Sunday Wrap

Happy International Women's Day …

… although that feels like a strange greeting this morning, just a few days after the field of challengers to President Trump was cut to just two elderly men. So, the world's most powerful country will be led by a man in his mid- to late-70s (or even early-80s) through 2024. Somehow, this does not feel very good to me.

Of course, just like the three (also white male, although younger) contenders to succeed Angela Merkel as head of Germany's CDU (i.e. Merz, Laschet and Röttgen) also look alike on paper, the three American candidates (Trump, Biden and Sanders) stand for dramatically different visions, and policies – which I'm sure you are aware of. The differences between the three German CDU contenders are certainly less pronounced than the choice facing the US voters, but they still represent fundamentally different directions for the CDU, and thereby – potentially – for Germany and Europe. Politico's Matthew Karnitschnig has a great discussion of this here: The battle for Germany's center right. For the cultural similarities, and lack of diversity, between the three candidates, Brookings' Constanze Stelzenmüller has this read-worthy piece in the FT: The fratboys vying to succeed Angela Merkel.

All topics for another day, but today, on International Women's Day, I feel like saying that I, for one, am longing for political leadership that better represents our societies - not least as we are heading into a serious (if hopefully short) crisis.

So, on to the issue of the virus:

The good news is that the spreading of the virus has now slowed down to a trickle in China. The Chinese government is therefore beginning to ease restrictions on public gatherings, including at work places, travel, etc. There are several indications that life and economic activity in most of China is starting to return to normal.

The bad news is that the virus is now multiplying rapidly in Europe, in the US and elsewhere. Europe is trying to contain the spreading by rolling out broadly similar measures as were employed in China. This morning, Italian PM Conte signed a decree locking down Lombardy and a number of smaller Italian provinces, de facto quarantining about 16 million people until early April. In the US, few restrictions have been imposed so far, mostly because President Trump remains in denial. The front page of this week's New Yorker says it all (https://www.newyorker.com/magazine) while this piece in the FT explains why the US is likely to be very vulnerable to the virus: Why the US is so vulnerable to coronavirus outbreak. Beyond Europe and the US, I worry about the spreading to Africa and other emerging markets where the healthcare systems will struggle tremendously to cope.

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Last Sunday, I suggested – via a chart showing the total number of cases in China vs the rest of the world (lagged by 28 days) – that we may be about a month away from seeing the peak in the European and US epidemic curves. After another week, this "mirroring" of the Chinese experience remains on track, with the rest of Europe and the US following Italy by about one week.

On the one hand, the good news is that Europe may benefit from what we have learned about the effectiveness of containment in China and from the fact that the European healthcare systems are among the best in the world. According to the WHO's 2020 index, France has the world's best healthcare system, including for preventive care, followed by Italy in second place. Spain is number 7, UK number 18 and Germany number 25, to mention a few. The US is number 37. Of course, these are broader indices than what might be relevant for specific virus-related issues, but the general picture, including the risk of the virus "crowding out" other important healthcare needs and treatments, is probably still broadly right. The WHO definitions and rankings are here: Best Healthcare In The World 2020.

On the other hand, the more draconian the measures to contain the spreading of the virus, the greater the (short term) economic shock will be. In other words, referring back to my three scenarios in last Sunday's Wrap, I now think the probability of the most benign scenario is very low, and that the odds may be moving from the second (central) scenario I discussed towards the third "worst case" scenario, i.e. with significant negative economic effects in Q2, and some spill-over into Q3.

While the debate about the relative importance of supply vs. demand shock continues, and hence on the effectiveness of policy stimulus, there can no disagreement that markets are now reacting in a way that will impose additional pain on the real economy.

Therefore, central banks need to (and will!) put in place measures to limit the disruption of markets so as to preserve as much as possible the critically important transmission mechanism from the central bank to the real economy. The bigger the role of the banking system in the transmission of credit, the more important this is – hence, the need for the ECB to act. And governments need to (and will!) step in with fiscal measures to provide a cushion at least for those directly impacted by the virus and the containment measures.

Below, I'll discuss:

- **The Fed's rate cut on Tuesday, which seemed a bit panicky to me. It'll have little effect on the real economy and it illustrates that there is no central bank policy coordination in the pipeline. This means additional volatility, particularly in the FX markets.**
- **How the ECB is likely to respond on Thursday, namely with a package of liquidity measures and they'll – hopefully – provide comfort about their continued ability to act.**
- **How Europe, including Germany, is now about to roll out a fiscal response; small to begin with, but the Rubicon of fiscal austerity has now been crossed.**

1. The Fed moves…

On Tuesday, the G7 finance ministers and central bank governors issued a joint statement promising action to soften the hit to the global economies of the virus outbreak, thereby providing hope of a coordinated policy approach among central banks. But that hope proved short-lived. Within a couple of hours of the G7 statement, the Fed announced a surprise 50bp rate cut to 1.00%-1.25%, sending the dollar substantially weaker, and triggering an almost immediate re-pricing of the forward curve to indicate a 90% probability of the Fed moving all the way to zero rates by the end of the year.

Jay Powell admitted that the rate cut might not have any substantial effect on the US economy, but – apparently – they felt they had to do something to send a signal (but of what?) The problem is that the Fed is now increasingly seen as reacting to the market, rather than guiding the market with its policies; a problem that could easily come back to haunt them going forward. Specifically, with further cuts virtually all the way down to zero now priced in, what's left in the Fed's traditional toolbox with which to impress markets?

Also, by going alone between meetings, and given the immediate effect on the dollar, you could almost hear the gasp in Frankfurt and several European capitals, followed by a pretty audible discussion of the perceived danger of a substantial euro appreciation. The trade-weighted euro is now 3% stronger than just three weeks ago. Of course, in a bigger perspective, EUR/USD looks more like an exchange rate hit by a jolt of volatility than on the road to a multi-year trend-reversal, but that this is policy-induced volatility (although not of historically significant magnitude) is regrettable.

The Fed's decision on Tuesday illustrates why I think the prospect of central bank coordination is dead for now. Without a doubt, the Fed could have waited to align the timing with other central banks' policy actions in coming days and weeks. So why did they move already Tuesday? Maybe in an unannounced attempt to weaken the dollar? (ineffective as that will be for the US economy, but maybe to please the president?)

If dollar weakness really is on their (unannounced) agenda, I strongly doubt that they'll be successful. Sure, EUR/USD may break 1.15 (I feel good about our 1.16 forecast for year-end), but I, for one, would be surprised if we were to see EUR/USD break 1.20 this year. Priorities for safe havens, more aggressive policy actions (good or bad), relative growth and other central banks' refusal to be taken for a ride would all likely limit the upside potential to EUR/USD this year.

I see three – partly related – reasons why G7 central bank coordination will be absent in their response to the virus-induced economic costs:

First, the existing very different stands of monetary policy (or, more precisely, use of tools) across the G7 makes it harder to coordinate comparable policy responses. Second, the pretty much exhausted toolbox for traditional tools makes it more tempting to beggar-thy-neighbor, i.e. attempt to generate FX weakness. Third, the US is governed by an "America first" president with no commitment to international coordination or multilateralism.

If I'm right on this, get ready for a new chapter of significant FX volatility as a proxy-FX-war may unfold, which – in my assessment – will be unlikely to get you any definitive new direction for any of the great FX crosses.

2. What's the ECB gonna do about it…?

This past Monday, the ECB issued a brief – but clear - statement in which they noted the "risks for the economic outlook and the functioning of financial markets", caused by the coronavirus outbreak, adding that they are "closely monitoring developments" and "stand ready to take appropriate and targeted measures, as necessary and commensurate with the underlying risks". (Later in the week, mirroring decisions being rolled out by most businesses across Europe, they announced restrictions on their own travel, and postponed all conferences.)

The Fed's move on Tuesday surely sharpened the attention in Europe, adding a likely FX-angle to the already identified need to limit the monetary tightening now in the pipeline for the next 4-6 months because of the TLTRO repayment schedule. If not addressed, we'll almost certainly see a tightening across several European curves and a disruption of the repo market, with consequences for other markets, and hence the real economy.

Let me explain the monetary tightening already in the oven – and how to fish it out before it's too late:

First recall that even after the massive net repayments (particularly by Italian and Spanish banks, which had been the biggest takers) of the TLTRO-II in September and December last year, eurozone banks in total still face a whopping EUR 222bn due on June 20 when the next TLTRO-II expires. In other words, the ECB and the eurozone financial system are facing an unfortunate coincidence of exceptionally large repayments of this specific TLTRO-II and the onset of the virus and its impact on lending.

Importantly, the squeeze from the June 20 expiry is imminent because banks will almost certainly be very reluctant to switch into the TLTRO-III (as originally planned) to fund the prepayment of the TLTRO-II. The reason is simple: Just at the time when banks in the eurozone are facing a slowdown in corporate lending amid weaker investment activities, lending will surely have further dried up in recent weeks because of the virus-related disruptions and fear among businesses and households. And as banks' eligible lending thresholds are not met (the time-frame for the required lending under the TLTRO-III is March 2019 to March 2021), the cost of the TLTRO-III will increase relative to their existing conditions; hence, the "now-build-in" monetary tightening - coming on top of the tightening of financial conditions caused by the stronger euro and weaker equity markets.

Facing the higher funding costs, banks will move their funding elsewhere, most obviously to the repo market, from where the spillover to funding costs for sovereigns will be potentially shift. The transmission to the entire economy is therefore eminent - and turbo-charged.

Surely, the ECB will want to avoid this (potentially spiraling) effect of tightening conditions at this time. Hence, at their meeting on Thursday, I expect them to decide on a mini-package with two key components, plus clear assurances that they have whatever firepower they deem necessary to stay ahead of the curve and do their share of guiding the eurozone economy through the crisis. Remember, a central bank never runs out of firepower! They may – temporarily – run out of "politically acceptable firepower", but politics change with circumstances and what looks like unavailable instruments today may become available tomorrow. (If in doubt, think about the discussion of QE in Europe in the latter part of 2014.)

Whether the ECB will also cut rates by 10bp in a (futile) attempt to stem the recent euro appreciation, I don't know, but surely I hope not because it'll be ineffective and very likely backfire.

Here's what I think the ECB should – and probably will – do on Thursday:

First, and most importantly, the ECB would want to create a bridge facility to be sure the financial system gets through the next 4-6 months of switches between TLTRO-II and TLTRO-III without an unintended policy tightening. The most obvious way of doing this would be a simple "old fashioned" 6-month LTRO-like facility with full allotment at an interest rate flat to the deposit rate (or a few basis points above).

Second, to keep some term-financing for the banks, they would want to announce temporary waivers (e.g. to the end of the year) for some of the conditions for the TLTRO-III and its cost, most importantly the threshold for lending volumes. Whether they should lower the 2.5% eligible lending threshold to, e.g., 0% or 1%, or introduce a multiplier for particularly desirable lending (e.g. to SMEs), I don't know because I don't have access to the detailed banking and lending numbers that they have. Personally, I'm doubtful about the wisdom of central banks trying to target specific sectors or areas for their policies.

In addition, on Thursday, I would hope that Lagarde will make a clear statement on the ECB's resolve to navigate the upcoming rough waters. Specifically, to provide longer term guidance, the ECB should consider announcing an additional window for the TLTRO-III beyond the present end in March 2021, to, e.g., the end of next year.

And finally, but importantly, to put the rumbling fear of a potential financial catastrophe to rest, this would be an excellent time for Lagarde to remind everyone of the existence of the ECB's unlimited firepower, and specifically the OMT. And what a great time for her to remind people of her extensive experience from the IMF, including her knowledge of appropriate policy conditionality – making the point that policies throughout the eurozone are already in fundamentally good enough shape to broadly serve as the necessary anchor (tied up in an ESM program, of course) for the OMT to become active, should that prove necessary.

3. And, finally, the fiscal to the rescue…

As I'm sure you are aware, this past week the Italian government announced a package of fiscal measures worth EUR 6.3bn (or 0.3% of GDP) to help tackle the effects of the outbreak, reportedly to include money for wage supplements, tax cuts (and tax credits) for firms in the affected areas, and healthcare related need. Parliament is expected to approve the bill next week, and the European Commission has already signed off, stating in their letter to the government "the Commission will be mindful of Member States' need to implement urgent measures to safeguard the wellbeing of citizens and mitigate the negative effects on economic growth of the Coronavirus outbreak."

And as the virus spreads, other governments are springing to attention as well. Tonight, in Berlin, the German governing coalition's leading politicians will meet to discuss their (first) fiscal response to the crisis. I don't know what they'll agree to do, but an extension of payments for short-term work (the so-called "Kurzarbeitergeld") and an acceleration of the planned reduction in the solidarity tax (the "Soli" from 1991) are being discussed in the coffee shops.

In addition to the specific fiscal emergency measures, like in Italy, I hope we'll soon see policy actions throughout Europe to protect the particularly heavily impacted sectors from the supply (and demand) shocks, including airlines, and – via the banking system – SMEs in tourism and other super-exposed sectors, now being serious squeezed.

I see calls for the SSM arm of the ECB to follow the Chinese example of temporarily waiving bad loan provisions for delayed principal and interest payments on loans to businesses and households in the affected areas. However, such "suspension of mark-to market" rules is a potentially troublesome route to take, not least following the great success of many banks in bringing down their NPLs. Rather, government guarantees for such politically desirable exposure by banks (of course capped at a percentage of SME loans), tiering the multiplier as discussed above and/or skipping the counter-cyclical buffer would all be healthier ways of delivering liquidity to ailing firms in the affected areas.

And, before I go, I have long been an advocate of a significant boost to public investment and education spending in Europe. While such measures may not be agreed and implemented fast enough to be effective during the virus crisis (which I still think will peak during Q2 and Q3), they would still help a faster and more complete recovery once we are through the trough – and add to potential growth longer term.

Either way, and whatever the details, it's clear the "Rubicon of fiscal austerity" has been crossed in Europe. Don't expect a big package right away, but my money is on a series of fiscal measures during the next few weeks. Will they be effective? Yes, at least somewhat – and if this is not the time for political leadership, when is?

And on that note, I think I'll grab a beer, throw myself in the couch and watch football this afternoon, while thinking about what the next 4-6 weeks may bring – and dream about the day when the composition of our political leadership will look a bit more like the composition of society (while remaining dedicated to the input of science in whatever they do).

Best

Erik

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