Sunday Wrap

Happy Sunday,

It's been two weeks of working from home now, including these past six days of quarantine – and I don't like it! And this is still only the "London style" light version of quarantine … Anyway, that's not the topic of this morning.

Rather, I'd like to reflect on this past week's odd combination of: (i) further bad news about the spreading of the virus and death rates in Europe and the US, (ii) the first clear signs of the extent of the economic damage - and its big! (iii) the crazy talk by Trump and others about a possible early (surely premature) lifting of restrictions, (iv) European leaders as divided as ever about the policy response to the crisis, (v) the ECB and the Fed adding to their already comprehensive response, and – the oddity - (vi) markets generally liking the balance of what they see with new support for parts of the risky asset universe and lower volatility.

So, you may say that I was wrong last Sunday to suggest it was too early to return to the risky asset classes. But I haven't changed my mind. Like the FT's Michael Mackenzie titled his excellent piece in the FT Weekend edition: "Rally shows too much faith that policymakers have this in hand", I'll like to see at least glimmer of actual light at the end of the tunnel before I can see myself recommend riskier assets – with the noticeable exception, of course, of assets explicitly (or implicitly) targeted by central banks, including eurozone sovereign spreads and investment grade credits.

Of the six issues I listed above, I assume you are on top of the dreadful daily numbers for new infections and deaths across Europe and the US, so I'll skip those and move straight to the following four – also skipping the sixth one above on markets because my conclusion remains the same: Too early for risky assets.

In other words, four headings today:

- **The first "coronavirus economic data" and what they tell about the outlook.**
- **Why Trump and others are wrong to suggest there is a trade-off between the health aspect and the economic aspect of all this.**
- **The big European debate about solidarity: The national vs. common response.**
- **The central banks keep coming… and the emergence of the new approach to policy coordination between fiscal and monetary.**

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1. The first "coronavirus economic data" and what they tell about the outlook.

This past week we got the first clear set of economic data and "official" estimates to illustrate the severity of the initial collapse in economic activity across Europe and the US. And it's grim - across the board: The flash PMIs tumbled to all-time lows and the consumer confidence indices followed closely behind. In France, the INSEE said it estimates (on the basis of electricity consumption, etc.) activity to have dropped by 35% relative to a normal week, noting that this means that every month of lockdown may knock 3% off annual GDP.

In hard numbers, US jobless claims jumped to 3.28 million, the highest number on record, while the German government said that it expects the number of (public supported) short-time workers to hit 2.35 million.

In my team, we are working on a new set of best guesstimates for GDP, which we'll publish this coming week. I don't know yet where exactly we'll land in terms of specific numbers, but our sense is that both the eurozone, the US and the UK will end up with drops in 2020 GDP between 10% and 15% - and that's under the assumption that we get through the trough in Q2 (and not later) and that the recovery during H2 will be quite fast. Roughly, and ever so tentatively, I'm thinking the bottom will be some three times deeper than what we experienced during the great financial crisis, but the recovery path may be about doubly as fast, both because of the policy measures, but also because private balance sheets are so much better this time around, particularly in Europe.

Let me make two observations about a possible drop in GDP of 10%-15%:

First, for those who see the near-elimination in activity in certain sectors and wonder why the GDP collapse is not deeper, I remind you that the public sector, which accounts for about 20% of eurozone gross value-added (and broadly similar in other countries), will not see any reduction in output, and governments still spend up to 50% of GDP on their various services, a number which is now being further boosted across the world – money which may not go straight to work in the economy given the fear, of course, but which will still provide some help.

Second, and by implication, a 10%-15% drop in GDP implies a drop in private sector activity of at least double that. Yet, while under "normal" circumstances, a drop in GDP of 10%-15% (and maybe the double of that in the private sector) would lead to a huge increase in bankruptcies and certainly trigger a banking crisis, and everything that comes with that, this time is likely to be different, particularly in those countries which are rolling out comprehensive guarantee schemes for the SME and corporate sectors. Basically, such guarantees will prevent the inevitable liquidity crisis among companies from developing into a solvency crisis. In other words, the usual correlation between GDP and default rates is almost certain to break down during this crisis, thereby also preventing bigger ramifications for the banking system – at least in the countries with the most comprehensive policies responses, which I'll discuss in the third section below.

2. Why Trump and others are wrong to suggest there is a trade-off between the health aspect and the economic aspect of all this.

As the economic indicators began to fall off the cliff this past week, you heard a number of people starting to advocate a reassessment of the balance between the hit by the virus to society (and the economy) vs. the hit caused by restrictions imposed to stop the spreading of the virus. President Trump tweeted (in capital letters, but I'll spare you that part): "We cannot let the cure be worse than the problem itself", but plenty of others also took to social media demanding the same.

Personally, I never understood the argument of putting economic growth above the health of the population, either ethically or economically, but on Thursday came the first properly researched argument against such folly.

Three economists from the Federal Reserve Board, the NY Fed and MIT (Sergio Correia, Stephan Luck, and Emil Verner) published a (preliminary) paper titled, "Pandemics Depress the Economy, Public Health Interventions Do Not: Evidence from the 1918 Flu" in which they study the economic consequences of an influenza pandemic and policy measures to contain the spreading of the decease.

Based on detailed data on mortality and output across US cities during the 1918 Flu Pandemic (which reduced manufacturing output by 18%), they show that US cities which intervened early and aggressively to stop the spreading of the decease grew faster after the pandemic was over than those which hesitated or intervened less aggressively. As they conclude: "evidence on manufacturing activity and bank assets suggests that the economy performed better in areas with more aggressive NPIs [Non-Pharmaceutical Interventions, i.e. "social distancing"] after the pandemic … pandemics are highly disruptive for economic activity. However, timely measures that can mitigate the severity of the pandemic can reduce the severity of the persistent economic downturn. That is, NPIs can reduce mortality while at the same time being economically beneficial." Their paper is here: Pandemics Depress the Economy, Public Health Interventions Do Not: Evidence from the 1918 Flu

To be sure, restrictions on activities that expose people to the virus need to be complemented by a huge additional effort to get as many people as possible tested. In case you doubt the importance of mass-testing, Professor Luigi Zingales of University of Chicago's Booth School of Business has this new and very persuasive brief note, well worth reading: Why Mass Testing Is Crucial: the US Should Study the Veneto Model to Fight Covid-19

My point here – as it leads to my next section – is that we are facing a health crisis of huge proportions, and all efforts, including money, ought to be focused on addressing that, before anything else. But, of course, as there'll be severe side-effects of these "fist-priority efforts" to stop the spreading of the virus on people's livelihood, measures are also needed to deal with that.

In other words, Trump's "the cure versus the problem [the virus] itself" illustrates not only a bizarre set of relative priorities (is economic growth really more important than life or death?), it also illustrates a profound confusion about economics: With or without restrictions, if there's a virus out there (on surfaces and in the air around two meters around some people) which has maybe a 1% chance of killing you within a few weeks, if you get it, people will be scared and change their behavior radically in a way that'll harm the economy profoundly anyway, as we enter a deeper version of "the economics of fear".

3. The big European debate about solidarity: The national vs. common response.

I have two big bones with the European fiscal policy responses so far: They are uncoordinated (and therefore very uneven), and there is no common approach.

First, the lack of coordination:

As I have discussed in recent weeks, Germany and France were first out of the starting blocks, designing impressive policy responses to the crisis. In total, Germany – first-in-class in this respect - has approved a fiscal package equivalent to 6.1% of 2019-GDP (roughly ¾ by the federal government, ¼ by the states) plus guarantees to the tune of 24% of GDP – as well as a stabilization fund of EUR 200bn (excluding guarantees; or 5.8% of GDP). This is truly unprecedented. France has approved a more modest 1.8% of 2019-GDP in fiscal expansion and 12.4% of GDP in guarantees. Armed with that – as well as an explicit blanket agreement from the European Commission that the fiscal rules are suspended for the time being and an implicit (but not hard to read) ECB offer to buy enough to keep funding costs in check – Germany and France went to the Eurogroup to try and lead a coordinated response of this sort of magnitude.

But for reasons I still don’t fully understand, few other eurozone countries seem to appreciate the severity of the crisis or have bought into the need to act decisively.

At the extreme, Italy – first and worst hit by the health crisis, and first with tough, but necessary, restrictions, killing lots of economic activity – has (so far) approved a fiscal package of only 1.4% of 2019-GDP, including about 0.3% of GDP which will be paid into funds to underwrite guarantees. We are still missing some of the information on the conditions for these guarantees to be provided, and we therefore don’t know the total amount of guarantees that will become available. But if the endowment were to be aggressively geared, it could lead to guarantees of up to EUR100bn, or 5.6% of GDP. But still, why the Italian government would leave their SMEs and households uncovered to such a degree is simply beyond my comprehension. For example, before the crisis, the total guarantees underwritten by the Italian government were equivalent to only 4.5% of GDP, which was almost 10pp less than in Germany. This provides a huge headroom for critically important support for Italian SMEs and other businesses. Why not use it in this mother of all crises? As a rough estimate, we think the difference in Italian GDP this year between a scenario with present policies, versus policies mirroring the German “first-in-class” policies, could be on the order of 10 percentage points!

For comparison, Spain and the UK have approved fiscal measures of 1.4% and 3.2% of 2019-GDP, respectively, and guarantees equivalent to 8.4% and 15% of 2019-GDP, respectively. Austria has weighted it the other way around with fiscal easing worth 7.3% of 2019-GDP (including loans which may later be converted into grants) and guarantees worth some 2.3% of GDP. The US bill signed into law on Friday provides fiscal stimulus of about 7.5% of 2019-GDP plus 2.5% of GDP worth of loans, including those backed by guarantees.

And now to the great European debate about solidarity, which has divided the eurozone like few things before. Jacques Delors broke his long-held silence and said that “the climate reigning among the heads of state and governments and the lack of European solidarity pose an existential danger to the European Union. The bacillus is back.” (And I don’t think he was referring to the coronavirus when mentioning the bacillus!)

For me, the issue of the European debate about solidarity can be broken down broadly as follows:

At the first level, solidarity is when you provide help to address problems facing someone else. After the first panicky missteps (e.g. national export bans on medical supplies), such solidarity is now in full flow across Europe. Much needed equipment is being donated across the European borders in pretty large quantities, and e.g. the German airforce is now flying Italian and French patients to hospitals with spare capacity across Germany.

Then there is the issue of providing money because you want to help shoulder the financial burden of the hardship of others who you care about. Here, I also hear an unmistakably clear message across Europe, and very loudly so in Berlin, of a desire to help Southern Europe. The way to provide the money – not whether to provide it - is where the real debate is.

But before I get to that, there is one more aspect beyond “charity” here. We are clearly facing a global crisis, and not a national one. Within Europe (and really the world at large), it ought to be everyone’s business how each country deals with the crisis because we won’t return to the free movement of people, goods and services across the EU until this health crisis is under control in all member countries. Therefore, it seems reasonable to me that the cost of testing, building prevention measures and treatment is shared across Europe (while still implemented nationally, of course, to take advantage of existing institutions.)

So now to the debate about how common money may be raised for the “European solidarity” effort:

As you know, nine countries, including France, Spain and Italy, have written to the Council president to advocate a large sized “Eurobond” to finance the fight against the virus; a move also supported by the ECB’s Lagarde. According to the Italian newspaper Repubblica, an additional five (small) countries have since signed on to the idea. The remaining countries, particularly Germany, the Netherlands and Austria, oppose te idea of a Eurobond.

As far as I can judge, this issue (of the mean with which to show solidarity, rather than solidarity itself) has divided the eurozone governments as badly as during the sovereign crisis – with the important difference that France this time has taken a clear position in line with “the South”.

According to Politico, arguing for the Eurobond, Macron argued that “the survival of the European project depends on the solidarity that we can show on all levels, namely the economic and financial levels… that we have a moral debt toward the countries that respected the European budgetary criteria and invested less in their health systems and are in trouble today.”

But here is my bottom line: There won’t be a Eurobond among the 19 eurozone members, even a one-off for a cause as noble and needed as in this health crisis, for the simple reason that the name – a Eurobond - is toxic in Berlin and The Hague.

This leaves three options on the table for the Eurogroup, which has been asked to come up with something within the next two weeks:

First, the nine (or 14) eurozone members which call for a Eurobond could threaten to issue one among themselves, and give others, e.g., one week to sign up, or be left outside “this union of solidarity”. I have no doubt that it would fly financially, and be priced attractively, not least with the ECB on the field. But it would leave Germany in a horrible bind: Even facing the prospect of being left outside a European project of solidarity, I just cannot see it pass the Bundestag – and if it did, it would surely face a legal challenge. Whether it could be constructed so as not to violate the German constitution, I’ll leave for the legal experts, but it’s surely not straight-forward. Macron knows this, and I just cannot see him push this one through and thereby break the very foundation of the European project, the German-French axis, on this issue.

Second, Germany and others have advocated credit lines (with marginal conditionality) from the ESM. Such funding would of course come at a lower financial cost than the sovereigns in Southern Europe can raise funds by themselves. Curiously, last week, Italian PM Conte endorsed this idea, but at the Summit this past week, he rejected it, probably as he realized that the ESM (and definitely the word "conditionality", however light or proforma it might be) is a no-go in Italy. Put differently, the idea of the ESM and conditionality is as toxic in Rome as a Eurobond is in Berlin.

More broadly, here is the issue with the ESM. It was built and scaled to deal with asymmetric shocks, against policy conditionality. Apart from the stigma, how do you now turn it into a eurozone-wide defense mechanism (that's big enough) against a pan-European shock, and make it conditionality-free? This is far from obvious to me.

Third, a special facility could be created at the European Commission (or at the EIB), funded by a one-off additional payment by all members. On the one hand, this would take advantage of existing institutions already geared to such transformation of money from some to others. On the other hand, both the Commission and the EIB are EU-wide institutions which might struggle with a eurozone-only initiative (and roping all 27 members into this would no doubt be too time-consuming, and lead to a result resembling an inadequate common denominator.)

We'll see what the Eurogroup comes up with, but my guess is on the "third way". In addition, one would hope that the mobilization of airforces and other institutions is expanded to help address the problem as comprehensively and as fast as possible.

4. The central banks – and the emergence of a new approach to policy coordination between the fiscal and monetary authorities.

The key central banks have already shown that they are "in it to win it", but they have also de facto (but unannounced) moved towards a new regime of coordinated monetary-fiscal policies, which may well (and hopefully) evolve towards a new form of controlled monetary financing.

The Fed and the Bank of England have not been particularly shy about their aim to underwrite the sovereign (the Fed announced unlimited purchases this past week!), while the ECB is in a different situation, of course. Yet, after the previous big announcements of asset purchases, this past week saw the ECB lift its self-imposed limits of 33% holding of any specific debt issue, and include maturities all the way down to 70 days. With that the ECB has basically created a set-up that'll allow them to operate with extreme flexibility to achieve what they want to achieve … and that is, without a doubt, a continued decently smooth transmission mechanism. This, in turn, means that sovereign spreads will be curtailed.

But what does this all mean for the future of policymaking, debt sustainability and growth? This is all too early to tell – and will require much more space than what I have left of my (self-imposed) limits for today's note.

But let me kick off the discussion with a reference to two recent pieces, both written in the FT by prominent former central bankers, namely Mario Draghi and Philipp Hildebrand:

Coming out of his self-imposed period of silence, Draghi argued that liquidity will not be enough, but needs to be supplemented with massive fiscal expansion and guarantees, so that companies will – and can – actually borrow. (As you know, this is very much the point I have been arguing here in recent weeks as well.) Here is what he wrote on this: " protecting employment and productive capacity at a time of dramatic income loss requires immediate liquidity support. … Several governments have already introduced welcome measures to channel liquidity to struggling businesses. But a more comprehensive approach is needed. …

the only effective way to reach immediately into every crack of the economy is to fully mobilize their entire financial systems: bond markets, mostly for large corporates, banking systems and in some countries even the postal system for everybody else. And it has to be done immediately, avoiding bureaucratic delays. Banks in particular extend across the entire economy and can create money instantly by allowing overdrafts or opening credit facilities. Banks must rapidly lend funds at zero cost to companies prepared to save jobs. Since in this way they are becoming a vehicle for public policy, the capital they need to perform this task must be provided by the government in the form of state guarantees on all additional overdrafts or loans."

Needless to say, Draghi explicitly accepts the build-up in public debt, but he also notes that debt sustainability may not become an issue, given the low interest rate environment that's likely to stay with us for a very long time. He could have added that the real interest burden (if yields are positive) is still mute to the extent the debt is held by the central bank.   His piece is here: Draghi: we face a war against coronavirus and must mobilise accordingly

But how will the fiscal and monetary coordination work in the future then. Again, too early to tell, but in another FT piece, Philipp Hildebrand repeating his (and his cis colleagues') call for a new framework, which they call "go direct" (which I discussed last year, the week after the published their paper), a very appealing framework for the future, in my opinion, which you might also call "controlled monetarization".

Hildebrand wrote in the FT that the policymaking world must evolve to a less simplistic understanding of central bank independence. To overcome the perennial inflation challenges of the past century, it was enough to assert that monetary policy decisions should be made independently from government decisions. But to deal with this existential threat to the very foundation of the world's economic system, a truly independent central bank needs to be confident in its ability to explicitly co-ordinate with other organs of policy, such as the state. What is required now is a co-ordinated approach in which governments disburse needed funds to provide a financial bridge to households and viable corporates. Meanwhile, central banks will be called upon to ensure that interest rates don't rise in an uncontrolled way amid the largest natural disaster relief programme ever recorded. Part of this will entail large-scale asset purchases by central banks in the bond market". His full piece is here: Central banks must evolve to help governments fight coronavirus

This is well said and indeed at least part of the regime we'll very likely move towards once we get through the health crisis. The good news is that most governments and all the major central banks are already moving towards this new arrangement. Within the European context, the irony is that it's being understood and taken advantage of by countries like Germany and France, but not by Italy or (fully) by Spain. If there ever was an example of a collision between the common stereotyping and reality, this is surely it!

And, on that note, I'll get up from my dining table and walk the approximately five meters across the room to an armchair to take a break and read my book…

No, I'm not happy with my confinement, and if you are not either, here is something to hopefully cheer you up in these times of social distancing: The Rotterdam Philharmonic Orchestra's virtual concert (from 19 musicians' homes) of Beethoven's Ode to Joy: Twitter - Reuters - The Rotterdam Philharmonic Orchestra

Best

Erik

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