Sunday Wrap

Happy Sunday,

What a unity of celebrations across the world this weekend and tomorrow. In no particular order, take your pick: I wish you a happy Fastnachtssonntag, happy carnival, happy Parininvana Day, happy Valentine's Day and a happy New Year of the Ox. What an opportunity for harmony at a time of global health and economic crises. (Personally, I'm particularly happy the year of the rat is – finally – behind us.)

Last Sunday, I discussed the massive fiscal stimulus underway in the US, and contrasted it with the stingy 2021 fiscal response in Europe. And I discussed the prospect of Mario Draghi forming a government in Italy and what policies he should pursue, including a sizable fiscal stimulus and structural reforms to boost potential output.

That note triggered an unprecedented amount of responses, mostly along the lines of whether Larry Summers isn't right that the US package may be self-defeating because it leads to excessive inflation which will then trigger Fed tightening and a recession. And, by implication, whether the cautious European approach isn't a wiser path to take. And when it comes to what Italy needs to do, I got a lot of pushback on my call to design policies to boost Italy's dismal labor participation rate. A lot of folks seem to wonder what good that would do when there (in their view) aren't any jobs to get.

These are both immensely important questions, so let me address them today in a bit more detail:

- **The risk of fiscal overkill in the US leading to inflation – and the (virtual) zero-risk of Europe doing enough.**
- **Why Italy's abnormally low participation rate has been possibly the single biggest impediment to growth in the past – and why boosting it will generate stronger growth. And now is the time to do it.**

1. The risks around the US-European fiscal divide.

I'll first remind you of the magnitude of the difference in fiscal approach in the US and the eurozone, and then discuss the risks around them.

The fiscal plans in the US and the eurozone for 2021 are mind-bogglingly different. While the US government is planning to inject some USD 2.8 trillion this year in discretionary fiscal measures (made up of the December package of USD 900bn and Biden's planned USD 1.9 trillion) to address the US health crisis and compensate the population for lost income, the eurozone plans to inject just EUR 420bn for the same objectives (made up of national fiscal authorities and NGEU money.)

The difference seems completely out of proportion – and if anything, the wrong way around. This is both a health and an economic crisis, and the roll-out of vaccination in Europe remains well behind that of the US (for reasons I still don't understand). In itself, this puts Europe on a slower recovery path than the US, and starting from a deeper hole. The economic cost of the pandemic has hit Europe considerably harder than the US. The eurozone output gap is now roughly double the size of the US output gap. Difficult as it is to estimate precisely, this provides the best indication we have of the size of the hole the government ought to fill. And when you know the government's intentions, it helps you, depending on elasticities, to assess the impact on growth and inflation.

In our "Chart of the Week" this past Wednesday, we illustrated these differences, using not the intentions of the US government, but scaled back to what we think will be agreed on (USD 1.2bn instead of USD 1.9bn), and adding the estimated automatic stabilizers. The chart illustrates the overkill in the US – and the shortfall in the eurozone. It's here, in case you missed it: The mind-boggling difference in approach to the crisis.

Not surprisingly, therefore, we (like consensus) think the US will have restored the pre-pandemic level of GDP already around mid-2021. But there is no such hope in Europe. At best, we'll get there about a year after the US, while Economics Commissioner Gentiloni was quoted by the FT this past week saying that even getting there by late 2022 requires that 70% of the European adult population is vaccinated before the end of the 2021 summer – which he acknowledged to be a stretch.

So, what are the risks associated with these forecasts?

In the US, there is an inspiring debate among economists and policymakers. Few things sum it up as well as this discussion between Larry Summers and Paul Krugman, moderated by professor Markus Brunnermeier of Princeton. https://www.youtube.com/watch?v=TdNYb3aOi9o . I recommend watching it in its entirety, but if I had to try to summarize it, it would be along these lines:

Summers and Krugman agree that massive fiscal stimulus is needed, and given the uncertainties, policymakers should aim to do too much rather than too little. They also agree that "the direct need" in the US is about USD 1.0 trillion. And they agree that the increase in the public debt is a non-issue, brushing it aside when Brunnermeier (still a European at heart!) asked about it.

Where they disagree is with respect to the "second half" of the package of roughly another trillion. Summers worries that it'll be spent during the next year or two, overheating the economy, pushing inflation above the Fed's target, which will then trigger a monetary policy tightening which – on historical evidence – will likely lead to a (mild) recession. This, in turn, leaves very little space for the "Build Back Better" investment program. Summers would have preferred that that "second trillion" would be targeting those investments (which will naturally take several years to materialize as demand), but to be legislated now.

Krugman argues that overdoing it is worth the risk, which he sees as smaller than Summers. (Incidentally, Krugman thinks they'll end up doing USD 1.7-1.9 trillion, which is more than anyone in the market thinks, as far as I know.) Krugman expects the "second trillion" (the "air" as they call it!) to mostly go to private savings with a very small multiplier. Hence, the risk of overheating is small, and if it should happen and the Fed were to tighten policy, he argues that a soft landing is more likely than a recession, pointing to previous experiences when the monetary tightening came after fiscal expansion. For Krugman, there is also the political dimension, namely that by showing resolve now and getting the crisis behind you as fast as possible, the government will buy credibility to launch the "Build Back Better" investment they both agree is needed.

So here is what I take away:

First, a fiscal stimulus 2-3 times the output gap will surely lead to a massive boost in demand and hence in growth. The exact numbers can be debated, but not the fact that the output gap will close about as fast as is realistically possible, creating a very large number of jobs.

Second, will it lead to excess inflation? Maybe, but on balance we think not. The reason is that we didn't see measurable inflation pressures in the past when the US closed the output gap, including as a result of Trump's tax cuts. (And listening to the Summers-Krugman debate, I failed to understand how Summers squares his conviction that "secular stagnation" is the key driver of low inflation with his expectation that a closing of the output gap will drive up inflation this fast.)

Third, if we are wrong and this mega-stimulus actually does fuel inflation, the question is by how much and how fast – and what the Fed's reaction will be. Remember, with their new average inflation targeting objective, their stated guidance is that they won't raise rates until they judge the labor market is at full employment and inflation has reached 2% and is on track to "moderately" exceed 2% "for some time" – but they haven't defined "moderately" or "for some time".

Fourth, if inflation (against the evidence from the past three decades) starts to accelerate to the 3%-4% level (or above), and the Fed does not react, I strongly suspect that the curve will steepen significantly, which will then cause a (potentially measurable) stock market correction. And if they do tighten, the question will be whether it'll lead to Krugman's soft landing or Summers recession. Personally, I'm with former NY Fed president Bill Dudley when he predicted (in a recent Bloomberg piece) a future taper tantrum whenever, and whichever way, the Fed signals or implements a turn – and I'm with Dudley when he implied "so what". (No, the market is not dictating the Fed!)

My totally non-quantifiable probability of this sequence leading to a recession over the next two years is well below 25%. For me, given the severity of the health and economic crisis, this is a perfectly reasonable risk to take by the fiscal authorities, although I agree with Summers that the design of the package is sub-optimal. Putting the "second trillion" into investment projects, rather than "air", would have been better.

But what a contrast to Europe!

While the US is debating whether to fill the output gap two or three times over, and whether to do the "overkill" as "air" or as investment, in Europe the fiscal authorities are contemplating a fiscal package, including the estimated automatic stabilizers, of only some 75% of the estimated output gap – with no visible discussion among policymakers and economists what the consequences will be.

To me, it is clear that the European fiscal response this year will be severely inadequate and that it'll leave us with a more moderate recovery, more unemployment, a greater degree of scarring (and hence damage to longer-term potential growth) and at least another couple of years of inflation below the desired target.

But worse, the risk is heavily skewed towards not just a 25% shortfall, but maybe a 50% shortfall relative to (a larger than appreciated) output gap. If so, the scarring will almost certainly cause not just a couple of years of economic underperformance, but of maybe a decade of inadequate European growth (in which case we just have to hope it doesn't lead to another period of political populism.)

Granted, the output gap is unobservable and difficult to estimate. We think it's probably about EUR 1.0 trillion in the eurozone. But while I have seen no credible analysis that suggests it's much smaller than that, there is pretty credible evidence that it could be EUR 300-500bn larger than that.

In particular, Robin Brooks and his team at the IIF have for the past couple of years been leading an important campaign to get the official sector, particularly in Europe, to recognize that their output gap estimates significantly underestimate the true output gaps. Whether you approach the issue from the angle of price or employment developments, their analysis is persuasive.

On Thursday, Brooks published his latest note on this: "Full Employment Output Gaps" in which he shows that the US estimate of an output gap of about 4.5% (the roughly USD 900bn in my chart above) is broadly confirmed by the employment data. For the eurozone, however, the employment data suggests an output gap that could some 30%-50% greater than our estimates (at a possible EUR 1.3-1.5 trillion, rather than the EUR 1.0 trillion).

Robin Brooks has kindly moved three key papers outside the IIF's paywall to help this critically important debate. They are here, and highly recommended: "Inflation-Consistent Output Gaps" https://bit.ly/3rKwsrq; "Output Gaps for Italy and Spain" https://bit.ly/3jKt10Z; and "Full Employment Output Gaps" https://bit.ly/3paU07j

In summary, there is no question that the planned fiscal response in the eurozone this year falls well short of the output gap, and the risk is that it could fall catastrophically short of what's needed. If you do too much fiscal stimulus (like in the US), the overwhelming probability is that the overkill will go into private savings (not driving inflation higher) from where – if needed – it can later be taken back via taxation or adjustments to spending, or neutralized via monetary tightening. In contrast, if you do too little, the scarring of the economy has the potential to lower potential growth for a decade.

2. Why Italy needs to boost the participation rate, and why that will generate growth.

Yesterday Mario Draghi was sworn in as prime minister with a new government made up mostly of politicians across a very wide majority in both chambers of parliament (but technocrats in a few key positions). As I discussed last Sunday, this is best possible outcome (and better than I had expected) because it provides a degree of stability and political accountability. Whether Draghi will lead the government for the roughly two years until the next scheduled elections, or whether he'll be elevated to the presidency in about a year remains to be seen.

Either way, Draghi now has a mandate to pursue potentially transformative policies in Italy. In my assessment, the incoming Italian government should do a massive fiscal easing, determined in size by "costing it up", but broadly aiming to close the Italian output gap of maybe 10% of GDP. This means 3%-5% of GDP in additional easing, on top of the 5% already legislated.

The stimulus should address the health crisis without delay, protect the economically most vulnerable in society, and it should finance structural policies designed to lift potential growth. The single most important such structural reform would be a set of policies to lift Italy's unusually low participation rate in the labor market.

Judged by the many replies I got this past week to last Sunday's note, this specific recommendation has caused a lot of confusion, centered around the (wrong) idea that it is no good to expand the supply of labor in a time of crisis because "there are no jobs available".

So, allow me to explain:

First, so we start on the same page: The participation rate is the share of the population between the age of 25 and 64 who either has a job or is looking for a job (the unemployed.) At just below 73%, Italy has the lowest participation rate in the OECD (where the average is 78%). For a highly-industrialized country in Europe, it is particularly low among women (at 57%, vs. 69% on average in the eurozone). The average participation rate for men and women, combined, in the EU is 80%, ranging from Italy's 73% at the bottom, to typically around 85% in Germany and Scandinavia. Indeed, you need to go to the EM world, e.g. South Africa, to find a participation rate as low as Italy's.

In recent decades, cultural changes and economic policies aimed at gender equality have led to a rise in the participation rate throughout Europe (and the rest of the OECD) among women, but also among men. But very sparsely so in Italy.

For example, fifty years ago, Scandinavia had a participation rate of 73% (where Italy is today), but it increased to roughly 85% during the 1970s – precisely during the decade characterized by the oil price-induced crisis. Of course, some of the increase went into part-time employment, particularly among women who joined the labor market for the first time. And for some years, unemployment increased – but so did job creation, just not quite as fast as the increase in the participation rate during the first few years of such changes.

In Southern Europe, most countries also saw their participation rate increase pretty continuously for the past few decades. In Spain, it has increased from just 60% in the mid-1970s to 73% in 2003 to now 81%. And just like in Northern Europe, the US and Japan, this increase in the supply of labor gradually generated a broadly equivalent demand for labor – and stronger growth in incomes and GDP.

The point is this: Just like in product and services markets, supply creates demand also in labor markets! (And particularly to anyone working in sales, I assume you agree that supply of good products, services and ideas does indeed create demand...)

If, in spite of the evidence from other countries, this still feels counter-intuitive, think of it this way:

Most people would agree that Italy needs structural reforms to increase competitiveness and growth, including in the judiciary sector, via a reduction in red tape, more smoothly functioning markets, etc. Suppose your dream prescription of such structural reforms came through tomorrow. Surely, a lot of people presently engaged with stamping papers, administering the red tape and – in the private sector – employed to navigate all these obstacles, would now become unemployed as efficiency increases. But when you prescribed your structural reforms you knew this, of course, but – I assume – you didn't think these (now redundant) people would remain unemployed forever? For a period of time, yes maybe, but the released labor supply stemming from such structural reforms would surely find employment down the line – and if policies, including the stimulus, are done right, surprisingly fast. The exact same thing happens when previously inactive parts of the population join the labor force.

My colleague, our chief Italian economist, Loredana Federico, has estimated that if Italy could bring its participation rate up to the eurozone average over the next ten years – i.e. from 75% to 79% for men and from 57% to 69% for women (which is no more ambitious than that other countries have achieved over a ten year period) – and even if only half of the new arrivals in the active labor market would find a job during this period (a rather conservative assumption), this would add 0.5pp to annual average GDP growth in Italy between now and 2030. In other words, this alone would broadly lift Italy's average growth rate to the eurozone average – basically putting public debt concerns to bed.

Such an increase in the participation rate should be encouraged via changes in the tax regime, e.g. by providing a substantial discount in the tax rate for the second income of a registered couple, by providing incentives for companies to offer part-time employment, and e.g. legislation to assure a certain number of allowed "child sick days", and by vastly subsidizing child care and after-school programs. In my view, this is really low-hanging fruit for the Draghi government to pursue because it has been tested and implemented in virtually all other European countries.

So, in addition to using the needed 3%-5% of GDP in further fiscal stimulus to pay for an accelerated roll-out of vaccination, support of the healthcare sector, a boost to education, the building of better infrastructure, including via digitalization, Draghi should boost spending, and cut taxes, with an explicit aim to bring Italy's participation rate up to the eurozone average.

There is no amount of fiscal "prudence" or market liberalizations to increase productivity that will generate the amount of income and growth in the medium term which will be needed to put the obsession of Italian public debt to rest, so long as only 73% of the adult population wants to work.

I am pretty confident Draghi and his key ministers know this – and will act accordingly. There really is a lot of upside here …

And on that note, I wish you a wonderful after afternoon – whichever of the many festivities you celebrate today.

Best

Erik

Erik F. Nielsen, Group Chief Economist, Global Head of CIB Research (UniCredit Bank, London)
+44 207 826-1765
erik.nielsen@unicredit.eu

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UniCredit Research* — Macro Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

International Economics Research

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head, Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

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