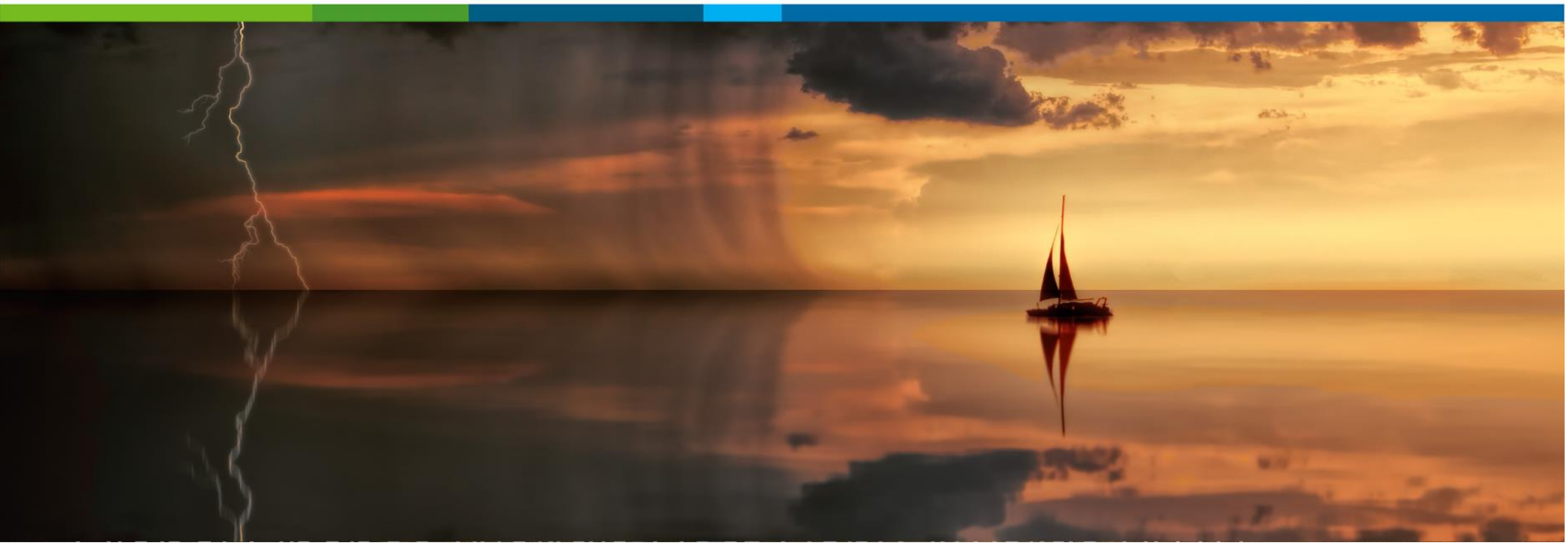

Euro area: headed for sharp contraction

The widespread lockdowns across Europe are likely to continue well into the second quarter, causing a sharp contraction in the region's GDP during the first half of the year.

However, the expected recovery in the second half is likely to drive up the 2021 GDP growth rate. We forecast euro-area GDP growth of -4.0 per cent in 2020 (previously -3.0 per cent), 3.5 per cent in 2021 (0.2 percent) and 1.2 per cent in 2022.

We expect GDP to contract 3.6 per cent in Germany in 2020, 4.0 per cent in France, 4.7 per cent in Italy and 3.5 per cent in Spain.

Continued social distancing after more severe restrictions are lifted, combined with the possibility of a second wave of the virus, present downside risks to the growth outlook.

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Policy response: "Whatever is necessary"

The European Central Bank (ECB) has announced unprecedented policy easing. New policies include significant refinancing at very preferential rates, and a substantially enhanced programme of quantitative easing.

The ECB Supervisory Board has also announced capital relief measures for banks to keep credit channels open to businesses and households. Capital requirements have been eased, which should provide some EUR120 billion of capital relief to help banks maintain their balance sheets. The rollout of new Basel III capital standards has been deferred for one year.

the growth outlook.

The EUR410 billion EU bailout fund provides an unlimited credit line under the Outright Monetary Transactions programme. In light of the coronavirus crisis, the tough compliance conditions for gaining access to this programme could be eased, if financially strong euro-area countries such as Germany and the Netherlands agree (they have not been supportive of a 'corona bond' so far).

Additionally, the EU has eased fiscal rules under its Stability and Growth Pact, and state aid rules have been relaxed to allow direct government support for struggling companies. We expect fiscal stimulus measures, combined with the downturn in GDP, to lead to euro-area fiscal balances of -9 per cent of GDP in 2020.

On the political front, there seems to be little appetite for political challenges to incumbent governments.

Currency outlook

With rate differentials moving in favour of the euro, we expect EUR-USD to rise to 1.16 by the end of the year.

UK – demand shock

The UK is in full lockdown until 13 April, and this is likely to be extended even if the spread of the virus shows signs of being contained. We expect a demand shock to result in a sharp recession in the second and third quarters. As a result, our base case is a collapse in UK economic activity in the second quarter as household expenditure and private investment contract sharply.

The likelihood of an extended lockdown shapes our 2020 growth forecast of -3 per cent. We expect a recovery to 3 per cent GDP growth in 2021, before the trend settles to 1 per cent in 2022.

Policy response: leaving no stone unturned

The UK's unprecedented fiscal response includes wage subsidies of up to 80 per cent for furloughed workers and the self-employed, significant boosts to welfare support, and GBP330 billion in loan guarantees to businesses, on top of the emergency measures already announced in the 11 March budget. We expect further measures in the coming weeks and months, as the government gradually fills in the gaps.

We now see the 2020 fiscal deficit widening sharply to at least 8.5 per cent of GDP (previously 2.8 per cent) due to fiscal expansion and lower tax revenues due to the expected GDP decline.

On the monetary policy front, the Bank of England (BoE) has also thrown the 'kitchen sink' at the economy, cutting the Bank Rate by 65bps in March to 0.1 per cent, and announcing on 19 March that it would restart quantitative easing purchases, looking to buy GBP200 billion of mainly government bonds "as soon as is operationally possible". We expect the BoE to start normalising policy in 2022, taking Bank Rate up to 0.25 per cent by the end of the year.

These aggressive fiscal and monetary actions should also enable a quick resumption of economic activity once the health situation improves.

Amidst the coronavirus crisis, Brexit has moved to the backburner, with talks unlikely to resume until mid-2020.

Currency outlook

The GBP was initially one of the worst performers of the G10 currencies after the coronavirus hit Europe, perhaps due to the UK's relatively slower and less stringent response to the virus. However, we see the 23 March lockdown announcement as potentially having turned the tide for the GBP. As markets anticipate the probability of a peak in cases in early to mid-April, we expect the GBP to continue to recover, and to rebound sharply once the disease comes under control.