# Sunday Wrap

Happy Sunday,

On Thursday, the ECB will announce its second-round COVID response. Its guiding principle from earlier this year surely remains in effect, namely, to prevent a tightening of monetary conditions as a result of the fiscal response to the pandemic, an objective that explicitly applies to all jurisdictions of the ECB. This is in all-but-name "yield-curve control" – and even if the ECB would never use the term, it is the right policy for these extraordinary times.

How the Governing Council will translate its guiding principle into concrete policies, given the huge uncertainties related to growth and fiscal policies, as well as the likely market reactions to possible disappointments, will be the topic of today's note.

But let me first remind you of what we expect to be announced on Thursday:

As my colleague Marco Valli has discussed in his notes, we think the PEPP will be boosted by EUR 500bn (on top of the EUR 600-650bn still in the tank from the first round) to be applied through at least the end of next year, possibly until mid-2022. The guidance on reinvestments, presently expected to run until at least the end of 2022, will be extended proportionately. And Christine Lagarde will repeat that the PEPP will be used flexibly across time, asset classes and jurisdictions to achieve its objective.

As the ECB extends easy monetary conditions for issuers of ECB-eligible debt (i.e. for sovereigns and investment-grade corporates), it'll attempt to provide a broadly comparable effect for the rest of the economy which needs to finance itself through banks (predominantly SMEs without access to the securities market as well as sub-investment-grade corporates) via a new round of TLTROs. The ECB may fiddle the conditions for TLTROs, but not materially so beyond the need to adjust the lending threshold to reflect the higher starting point. And with banks left out of all this, while seeing profitability getting further under pressure, thereby impairing the transmission, I assume we'll also see some adjustment to the tiering multiplier.

**So, three brief sections below:**

- **What we expect the ECB's new central forecast to be.**
- **The specific risks to the growth path stemming from the second virus wave and the roll-out of vaccines.**
- **The risk stemming from fiscal policy-related issues.**

## 1. The central growth outlook

The ECB's updated macro forecasts and the risks surrounding them, to be presented on Thursday, will of course provide the rationale for the size and composition of further policy measures. And there'll be plenty of rationale for being aggressive: The growth outlook has weakened in recent months, and additional fiscal measures have been announced (or are about to be announced) across the eurozone.

Hence, it's clear that the ECB will lower its 2021 GDP forecast from the +5% it estimated back in September. We think it'll come in at a number very close to our forecast of 3%, a down-revision that will mean a stronger recovery in 2022 of 4-5% (like our forecast, up from the bank's September forecast of 3.2%), also boosted by the now more realistic outlook for the roll-out of effective vaccines.

If we are more or less right about these new forecasts, the ECB will share our estimate that the eurozone will reach its pre-crisis level only during the second half of 2022. This is the important part because on present thinking by the majority of Governing Council members reaching the pre-pandemic GDP level would be good enough to start a "normalization" of policies via the gradual unwinding of the exceptional COVID-related measures. (Personally, I find that to be a too unambitious definition of the end of the COVID-inflicted damage to the economy; something closer to a moderately adjusted GDP trend line from the pre-pandemic period would be much more appropriate, but I'll leave that for another day.)

The bottom line here is that on present thinking by the ECB, the PEPP and TLTRO can be extended until mid-2022, but whether the central bank will go quite that far already next week is not clear. Caution, rather than boldness, remains the preferred approach among some GC members. And with Lagarde's commitment to moving with as great a consensus as possible, the hawks may try to lower the firepower that is brought to bear.

While I would prefer a proper-sized bazooka and accept that it may never be fully used, the more-cautious approach could be justified by the amount of uncertainties – and the ever-standing commitment to do more, if needed. (Note to the hawks: Just remember that the key reason why only about half of the first-round PEPP has been needed to achieve the objective of preventing a tightening of monetary conditions is precisely the size that was announced and the communication on its flexible use, which led markets to do most of the heavy lifting.)

And there are indeed two key risks – both two-sided – to the outlook: First, there is the path of the second wave of the pandemic, and the effect of the roll-out of vaccines now about to start. Second, the outlook for fiscal policy remains uncertain, including the timing of Next Generation EU's EUR 750bn, and the future definition and application of the fiscal rules are still up in the air beyond next year, and hence the outlook for 2022 national fiscal policies and debt issuance.

I'll briefly discuss each of these in turn:

## 2. The risk stemming from the path of the pandemic

As I'm sure you are aware, the second wave of the pandemic is taking its toll right now across Europe. While the latest restrictions have led to infection rates trending down again, the death toll peaked less than a week ago.

The second wave is having its impact on the economic indicators, making a contraction of 4Q GDP a virtual certainty. We expect negative growth in the present quarter of about 3% (qoq) in the eurozone, and of another 1-2% in the first quarter of next year. While it's possible that some restrictions may be lifted temporarily around Christmas, I think it's a safe bet that the usual gatherings in restaurants, bars and cafés, and at private homes, will either not happen at all this year, or be rather subdued. And then the hard slog through January-February begins while we all – or most of us – wait for the offer to get vaccinated. But how long and deep exactly this second technical recession will be remains unknown.

More importantly for the growth path back to pre-pandemic levels (and beyond) is the timing and effectiveness of the roll-out of the vaccines, including the number of people wanting to be vaccinated. A lot has been made of opinion polls, which suggest that a large portion of the population does not want to be vaccinated, which would delay the day when herd immunity would be reached. The most recent comprehensive poll that I am aware of – an IPSOS poll from a month ago, but based on data collected during the second week of October – suggests that the share of the population that says they'll want to be vaccinated ranges from 54% in France to 65% in Italy and Spain to 69% in Germany. The rest of the population is pretty evenly split between those who say that they don't want to be vaccinated and those who say they don't know yet.

However, my guess is that the share of the population who wants to be vaccinated will increase as information about the pros and cons gets more widely disseminated and leaders in politics, business and the arts presumably will lead a campaign to get the jab. Furthermore, I hope legislation will be forthcoming, not to make vaccination compulsory, but to allow private businesses (and maybe public transportation) to discriminate between those who have been vaccinated and those who have not. That would be some incentive…

This leads me to the second risk to growth, namely the question as to how the population will react to the gradual onset of normalization that will come with the roll-out of vaccination.

Eurozone households doubled their savings ratio from the 12-14% of their income that's prevailed for many years to about 24% as the first-round lockdowns and fear of infection led to an unprecedented withdrawal of consumption – and to a massive shift from social goods like travel and hospitality to durable goods.

The savings rate came down some in 3Q, but remains, without a doubt, at extremely elevated levels (the number for the eurozone has still not been published). What happens as normality begins to return next summer is anyone's guess. That the savings rate will come down further  seems a fair assumption, but how fast and to what level are unknown. As Marco discussed in our 2021 Outlook, published on 19 November, we assume that after the first quick fall, it'll move down more gradually, and that it'll stabilize at a level above the long-run average for at least a year or two as households hold on to some extra precautionary savings. This assumption is also based on the expectation that households will begin to shift their spending pattern back towards normal.

## 3. The fiscal risk

Next year will be another year of very aggressive fiscal measures in the eurozone – and rightly so. Even with an economic recovery under way in several months, the amount of spare capacity will remain considerable for at least another 6-8 quarters until pre-pandemic GDP levels have been restored, and almost certainty well beyond that. It's paramount that this does not lead to scarring of the economy.

We estimate an overall cash deficit of all eurozone sovereigns of about EUR 835bn next year, which is only moderately lower than this year. With medium- and long-term redemptions of eurozone sovereign bonds on the order of EUR 665bn, my colleagues Chiara Cremonesi and Francesco Di Bella estimate an overall financing need of a some EUR 1.52 trillion in 2021 (marginally down from 2020), about EUR 1.3 trillion of which will likely be secured through medium- and long-term securities.

In line with the ECB's key objective of preventing a tightening of monetary conditions as a result of the necessary fiscal expansion, its purchases next year will again broadly match the entire net issuance number. If you missed their "Rates Perspectives" and want to dig deeper into Chiara's and Francesco's analysis, it's here: 2021: Another year of heavy issuance but ECB to remain supportive

I see two key risks to the fiscal outlook and the effects on growth, issuance and, hence, ECB activity:

First, the EU's mega-sized NGEU deal is still not in place. As you know, Poland and Hungary are holding out because of the requirement that they adhere to the EU's core principle of the rule of law (after having initially agreed to this provision).

European leaders will meet on Thursday (and Friday) for what's supposed to be the last summit of the year, and the last under the German presidency. They are scheduled to discuss COVID-19, including the roll-out of vaccines and the expected gradual lifting of restrictions, climate change, security and external relations, but I'm sure that they'll also make one last effort to get Poland and Hungary to drop their opposition to the NGEU and the EU's next multi-year budget (and they'll scratch their collective heads over the latest setback on Brexit as the UK government prepares to push two bills through parliament this coming week that will both breach international law.)

As I discussed last Sunday, my guess is that the heads of state will rather quickly agree to move to Plan B for the NGEU, which almost certainly means "Enhanced Cooperation" among the 25 agreeing members – at which time I suspect that Poland and Hungary will fold their tents with only the question of face-savings gestures, if any, to be answered.

As Chiara and Francesco discussed in their note on Friday, the use of funds from the EU under SURE and NGEU will only marginally reduce next year's intense issuance activity by national governments, maybe by some EUR 90bn. (The NGEU will have much greater effect the following three years.) However, should the EU fail to get NGEU done in time for the 2021 roll-out, markets would no doubt react measurably. The negative effects would obviously be felt primarily in CEE, starting with Croatia, Romania and Bulgaria, but also hit Hungary and Poland, as discussed by Dan Bucsa in our 2021 Outlook, published on 19 November. In the eurozone, Greece and the rest of Southern Europe would also be hit, but this would then be countered by the ECB's PEPP – hence the need for a proper-sized bazooka on Thursday.

The second fiscal-related risk stems from uncertainties associated with the fiscal rules: how long they'll remain suspended (so far only for next year), and what type of revisions will be made to them once they come back into force. While these would only be applicable from 2022 at the earliest, clarity will begin to emerge already in about six months, and a misguided approach – as I presently fear may be the case – either in the form of a return to rules too closely resembling those of the past, or insufficient flexibility, would lead to potentially significant market reactions as the European recovery prospects would become in doubt. There are few things markets agree on as much as the damage done to European growth by the pro-cyclical fiscal austerity following the great financial crisis, and the relief that this time it's different. Let's hope it'll remain different from the mistakes of the past.

**I discussed the issue of the fiscal rules a few weeks ago, so I won't repeat myself here, but simply note the following three quick points:**

First, as they stand and worth repeating, the fiscal rules bear considerable responsibility for misguiding European policymakers to pro-cyclical fiscal austerity in the wake of the financial crisis. Those policies not only lowered growth during those years, but they also cut into longer-term potential growth as net public investment was cut from a long-running average of a little less than 1% of GDP (already too low) to zero. The key reasons why the fiscal rules sent the wrong signal include the reliance on highly questionable estimates of potential output and output gaps.

Second, while the fiscal rules' focus on securing debt sustainability is critically important, the presently ruling definition of debt sustainability is flawed because it focuses excessively on the debt stock rather than on the cost of the debt stock. In other words, policymakers (and many others) overestimate the importance of debt-to-GDP ratios, rather than focusing on debt service (or interest payments) over fiscal revenue or GDP. (In my assessment, interest payments over fiscal revenue, rather than GDP, is the preferred measure because it's better to have one bird in hand (revenue) than ten in the bush (GDP, which is a measure of the source of possible future revenue, but questionably so in times of economic stress)). To illustrate this, while Italian sovereign debt increased from 120% of GDP 25 years ago to 135% of GDP last year, interest payments as a share of fiscal revenue declined from more than 20% to less than 8% during the same period. Surely, paying 8% of fiscal revenue is more sustainable than paying 20%, whether debt/GDP is 135% or 120%, and even under the wildest scenarios for the next several years, Italian interest payments as a share of revenues will remain single-digit. (Incidentally, 25 years ago, Germany and France allocated some 8% of fiscal revenue to interest payments, and I don't recall anyone worrying about their debt sustainability at that time.)

Third, when I last discussed the issue of the fiscal rules I referred to my own preferred way forward, namely a change from "fiscal rules" to "fiscal standards" broadly along the suggestions made by Olivier Blanchard et al (discussed here: Fiscal Standards for Europe).

Since then – this past Monday – a seminal paper on fiscal policy was published by Jason Furman and Larry Summers in which they discuss the key three implications for fiscal policy of low interest rates: First, they argue that "fiscal policy must play a crucial role in stabilization policy in a world where monetary policy can counteract financial instability but otherwise is largely 'pushing on a string' when it comes to accelerating economic growth." Second, they argue that "debt-to-GDP ratios are a misleading metric of fiscal sustainability that do not reflect the fact that both the present value of GDP has risen and debt service costs have fallen as interest rates have fallen." Therefore, they propose that "it is more appropriate to compare debt stocks to the present value of GDP or interest rate flows with GDP flows" (as noted above, I prefer comparing interest rate flows with fiscal revenue, but this is a detail in this bigger story). Third, Furman and Summers plea for a more-informed way of thinking about fiscal policies, taking into account how borrowed funds are used, most importantly whether for consumption or investment. They conclude that "the traditional ideas of a cyclically balanced budget … would likely lead to inadequate growth and excessive financial instability." While they focus on the US, without a doubt, that conclusion also holds true for Europe.

Furman and Summers' highly read-worthy paper is here: A Reconsideration of Fiscal Policy in the Era of Low Interest Rates.

And here is a very good debate of the issues between Furman, Summers, Ben Bernanke, Ken Rogoff and Olivier Blanchard: https://m.youtube.com/watch?feature=youtu.be&v=P_8bBx7WptE

So, let me close today's note with the hope that the fiscal discussion in Europe will also soon become guided by a broader and more updated analysis than the balance of discussion has been so far. I echo BlackRock's Isabelle Mateos y Lago's tweet in reaction to this excellent Brookings and PIIE hosted debate: "Can you take the show to Europe please, before SGP and other fiscal rules are put back on the table?" (PIIE president Adam Posen replied: "I just suggested that to Blanchard and Furman …. Watch this space".)

If Europe does not get its fiscal analysis and policy guidance right once the pandemic-generated emergency is over, I suspect a return of the ECB to more-traditional monetary policy tools will be a very troublesome route to travel.

And on that note, I wish you a continued good Sunday afternoon.

Best

Erik

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