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MACRO ECONOMIC UPDATE

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How to keep track of the latest health toll?

- ✓ The good news is that the lockdown and social distancing measures result in flattening curves. There are several interesting and useful sources to stay informed about the latest developments. Most international top newspapers such as the Financial Times provide excellent information in this respect. Many of these sources are relying on the figures from John Hopkins University. Our World in Data is also offering easy access to the underlying data, in turn stemming from the European Centre for Disease Prevention and Control.

How to keep track of the policy support measures?

- ✓ It's far from easy to keep track of all the government support measures that have been put into practice. Crucially, effective policy requires central banks and governments to work closely together. Policymakers are not merely stimulating the economy, at least not at this stage. Above all, they are providing life support, to an unprecedented extent, in order to try to limit the hardship for millions and millions of firms and households. This is about maintaining the economic system so that we will see a faster economic recovery once the virus is brought under control. The OECD does a very good job in keeping track of the implemented policy support measures. Please find more information here (scroll down) in detail.
- ✓ Note, however, that it's impossible to just add up direct measures (such as medical resources, keeping people employed, subsidizing SMEs or public investment) and other supporting measures including deferrals, guarantees and liquidity provisions (let alone adding up QE, credit lines, lower capital keys for banks, relaxation of collateral…). In this recent blogpost Bruegel makes an interesting summary and comparison of the fiscal responses of EU countries, the UK and the United States.

What kind of economic crisis?

- ✓ This is a crisis like no other. It is atypical in the sense that we are not dealing with an ordinary collapse in demand stemming from risks built up over time in the financial system itself. This is more like a self-induced coma as parts of the economy and society have been deliberately switched off in order to limit the spread of the coronavirus. Containment measures are having a disproportionate effect on consumer-facing sectors in particular. The crisis is also truly global and highly uncertain in nature since pandemics don't respect borders and we don't yet fully understand how the virus will behave.
- ✓ The initial economic impact is absolutely brutal and requires relentless efforts to limit both the duration and the depth of the economic crisis. This is easier said than done. For example, in the United States (where the system of wage subsidy schemes is largely absent) unemployment will likely hit depression-like levels. It remains to be seen to what extent and how fast employment will pick up in the future. Obviously, this will depend on the strength of the economic recovery (see below) but undoubtedly many firms across the globe will take this crisis as an 'opportunity' to seek efficiency gains. Indeed, this pandemic and subsequent recovery will likely accelerate the ongoing digitization and automation of work (see below).

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What kind of economic recovery?

- ✓ Economic growth is still expected to turn positive in the second half of the year (actually already as soon as May) as restrictions are gradually being lifted. In that respect, the recovery can begin fairly quickly. That said, economic activity will likely remain significantly below its pre-virus path for several years as epidemiologists keep on warning that only a vaccine will provide a final solution. Consensus seems to be that we are still at least twelve to eighteen months away before it will be up and running. Meanwhile, consumers are expected to remain wary of crowded places. In addition, some restrictions will remain in place for many months and others may end up being re-imposed if a new wave of infections would hit (see below). In other words, while we are likely to see some impressive growth rates during the initial stages of the recovery, the comeback process looks set to be rather long and painful. Or, as Bill Gates has repeated several times: humanity will beat this pandemic, but only when most of the population is vaccinated. Until then, life will not return to normal.' This is also what the world-renowned Belgian virologist Peter Piot says. The Economist calls it the '90% economy'.
- ✓ What is the Chinese story telling us? While the total number of infections has stabilized, the economy has not. Activity is recovering but only gradually and output is still way below levels seen at the start of the year. Weakness will drag on because China is now facing severe headwinds from falling demand overseas.

What about a new wave of infections?

- ✓ Epidemiologists have warned from the beginning that there could be several waves of infections. After all, history taught that major pandemics have come in waves, from the plague in the 14th century to the smallpox epidemic in the 18th century. Sometimes the second wave was worse than the first, like the Spanish flu just after WWI. Actually, the 1918 flu pandemic came in three waves with each more severe than the last. The flu pandemics in 1957 and 1968 also had multiple waves. That said, SARS (also a coronavirus) in 2003 had no major second wave.
- ✓ Uncertainty looms large but an important reason to expect a second wave is the fact that we are far from having group immunity. Although the reproduction rate has dropped below one in most countries during the lockdowns, there have already been indications from Germany and Singapore that improvements can be partially reversed as restrictions are relaxed. That's why Angela Merkel recently underlined that Germany is 'still at the beginning of the coronavirus crisis'. It could be argued of course that the world economy would be better prepared to deal with a second wave through intensive testing and tracing. That said, the risk of structural economic damage and permanent changes in consumer behavior would only increase.

What kind of economic growth figures are we looking at?

- ✓ The pandemic-related lockdowns were only fully implemented in the final two weeks of March. Nevertheless, preliminary Q1 GDP figures coming in from various European countries including France (-5.8% QoQ), Belgium (-3.9%), Italy (-4.7%), Spain (-5.2%) confirm the impact is absolutely devastating. Aggregate Eurozone GDP contracted by a record 3.8% in the first quarter. GDP figures in Q2 are expected to come in a lot worse still. Estimates range widely. It looks reasonable to expect GDP in the US and the Eurozone to drop by respectively 15 and 20% in the second quarter. Obviously, significant differences between sectors, states and countries exist.
- ✓ Tremendous uncertainty about the exit-strategies and the evolution of the virus itself imply that economic forecasts further down the road are even more uncertain. The ultimate effects of this pandemic are extremely uncertain (see also further below). Economists confidently predicting the economic and social fallout are mainly making astrology look good, as the saying goes. The IMF recently projected the global economy to contract by 3% in 2020 (much worse than during the GFC) followed by a 5.8% expansion in 2021. But, as argued before, we

think that the IMF's baseline projections will prove too optimistic. The same may hold for the EC's recent economic update which also underlined that the downside risks to its forecasts are 'extraordinarily large'. Even more important, the EC also stated that some of the Member States hit hardest by the virus are also those with the least policy space to respond, implying that divergences across countries could become entrenched if national policy responses are not sufficiently coordinated or if there is no strong common response at the EU level (see below). This could distort the internal market and ultimately threaten the stability of the euro area.

To what extent should we fear inflation?

- ✓ Supply-side constraints are real but against the back of rapidly rising unemployment, collapsing private sector investments, falling inflation expectations and stumbling commodity prices (persistent worries about oversupply of oil and inadequate storage capacity will send headline into negative territory), actual deflation (or disinflation) rather than rising inflation is the biggest concern, certainly in the near future.
- ✓ Some fear that inflation will pick up quickly when restrictions are being lifted. The combination of pent-up demand and large fiscal programs, it is believed, will then result in inflation increasing significantly above central bank targets. However, this reasoning is not very convincing. It seems more likely that consumption and investment will stay under pressure for longer due to high uncertainty. Indeed, consumers will likely favor higher precautionary savings while firms will be paying back loans. Meanwhile, supply should come back onstream fairly quickly once the virus passes.
- ✓ What about the large-scale QE programs? It is crucial to make a distinction between base money and the money supply in this respect. When the central bank buys assets it increases the money base (through commercial banks' deposits at the central bank). This does not mean that the money supply also increases. The latter is merely a function of bank lending to the real economy. In periods of weak economic demand, demand for loans will also be weak. The risk of underlying inflation pressures, as a result, will also diminish. It's only when the economy returns to full capacity that the risk of inflation increases again (remark: note, however, that the so-called Phillips-curve has flattened in recent decades; the relationship between wage inflation and unemployment is still rather solid while the relationship between price inflation and unemployment is weak).
- ✓ Importantly, this does not mean that we should totally dismiss the risk of high(er) inflation further down the road as also highlighted by former IMF chief economist Olivier Blanchard here.

How much should we fear high public debt levels?

- ✓ Needless to say, public deficits and debt levels are soaring. The least painful option is to let the debt be eroded gradually by economic growth (as long as the primary deficit is kept low enough to ensure that debt is rising slower than GDP, the ratio of debt to GDP will fall). This could be combined with some form of financial repression to keep real interest rates low (i.e. large-scale QE and requiring banks to hold some government bonds). That is basically how the US and UK reduced debt levels after WWII. Indeed, remember that it's not the level of public debt that determines the sustainability of public finances but the joint dynamics of the primary deficit, the implicit interest rate and economic growth (true, more specifically for EM's the currency and maturity composition of outstanding debt also matter a lot).
- ✓ Countries with weak nominal growth prospects are in a more difficult position and face several options, none of them appealing. The first would be austerity in order to run tight(er) budgets. But that didn't exactly go well after the global financial crisis, was counter-productive at times and is politically difficult to sustain. The second would be to inflate away the debt, but this is easier said than done (Japan had only limited success in this respect and Italy cannot do this on its own anyway as it does not have its own central bank). Another would be

outright default. Some emerging markets are expected to go down this route, and it cannot be excluded that Italy may end up doing this eventually too.

What about the common European response?

- ✓ With economic activity remaining well below its pre-crisis level for a long time to come, and southern economies harder hit than those in the north, the governance of the currency union has again become more challenging going forward. This risk has been amplified by a perceived lack of solidarity in countries like Spain and Italy. Luckily, the ECB acted immediately (even though more will probably be needed). In its efforts to prevent a fresh sovereign bond crisis, the ECB has launched a €750bn Pandemic Emergency Purchase Programme (including a deviation from its capital keys and issuer limits).
- ✓ Eurozone leaders also agreed on a €540bn rescue package. The core elements of this package consist of 1) pandemic credit lines from the European Stability Mechanism (€240bn); 2) a boost to the lending capacity of the European Investment Bank (€200bn) and 3) a new unemployment insurance scheme proposed by the European Commission (€100bn). The European Council also agreed in principle on a 'Roadmap to Recovery' and on establishing a new fund with the volume of more than €1 trillion to help overcome the severe economic crisis. This fourth pillar is the one that matters most. Indeed, the first three pillars of the joint response are not enough because these are merely loans and countries' access to financing is not the main problem at present thanks to the ECB's backstop. What is needed is a clear sign of European solidarity with the most affected and economically most vulnerable countries.
- ✓ This is important because excessive regional economic disparities will hamper the functioning of a monetary union. Remember that Italy was already struggling with structural (youth) unemployment, high debt levels and sluggish income growth. It is also in the interest of the northern member states that the southern economies recover as quickly as possible. There are also political risks. A recent survey suggests that the support of the Italian population for the European project is again declining.
- ✓ The European Commission has now been asked to develop a proposal on how to use this recovery fund. This remains unclear for the time being but most likely the outcome will be integrated into the European multi-annual financial framework 2021-2027. All in all, however, the main risk is that it will prove 'too little too late' as ECB President Christine Lagarde put it recently.

What about the German Constitutional Court's decision on the ECB's asset purchases?

- ✓ The German Constitutional Court ruled that the ECB and ECJ overstepped their mandate. According to the court, the ECB did so with its March 2015 decision to purchase government bonds while the European Court of Justice (ECJ) did so by approving this decision in December 2018. The court now requests that the German government and parliament ask the ECB to explain that its purchases meet the test of 'proportionality' within the next 3 months. More specifically, the Bundesbank may, after a transitional period of no more than three months, no longer participate in the QE programme unless the ECB Governing Council 'demonstrates in a comprehensible and substantiated manner' that the far-reaching economic and fiscal policy effects are not disproportionate relative to the monetary policy objective of the QE programme (i.e. reaching the inflation target). The ECB already took note and cleverly pointed to the fact the ECJ ruled that the ECB is covered by its price stability mandate. In other words, the ECB is not inclined to respond directly to the court as that would undermine its independence and expose it to pressure from other national courts.
- ✓ At the same time, the court followed the judgement of the ECJ from 2018 that QE does not constitute monetary financing. However, the reasons cited merit attention: (i) the volume of the purchases is 'limited from the

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outset'; (ii) the 33% issuer limit is observed; (iii) purchases are in line with the capital key; (iv) bonds may only be purchased if the issuer has a minimum credit quality; and (v) purchases must be discontinued if not necessary to achieve the inflation target. The PEPP (see above), launched on 18th March, does obviously not meet these criteria. As a result, there's a big chance that the current all-important PEPP will someday be challenged in court. Logically, these endless disputes over the legality of the ECB's policies undermine the ECB's efforts and add to uncertainty about the future of the Eurozone and Europe.

How will this crisis affect the upcoming US elections?

- ✓ The coronavirus has raised a lot of questions about the 2020 presidential election. What will the economy look like in November? How do voters assess Trump's handling of the crisis? Will Americans be able to physically cast their votes? And could this moment be so extraordinary that it causes Republican voters to abandon Trump in November?
- ✓ The economy will certainly not be firing on all cylinders (it's the economy stupid!), quit the contrary (and what about a second wave deterring mainly older Republican voters to go to the polling station?). And Trump has not exactly had a 'good crisis'. His misjudgement and ignorance are probably unbeatable. Logic tells us he can't possibly be re-elected.
- ✓ However, we should be careful drawing quick conclusions. First, Trump is of course refocusing the debate on 'Reopening America' ('liberate Michigan!', 'liberate Pennsylvania!'). By downplaying the health costs of the pandemic and emphasizing the economic costs, Trump hopes to come out as the rescuer of the US economy. Moreover, Trump will find a way to argue that he prevented a worse health disaster. In addition, the Trump administration is looking for a noisy conflict with China to divert attention from the socio-economic problems at home. This tactic is predictable but may deliver. A recent Pew Research Center report finds that more Americans have a negative attitude toward China now than at any other point since they began tracking this question in 2006. Also, Joe Biden is having a hard time getting attention as he holds no political office. Finally, there's little sign that Republicans are backing away from Trump.

How to assess the crisis in emerging markets?

- ✓ Emerging markets are hit in several ways including 1) massive capital outflows and less remittances, 2) an implosion of global trade and tourism and a possible re-shoring of activities, 3) weaker health systems and difficulties to implement social distancing measures, 4) collapse in commodity prices and 5) relatively less room for budgetary and monetary policy support.
- ✓ China has successfully flattened its infections curve, has eased many restrictions and its economy is showing signs of recovery. High-frequency data point to a pick-up in coal consumption, property sales and passenger travel. That said, the recovery will take time. People are cautious to return to public places and exports will continue to suffer on the back of weak global demand.
- ✓ A handful of other early responders to the health crisis including Korea, Taiwan, Vietnam and the Czech Republic, have also successfully flattened their infection curves. Economic activity should recover in the coming months (even though China's example suggests that this will happen slowly). However, much of Latin America, Africa, Russia and India, where policymakers were slower to react, have had less success in flattening their curves, suggesting that social distancing measures and lockdowns will need to remain in place for longer.
- ✓ International support measures put forward by the G20, the IMF, the World Bank and the Fed are helpful but are likely to fall short to prevent a flurry of disorderly defaults. More efforts are needed. The good news is that solutions exist. From an investment point of view, in order to better understand which EM are the most in

distress, have a look at this interesting exercise (obviously, this is not the whole story; contact us if you have more specific questions).

What important global economic and political shifts can we expect?

- Predictions are hard, especially about the future, as the saying goes. The pandemic will lead to permanent shifts both politically and economically in ways that will become clear only later (the hindsight bias will of course kick in meaning that many observers 'knew it all along'). That said, we cannot be blamed for trying.
- One potential consequence is that this pandemic adds momentum to the ongoing deglobalisation trend already present before. Support for globalization was already declining before the pandemic struck (lower cross-border capital flows, lower political support for immigration, trade protectionism, new technologies favouring re-shoring, climate and environmental concerns). Even before the coronavirus emerged, tensions between Washington and Beijing were rising. The Trump administration initiated a trade ware and China had challenged American power in the Pacific. This crisis will also likely speed up the reassessment of globalization's costs and benefits. Firms that are part of global supply chains have witnessed first-hand the risks inherent in their interdependencies and the large losses caused by disruption. These firms are likely to take greater account of the tail risks, resulting in supply chains that are more local and robust.
- This should not necessarily be dramatized. After all, one could argue that economic globalization has far outpaced political globalization (cfr. winners and losers of globalization) and a correction was long overdue in this respect. However, the damage to international trade will likely be extensive and lasting. Moreover, there's a clear risk of overreaction and a further slide to protectionism. The absence of US leadership is leaving a vacuum in the world trading system (recent developments may well accelerate a move away from US-centric globalization to a more China-centric globalization). Lack of coordinated and cooperative response could accelerate destructive beggar-thy-neighbour policies. Some observers have said this crisis will lead to new international institutions as was the case after WWII (with the creation of the WB and IMF) but the current geopolitical climate does not seem conducive to such initiatives. Local politicians are already trying to exploit fears over open borders. Indeed, the rise of populism in many countries tends to result in home bias. All this does not mean of course that global trade will not recover from the brutal collapse.
- The economic fallout of this crisis is just incredible. Many countries are experiencing a far deeper economic shock than they've ever experienced before. In sectors like retail (already under fierce pressure from online competition and tech giants) the temporary lockdown may prove to be terminal for many stores. The pandemic will also accelerate the ongoing digitization and automation of work (eroding middle-skill jobs while increasing high-skill jobs) and might lead to more median wage stagnation and rising income inequality in absence of corrective policy measures. All in all, our long held underlying baseline economic scenario of modest growth, low inflation and near-zero policy rates (negative real interest rates) remains in place for now. This is the secular stagnation/liquidity trap scenario elaborated on in many previous communications. Therefore, there is a good case for more permanent budgetary stimulus. Importantly, if the response by businesses and households include long-lasting risk-aversion and a flight to safety, this will only strengthen the forces of stagnation. And if the public response to the debts accumulated by the crisis is austerity, that would only make things worse.

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