Sunday Wrap

Happy Sunday (and Happy Palm Sunday to those who celebrate it),

Let's start with a small celebration: Yesterday was the first day when Italy reported a decline in the total number of patients in intensive care (-1.8%) – and the number of daily deaths from the virus in Italy continues to decline, now at 681. While that's certainly still a tragic number, it is well off the peak of daily deaths of 919 on Thursday, 27 March.

Also (relatively) good news: The expected lags between countries, which I (and many others) have discussed this past month, seems to hold: In Germany, France and Spain, for example, the number of daily deaths (hopefully) peaked this past Thursday (at 176, 1,355 and 961, respectively), exactly a week after Italy's peak, with the daily number in those countries dropping yesterday to 169, 1,053 and 749, respectively.

In other words, with aggressive policies of social distancing and testing (and good healthcare systems), there is light at the end of the tunnel!

But now the bad news: It's still a long tunnel:

It's a long tunnel because a number of countries, including the UK and US, remain even further behind Italy (and hence behind where they could have been with an open mind and better policies). In the UK, where the daily number of deaths climbed to 708 yesterday, we are still probably a week away from the peak. In the US, it'll probably be another two weeks. Then there's the emerging markets, where we almost certainly are even further behind in getting a grip on the spreading of the virus.

And until the world has brought this crisis under control, life is unlikely to return to normal. Early indications from Asia show that even their partial lifting of restrictions on social distancing has led to a (mild) second wave of infections. As a result, Singapore, for example, has re-imposed restrictions for the next four weeks.

In other words, restrictions on our mobility, and thereby on economic activity, could be with us – in one form or the other – for a long time; maybe until a vaccine has been developed, or herd immunity has been reached. (The good news here is that two German companies have now starting testing what could be such a vaccine, but the experts say that we are still at least 12-18 months away from having a vaccine widely available.)

Importantly, however, while our policymakers are responding with uneven determination to beat the virus, their resolve to shelter the population to the extent possible from the hit to income is unquestionable. In Europe, we see a fiscal policy vigor I thought had long evaporated from the Continent and – as a further sign of this new world - it's Germany leading the efforts with eyewatering fiscal policy initiatives. Sadly, much of the south, including Italy and Spain, are still holding back some, despite being hit the hardest and despite the carte blanche on fiscal policy from the European Commission - and an unmistakably clear pledge from the ECB that they'll buy "whatever it takes" to control the funding cost.

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So here is my agenda for today:

- **Our guestimate of how bad it'll get, the impact on debt – and why the fiscal authorities should do still more.**

- **Ironically, in the middle of all the pain, there is one group of society now benefitting from a massive windfall, namely consumers of oil. I'll summarize why – and how – that gain ought to be redistributed to more deserving groups.**

1. Our outlook: The mother of all recessions, the explosion in public debt – and why it doesn't have to be a problem.

As the European and US economies have entered a virtual free fall, we ventured our guess this past Thursday on what 2020 (and 2021) may end up looking like in terms of GDP and public finances. The full report is here: The UniCredit Economics Chartbook: The mother of all recessions has arrived

Needless to say, nobody knows how this whole thing will pan out during the next year or two, but it seems a given that Q2 will see the biggest GDP collapse in modern history, maybe on the order of 20%.

I am convinced that this will trigger further policy measures during the spring. Most fiscal authorities will add more stimulus (and they should!), and the European (common) level will also get into the game, although this will be limited in size compared with national efforts and most of it – apart from the ESM – will take longer to activate.

In the process, the ECB will need to expand its asset purchase programs to meet its clear, if unannounced, objective of controlling the yield curves, including the sovereign spreads, during this crisis. While daunting, the ECB and other central banks just cannot – and will not - allow monetary conditions to tighten (including via higher yields) as a result of critical fiscal expansion during this huge health crisis. For now, the PEPP and the flexibility in its implementation will be enough to achieve this, but by summer we'll almost certainly need more.

What happens to growth during the second half of the year and into 2021 is particularly unclear. Our best guess – really not much more than an assumption, to be honest – is that as the epidemic curves flatten during April, some of the restrictions on social and economic activity will be lifted gradually, maybe by June. If so, we'll get some resumption in growth in H2, but we won't see pre-crisis GDP levels restored for another couple of years.

If we are broadly right on this, budget deficits throughout Europe (and in the US) will end up on the order of 10%-13% of GDP this year, contributing to pushing public debt-to-GDP up by maybe 20-40pp by the time the crisis is over, and corporate and household debt by maybe half of that.

Yes, there is this grand European debate about fiscal solidarity, but unfortunately, it's been muddled by politics about which vehicle to use. As I discussed last Sunday, there is no serious argument in Berlin against providing help to Italy and Spain. This past week, even the all-powerful Bild called for Germany to help Italy to a greater extent.

As you know, the Eurogroup will meet on Tuesday, and my two cents worth is that we are heading for an agreement on a combination of European measures, including additional capital for the EIB to boost guarantees by more than EUR 200bn (great and very important for developments down the line), the Commission's EUR 100bn unemployment fund will be approved (I'm less impressed), a credit line from the ESM to Italy (and Spain?) will be agreed, which they'll probably never use, even though they should (it's cheap money) and something non-trivial on the Commission's budget.

Such increases in debt, particularly in public debt, have led to much huffing and puffing about debt sustainability in some policy and market circles. But this concerns are mostly misplaced.

Indeed, I would argue that the more governments hit the fiscal accelerator now to protect people's livelihoods, the better also for longer-term sustainability. This is so because – for both economic and social reasons – in times of this type of crisis, you want so socialize as much of the incremental debt as possible. In other words, you want to prevent private sector debt from increasing more than necessary during the next couple of years, and if that implies e.g. a 50pp increase in public debt, so be it!

The reason is simple: First, boosting private sector income to avoid a debt build-up in the private sector (particularly for smaller businesses, their owners, as well as lower income groups) will help boost the recovery when it comes as well as longer-term growth and stability (and this is even before I incorporate the benefit of starving the extreme political parties of their misguided political ammunition). Second, in this environment of rapidly declining velocity of money, virtually all the new public debt will be (and has to be) absorbed by the central banks. With most of the additional debt held by the central banks, governments will pay the additional interest to their central banks, thereby boosting their profits – which will be returned to the central banks' owners, namely the government, making the interest payments de fact zero.

And this leads me to my key point: After years of (at times) agonizing conflict between the fiscal authorities and the central banks, these two critical policymakers are now finally working in tandem, rather than against each other. Almost without a doubt, this new-found cooperation will continue - and deepen - in the post-crisis future. The exact form of this future policy regime is still unclear, of course, but – as I have discussed before – something along the lines outlined by Philipp Hildebrand et al, titled "go direct", is probably as good a starting point for this discussion as any.

Think of it this way: Apart from the fact that it seems only morally right for society to cushion its innocent citizens to the extent possible from the effects of a "natural disaster", what's the alternative? Huge income loss or indebtedness among innocent people and businesses? – and if so, what would that do to future growth and income – or political or financial stability?

In sharp contrast, what's the worst thing that could happen if the fiscal authorities and central banks went all out in their effort to shelter the population from this storm? Even if fiscal expansion and central bank QE were to overdo it during the crisis, then aggregate demand would end up exceeding aggregate supply in coming years, maybe even to a degree when inflation would pick up. However, this can only happen if spare capacity gets eliminated, including in the form of full employment.

Personally, I would take a scenario of some years of strong demand (i.e. growth), full employment, and maybe 5%-10% inflation any time these days. And if we all got too much of this good thing, it would almost certainly not be too complicated to correct it. An acceleration in fiscal consolidation would be your obvious route, but monetary tightening would also be on the table. And while the world's central banks learned the hard way in recent years that it is terribly difficult to "push on a string", they'll all find that it's rather easy to "pull a string". In other words, if there is too much money around chasing too few goods and services, fiscal authorities can cut spending, raise taxes, and/or central banks can start selling some of their enormous holdings of securities to mop-up liquidity, and/or raise interest rates.

Yes, you can construct a scenario in which real interest rates are pushed higher to tame inflation, thereby challenging sovereign debt sustainability. But this would be only one of a lot of possible scenarios, and really not one I would worry about in this new world of proper policy coordination between the fiscal and monetary authorities.

So, to Europe’s fiscal authorities: You have (generally) done a great job so far, but there is more to be done: So, “just do it!” Protect the population and its income and hence private sector balance sheets, and don’t worry about public debt. We are in it together… across Europe.

2. Oil: Winners and losers… and an idea how to get this right…

While our policymakers scramble for the best ways to protect the hardest hit in society from the economic consequences of the measures to stop the spreading of the virus, one group is now enjoying one of the greatest windfall gains in living memory: Consumers of oil and oil products – who are, ironically until about a month ago, exactly the groups which were meant to face the exact opposite: An incentive to reduce their use of oil as we were (back then) focused on climate change.

Hence, in my opinion, there is a strong case for redistributing most of this windfall away from oil consumers to those suffering the most and those most in need right now, including healthcare workers, producers of healthcare equipment and researchers chasing the vaccine.

Let me explain: As I’m sure you have noticed, oil prices has taken a nosedive this past month – from a range mostly between USD 50 and USD 60 per barrel of Brent during 2019 and the first two months of this year, it dropped abruptly following Russia’s decision in early March to not cooperate with Saudi Arabia within the so-called OPEC+ cartel. Instead, Russia kept pumping oil to push prices lower, thereby squeezing particularly US shale gas producers. Saudi Arabia, in turn, turned up its production, primarily to put pressure on Russia to get into the fold of OPEC+.

This, of course, all happened as Europe and the US got hit by the virus, and demand for oil collapsed as the Western world’s economy collapsed. So, by mid-March, Brent was trading around USD 25. It then stabilized slightly, before moving another leg down earlier this past week as the agreed on OPEC+ curbs on production actually expired.

In Europe, the oil majors headed to financial markets to raise more than USD 10bn, according to Reuters, while the usually tough US oil- and gasmen (traditional preachers of free markets and small government) headed to Washington on Friday to plead for help from President Trump, asking for anything from tariffs on oil imports, sanctions on Russia and Saudi Arabia to outright government bail-outs.

No doubt in anticipation of his meeting with the oilmen, Trump tweeted on Thursday that he had talked to Russia and Saudi Arabia and claimed there’ll be an agreement to cut oil production – and prices soared some 50%. But on Friday, prices dropped again in very volatile markets as a Kremlin spokesman said that there had been no conversation between Putin and Mohammed bin Salman.

To be sure, I don’t know where oil prices will go from here. OPEC+ (maybe also to include the US and Canada) is scheduled to have a conference call to discuss production cuts. My colleague, Edoardo Campanella, estimates that, with the world's storage capacity basically gone, it would take cuts of some 6-7mb/d to get prices back above USD40 per barrel. Do-able? I doubt it – maybe as a statement after the call, yes, but in terms of implementation? I'd happily bet my money against it. In contrast, on Edoardo's estimates, no deal to cut supply could see prices fall to USD 5-USD 10 per barrel. Probably not realistic either – at least no for any longer period of time.

So, if we were to enjoy a period of prices somewhat below last year's average, a natural question arises as to who should benefit from this windfall in Europe. If you dialed into our weekly conference call this past Thursday, you would have heard me muse about the idea of reallocating this luck to those more in need than the general community of oil and oil product users - the oil companies, if they delay the passing-through of their gains to their customers, as usually is the case.

And remember, as part of the climate debate until just one month or two ago, the entire discussion was how to incentivize society to reduce the use of oil. As you'll recall, just this past fall, the IMF dedicated its entire Fiscal Monitor to advocating a carbon tax to lower the use of oil. Now markets are providing the exact opposite incentive to the private sector. And this at the same time as the climate debate was moved to the backburner (so to speak), the desperate need for financial support to the health sector and all the SMEs and others struggling to survive the lockdown has become an obvious and urgent priority.

So, here is a simple idea:

Let's put a tax on crude oil in Europe during the remainder of 2020 and distribute the proceeds to the healthcare- and related sectors. For example, average oil prices in 2019 were about USD 60 per barrel (or a tad more than EUR 50). Now they are roughly half of that, so why not pop a EUR 15 tariff on each barrel of oil (leaving roughly EUR 10 untouched to account for the different tax regimes for oil products between eurozone countries.)

Last year, the eurozone imported 3,942 mbd, and if we assume this year will see a 15% drop in consumption (to reflect our forecast of lower GDP), each taxed by EUR 15, we'll have EUR 34bn during just the remainder of this year. Personally, I think EUR 34bn would be better spent this year in Europe's healthcare sector than leaving it with oil users and companies.

Of course, we can make it a flexible tariff so that if oil prices were to move back to USD 40-USD 50, the tariff could be scaled back so as not to cause disadvantage to European businesses compared to what they faced last year (although, beyond this health crisis, I still think we'll need a carbon tax…).

Yes, I know there are many practical and political hurdles, but hey, at a time of great needs in parts of society, it seems strange to me to just leave another part (which under normal circumstances ought to face a carbon tax as part of the climate change agenda) with a huge windfall, caused by some interesting political issues between Putin and MBS. Just saying …

So, on that note, I'll wrap it up for today. Next Sunday, I'll probably take a break from these weekend musings due to the Easter break – not that I have any exciting plans, to be honest! But maybe I'll spend next Sunday morning in an armchair five meters from here, reading a book, instead of sitting at my dining table typing away. Strange life indeed.

Best wishes for good health and not too much boredom or stress in all our induvial confinements.

Erik

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