We've never had it so loose...

Economic outlook

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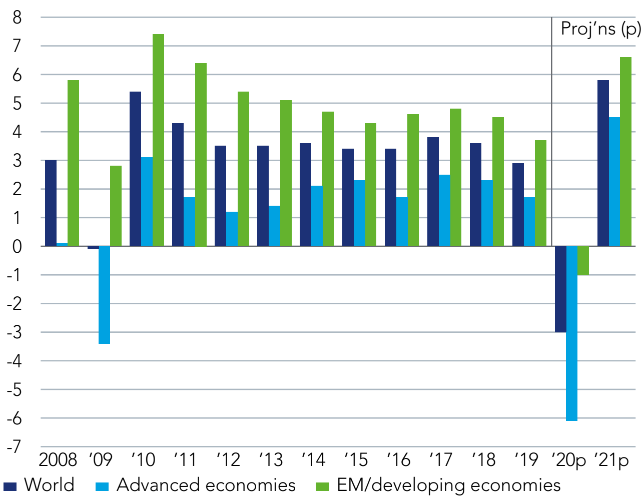
Main points

- The virus, as an exogenous shock, is a medical crisis that compels financial markets to assess the economic damage. Thusfar, growth assets are taking a glass-half-full view, fuelled by unprecedented liquidity, and, unlike 2008-09, governments opening the fiscal floodgates. Their actions have shaped early expectations that growth can snap back in 2021.
- Yet, how the situation plays out rests on more than finance, and analysts' implicit assumption that Covid-19 is nearing its (only) peak probably depends on a vaccine yet to be found. For this and other reasons, GDP-projections are, rightly, now moderating. But, the close-to 'V'-shape still hoped for looks a big ask, and a 'U','W', or even 'L' seem more likely.
- It took five-six years after 2008-09 for the US and UK to reclaim their real GDP. Consumers in deflationary Japan, and Italy and Spain, locked into the euro, have yet to recover. And worrying this time is the rapidity of labour's response. US job losses chime with the 1930s.
- Even if 60% of these prove 'temporary', the 8% unemployment rate on a full, immediate rehire would be more than double February's. Rapid labour downturns do not guarantee sharp recoveries. And, benefit cuts, and difficulties locating those who need state support the most question just how spendthrift returning workers can be.
- Updated for the emergency measures, our analysis suggests true, QE-adjusted policy rates now as low as -10% in the US, and -6% in the UK. It confirms by far the loosest overall stance in nearly three decades of data, probably post-War, with little correction in 2021. It also questions the need for the US Fed and BoE to follow the ECB and BoJ onto negative 'headline' rates.
- Fiscal expansions are varying in speed and scale, but the legacy will be debt build-up. The US, euro-zone, and UK government's debt-ratios are already twice Japan's when it entered its 'lost decade'. Were their nominal growth now also held back, even a modest 1%yoy rise in the debt stock would lift their respective net ratios toward 120%, 90%, and 110% by 2040.
- The QE-drug would, thus, be even more difficult to kick, especially as central banks' skin in the game leaves them striving for the *status quo*. Precedent and government dependence now on their central banks suggest we may be little more than half-way through this era of cheap money.
- Tellingly, in 1951, the US Treasury-Federal Reserve Accord was the reason for stopping QE. This will not be repeated, and could (risk case) even be revoked. Either way, in a high-debt world, a challenge will be keeping clear the operational distinction between the monetary and fiscal authorities, as bond issuance escalates, and governments' addiction to QE builds...

Chart 1. Growth rates are assumed to bounce back in 2021...

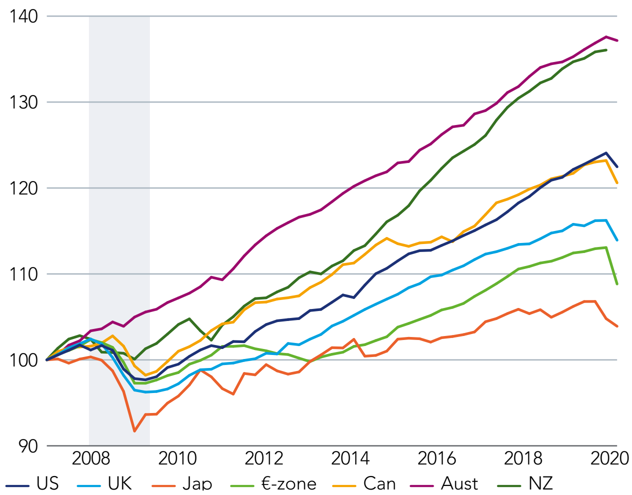
IMF's real-GDP growth projections: world, advanced, & EM/developing (%yoy)



Source: IMF's April 2020 world economic projections

Chart 2. But, GDP recovery from 2008/09 was closer to a drawn-out 'tick'

Real GDP level re-based to Q1 2007 (=100). Grey block denotes US recession



Source: Refinitiv Datastream, based on national data

Comment

The virus, as an exogenous shock, is a medical crisis that compels financial markets to assess the economic damage. Thusfar, growth assets are taking a glass-half-full view, fuelled by central banks' unprecedented liquidity-provision, and governments avoiding the pedestrian fiscal approach of 2008-09. Their actions this time – including close to free money, an extra $4trn of QE (to $19trn) since February, wider asset purchases (chart 4), fiscal spending, tax breaks, and unbridled cash-flow help – shaped early expectations that global-growth can more than snap back in 2021 (chart 1).

Yet, how the situation plays out, of course, rests on more than finance, and analysts' implicit assumption that Covid-19 is nearing its (only) peak probably depends on a vaccine yet to be found. GDP-projections are now moderating (see tables on pages 5-11). But, the swift 'V'-shape still hoped for looks a big ask, and a 'U','W', or even 'L' seem more likely.

Difficult to see how this stimulus can ever be reversed…

With Q2 data to confirm G7 recession (two consecutive quarters of falling GDP), base-effect will, at some stage, redeliver growth. But, more telling, will be how painlessly GDP *levels* can return to trend. Chart 2 reminds us it took five-six years after 2008-09 (which also needed balance-sheet repair) for the US and UK to reclaim their real GDP. Consumers in Japan (with deflation), and Italy and Spain (locked in the euro) have yet to recover (chart 3). And worrying this time is the rapidity of labour's response. The US's job losses are 'eye watering', and chime with unemployment rates in the 1930s. Even if 60% of these prove 'temporary', the 8% unemployment rate on a full, immediate rehire would be more than double February's. And, rapid labour downturns do not guarantee sharp recoveries (chart 6, on page 6).

It also remains to be seen how spendthrift returning 'furloughers' can be, given US benefit-cuts (predominantly healthcare), difficulties in finding the lowest earners for support, and the 11 million 'undocumented' workers. Lower oil prices help costs, but offer little real benefit when demand is locked down, and correlations with employment weakened in 2010-11 on US self-sufficiency. Early clues include one-half of low-income households having lost a job/taken a pay cut because of the virus, with 70% using the funds for paying bills, not discretionary spending. In the UK too, support is rightly helping cash-flow. But, the extension there of 'furloughing' to October, even with firms contributing, could take the fiscal cost to £84bn (3.9% of GDP). And, taking all virus measures together, the budget deficit balloons to nearly £300bn in 2020/21. At 15% of GDP, this is easily a post-War high, and dwarfs the 2.4% expected in March (page 11).

We thus update our *Policy Looseness Analysis* to show the impact of emergency measures on the overall policy-mix. On the basis of the above plus the US's $2.5trn fiscal package, charts 5 and 11 suggest true, QE-adjusted policy rates as low as -10% in the US, and -6% in the UK. (-12% and -8% in real terms). They thus confirm by far the loosest overall stance in nearly three decades of data (probably post-War), and highlight how little correction there'll be in 2021. They also question the need for the US Fed and BoE to follow the ECB and BoJ on negative 'headline' rates.

Fiscal expansions, though, will vary in speed and scale. Front-runners are the US, Japan, and UK, with packages equivalent to about 12%, 23%, and 6% of respective GDPs. Lagging are China, having just favoured a cautious 3.6% of GDP spending-programme to avoid the over-stimulation of 2008 (page 13), and a euro-zone offering about 4.3%. The latter, though, could go to 8%, if the Recovery Fund can become less controversial to sceptics of debt-sharing (page 9). Either way, the legacy will be debt build-up. In 2019, the US, euro-zone, and UK governments' net debt averaged 76% of GDP, about twice Japan's (34%) when it entered its lost-decade in the mid-1990s. Higher net-debt ratios now look inevitable for 2020 and beyond.

Japan 'gets away with it' from having all its JGBs local-currency denominated, held predominately (97%) by a domestic investor-base less sensitive to yield/foreign-currency ratings. Thankfully, the US, euro-zone, and UK's too are in local currency, also implying default-risk is next to zero. This gives governments (especially those facing voter enmity) unlimited time to put growth and inflation considerations ahead of more direct ways (tax rises, spending cuts) to addressing debt. This is akin to the relaxed approach to dealing with the UK's post-War debt burden (250% of GDP). An advantage this time is no longer having the USD-denominated obligations that contributed to our having to borrow from the IMF in 1976.

Yet, governments cannot be complacent. With up to 40% of US, core euro-zone and UK government debt owned internationally, *"the kindness of strangers"* (Carney) will hinge more on yield/ratings considerations. And, were their nominal GDP also held back by deflation, even a modest 1%yoy rise in their debt would lift their respective net ratios toward 120%, 90%, and 110% by 2040 (OECD definitions). This would wipe out officials' hopes of ever eroding the debt via inflation. One early warning could be political capital as the 'blame-game' intensifies. Bargaining over the US's gross $24trn (117% of GDP) debt-ceiling in mid-2021 may flag up China's $1.1trn claim on it. This would revive tensions as China prepares for its 2022 National Congress.

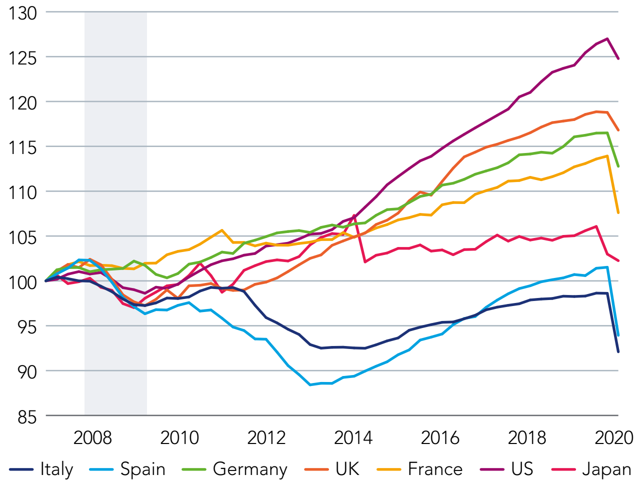
And, for other emerging markets, the outlook may not be as rosy as the IMF suggests (chart 1). This year's GDP-contraction may be prolonged if current virus catch-up in the more densely-populated Brazil, India, and Russia, for example, persists. And, even after that, in a potentially more protectionist, stronger USD, environment. Vulnerabilities lie with those non-commodity exporters with high exposure to short-term USD debt and foreign saving needs, including Argentina, Turkey, Ukraine, and South Africa. But, for others, external debt-ratios are lower, with few currency pegs to protect. And, as their domestic debt climbs, they too can run QE.

The implications are clear. Sluggish GDP, low inflation, and rising debt suggest the QE-drug will become even harder to kick. Japan, even after 22 years, is about to accelerate it (page 7). The previous time proper was the 1930s depression when US QE ran for 14 years to 1951, despite double-digit inflation. This was a different time, but, if a guide, we may be little more than half-way through our own era of cheap money. After all, central banks' skin in the game via bloated balance sheets suggests they, like the BoJ, will strive for the *status quo*. And, if they don't, mandates could change, especially with their traditional reaction-functions, like CPI targets and Phillips Curves, looking broken.

Tellingly, in 1951, the US Treasury-Federal Reserve Accord was the reason for stopping QE. This will not be repeated, and could (risk case) even be revoked, formalising the dependence QE-governments now have on their central banks. So, in an even-higher-debt world, a challenge will be keeping clear the operational distinction between the monetary and fiscal authorities, as bond issuance escalates, and governments' addiction to QE builds.

Chart 3. And, personal consumption did not spring back for all

Real household consumption re-based to Q1 2007 (=100). Grey block denotes US recession



Source: Refinitiv Datastream, based on national data

Chart 4. Summary of central banks' extra stimulus

Central Bank	Pre-crisis rate (%)	Current rate (%)	Summary of latest main policy actions
Fed (Funds target range)	1.50-1.75	0.0-0.25	Unlimited, open-ended QE (US Treasuries & MBS), expanded loan & funding facilities, and up to $750bn SPVs to buy corporate names, including qualifying 'fallen angels'
ECB (Deposit rate)	-0.5	-0.5	Asset purchases upped to at least €100bn per month (Sovereigns, corporates), from €20bn (was €80bn in 2015), with more "flexible approach" to the Capital Key buying limits. 'PEPP' includes CP, & some private assets
BoE (Bank rate)	0.75	0.1	An extra £200bn of QE (mainly Gilts, but also corporates), CP assistance, and bank funding facility
BoJ (Overnight rate)	-0.1	-0.1	Still targeting a 0% 10-yr JGB yield by flexibly varying the amount of QE. Asset purchases had been centred on ¥80trn per annum; mainly JGBs but also REITs & corporate bonds. CP & corporate bond purchases raised from ¥5.4trn to ¥20.4trn (=23% coverage)

Source: Federated Hermes, based on central banks

US

With the US Fed questioning a swift 'V-shape' recovery – warning instead of a *"sharp decline"* in output, *"surge"* in unemployment, and *"considerable risks"* even after stimulus – more policy accommodation could follow.

At the very least, policy rates will stay close to zero, and its 'kitchen sink' approach to asset-purchases in place (including eligible corporate 'fallen angels') until "*the economy...is on track to achieve its maximum employment and price-stability goals*". Our interpretation of this is an unemployment rate closer to their long-term NAIRU of 4.2% (from May's 13.3%), with PCE inflation ingrained (for demand, rather than cost reasons) around 2%yoy. With US Covid-19 cases per-million the G7's highest after Italy (WHO data), the job-saving impact of furloughing yet to be confirmed, and inflation expectations anchored under the Fed's preferred 2% (lower than when QE started), these conditions look unlikely before 2022-23.

Labour data that chime with the 1930s...

GDP-recession should be confirmed by Q2's data, probably ending the NBER's 11-year business expansion. The labour market may remain the most visible pressure release. Traditionally a lagging indicator, the rapidity of employment losses has been far more striking than in recent recessions. As chart 6 attests, the more rapid downturns in the labour market, such as 2007/09 which also needed balance-sheet repair, do not guarantee the sharpest recoveries. The 36.5 million new jobless claims in the two months to mid-May, and leap in the unemployment rate from 3.5% surpasses anything from the Volcker rate-tightening of the late 1970s/early 80s. And, with comparable data only since 1948, it chimes with earlier Census Bureau estimates of 25% in the 1930s.

BLS data suggest 16 million of the 21 million job losses in April (the hardest-hit month) could be 'temporary'. With a further six million people leaving the labour force, they could account for as much as 60% of the combined total. Hypothetically, this offers an 8% unemployment rate on full, immediate rehiring. Yet, even this would be an eight-year high, and a-more-than doubling of the rate since February. The 'under-employment' rate (which includes those not searching, but wanting to work/more), now at 21.2%, may be slower to fall. May's 2.5 million job gains are encouraging, offering hope that in those states 'reopening', gradually returning furloughed workers may be outnumbering those losing jobs.

But it remains to be seen how spendthrift returning 'furloughers' can be, given benefit-cuts (predominantly healthcare), and difficulties using the tax system to find the lowest earners for the $1,200 per-adult rebate, and 11 million 'undocumented' workers. Early clues are one-half of low-income households having lost a job/taking a pay cut from Covid-19, with 70% using the funds for bills, rather than discretionary spending (Pew Research Center, April).

Either way, macro policy will remain loose. To gauge the impact of March/April's $2.5trn (12% of GDP) fiscal package of tax, spending and liquidity measures, and the Fed's open-ended QE, we update our *Policy Looseness Analysis* (see our *Tightening by doing nothing report*, May 2017). On the basis of the Fed's own policy rate/QE trade-offs, and our conservative assumptions of 'just' +$5trn QE in 2020 and +$2trn in 2021, it suggests a true, QE/QT-adjusted funds rate currently closer to -10%, or -12% in real terms (chart 5)! It, thus, also quantifies how far short we'll be, even in 2021, from taking the overall policy-mix back toward 2008 levels.

Which should help a President for whom the politics will be difficult. The bipartisan, election-year fiscal stimulus is not unprecedented, with a Republican President/Democrat-led House having passed a $152bn (1% of GDP) package in 2008. But, with his approval historically low and stable (40-45%), re-election may need him to re-attract centrists or step up the one-nation policies that hold his base. And, while a legacy will be government debt (now passing $24trn, 117% of GDP), some upheaval will at least have been deferred, by Congress' 2019 raising of the debt ceiling till mid-2021.

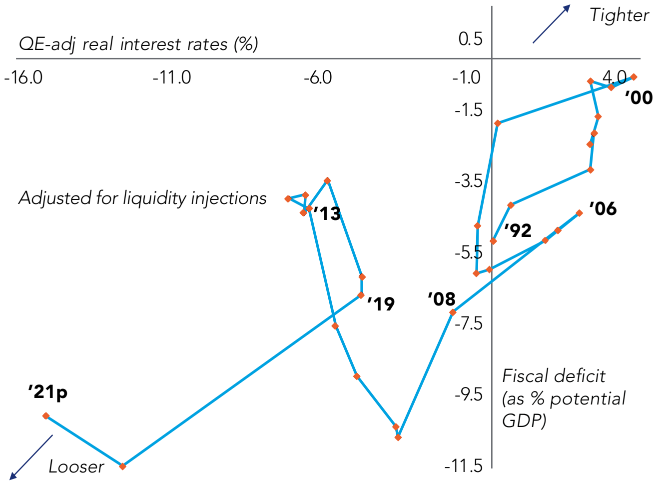
May 2020 consensus projections (p). April's are in parentheses

% yoy unless stated	'15	'16	'17	'18	'19	'20p	'21p
Real GDP	2.9	1.6	2.4	2.9	2.3	-5.4 (-4.0)	4.3 (3.9)
Personal consumption	3.7	2.7	2.6	3.0	2.6	-6.3 (-4.4)	4.9 (4.4)
Business investment	1.8	0.7	4.4	6.4	2.1	-9.4	3.1
Industrial production	-1.0	-2.0	2.3	4.0	0.9	-9.0	3.0
Consumer prices (nsa)	0.1	1.3	2.1	2.4	1.8	0.7	1.8
Unemployment rate (%)	5.3	4.9	4.4	3.9	3.7	10.1	8.1
Govt budget balance (% GDP)		-3.1	-3.4	-3.8	-4.6	-15.4	-9.3
Govt gross debt liabilities (% GDP)*					109.0	131.1	131.9
10-year Govt bond yield (yr-end %)		2.5	2.8	2.7	1.9	0.8	1.7
3-month rate (yr-end, %)		0.5	1.4	2.4	1.5	0.0	0.0

Source: National data, IMF*, & Consensus Economics (May 2020)

Chart 5. The US's macro policy mix including emergency measures

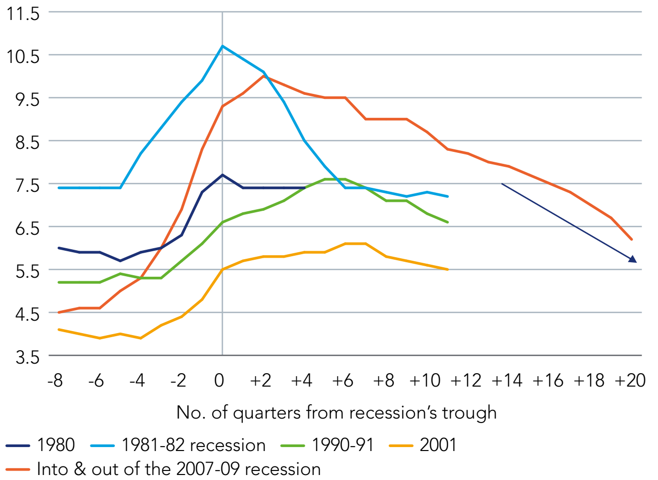
Using QE-adjusted funds target, core PCE, & cyc adj fiscal bal. Unch Funds rate in 2021



Source: Federated Hermes, based on OECD , FRB, & Bloomberg data

Chart 6. Unemployment in US recoveries

Unemployment rate (%) into & out of recessions. Years are NBER-defined recessions



Source: Federated Hermes, based on BLS, & NBER data

Japan

The virus provides an important reason for prolonging a policy-loosening spanning 22 years.

The MoF's three emergency packages include direct cash-handouts of ¥100,000 to all individuals ($938, or an aggregate 2.4% of GDP), loans to firms, one-year deferral of tax payments/social security *premia*, and cash-flow support to SMEs for wages and rent. Together, these total ¥127trn (23% of GDP). With the BoJ loathe to hurt banks by going further into negative-rate territory, and the yen held up by safe-haven flows, QE will again have to do the monetary work. The BoJ's lifting of its commercial paper and corporate bond purchases, from ¥5.4trn to ¥20.4trn, now secures 23% coverage of those markets, and should absorb any new borrowing. And, given the MoF's revised plan now for ¥59trn of new JGB issuance in FY20 (year ending March 2021), the BoJ would have to almost double last year's ¥80trn annual purchases just to maintain the same run-rate, of mopping them up at more than twice the pace of new supply.

Virus only deepens dependence on the BoJ...

And especially should virus effects worsen: end-of-April WHO estimates suggest Japan's infection-rate per-million, at 105, sitting in the middle of China's 60, and 210 in South Korea. Depending on where global yields go, this ¥80trn will anyway vary, reflecting the needs to meet the BoJ's near-zero 10-year yield-target. Any rise at a zero/negative yield should, thus, be seen as a loosening. For BoJ Governor Kuroda, there is no QE *"reversal"* until a +2%yoy CPI (latest +0.1%yoy) is the norm, presumably driven by demand, not costs. With the BoJ now expecting a return to deflation at least in its core-CPI (CPI ex fresh-food) of -0.5%yoy in FY20, its share of JGBs outstanding should surpass 50%. Institutions will thus look overseas, hopefully softening the yen.

Wider deflation would be unpalatable into 2021's Lower House election, when PM Abe's tenure ends. With the developed world's highest government liabilities-to-GDP, at about 250%, the MoF faces one of the biggest risks from deflation. While boosting real activity (as the deflator falls), nominal GDP would again be eroded. Chart 7 illustrates the extent of Japan's underperformance during its economy-wide deflation (using GDP deflators). After 25 years, it's barely back to square one.

With deflation raising the real value of debt, and deflation and recession eating into nominal GDP, debt-ratios are blown up. The MoF will now strive to get nominal growth (-0.9%yoy in Q1) back above the long-term interest rate, to borrow without raising the debt ratio. The BoJ may thus be the last to ever stop QE, maintaining the MoF's dependence on it.

Encouragingly, land prices – critical for balance sheets and collateral – are creeping back up, with an average +0.8%yoy since 2016. Having fallen for most of the previous 25 years, it was the common link when the MoF raised the sales tax in 1997 and 2014, requiring the BoJ to compensate as consumption and inflation slumped. Last October's, third tax rise sparked Q4's 1.9%qoq GDP drop. This, together with the demographics crimping productivity and tax revenue, also questions any scaling-back of QE.

For inflation, the spring wage-round (*shunto*) was critical, but obfuscated by virus uncertainty. Major companies (e.g Toyota, Nissan) look reluctant to offer anything perkier than the 2.0-2.4% one-off wage hikes in 2014-19. Sustained wage-growth would probably lift the CPI, given steepness of the Phillips Curve (chart 8), and BoJ research identifying greater long-term wage responsiveness than in the US. Yet, in Japan's liquidity trap, it's doubtful easier money will prove any different, in terms of breaking the deflationary psychology. And, especially with the demand-fillip from hosting the summer Olympics and Paralympics now deferred to 2021.

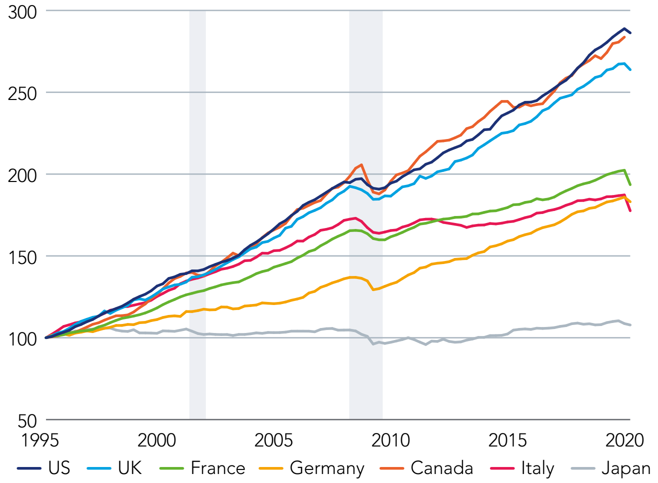
May 2020 consensus projections (p). April's are in parentheses

% yoy unless stated	'15	'16	'17	'18	'19	'20p	'21p
Real GDP	1.3	0.5	2.2	0.3	0.7	-5.5 (-3.3)	2.4 (2.1)
Private consumption	-0.2	-0.3	1.3	0.0	0.2	-6.2 (-3.1)	2.3 (1.9)
Business investment	3.3	-1.5	4.1	2.2	0.7	-8.6	2.7
Industrial production	-1.1	0.2	2.9	1.0	-2.7	-9.0	3.2
Consumer prices	0.8	-0.1	0.5	1.0	0.5	-0.4	0.1
Unemployment rate (%)	3.4	3.1	2.8	2.4	2.4	3.1	3.1
Govt budget balance (% GDP)		-3.4	-2.7	-2.7	-3.6	-8.8	-5.1
Govt gross debt liabilities (% GDP)*					237.4	251.9	247.6
10-year Govt bond yield (yr-end %)		0.0	0.1	0.0	0.0	0.0	-0.1
3-month rate (yr-end, %)		0.1	0.1	0.1	0.1	0.0	0.0

Source: National data, IMF*, & Consensus Economics (May 2020)

Chart 7. GDP levels since Japan has had (economy-wide) deflation

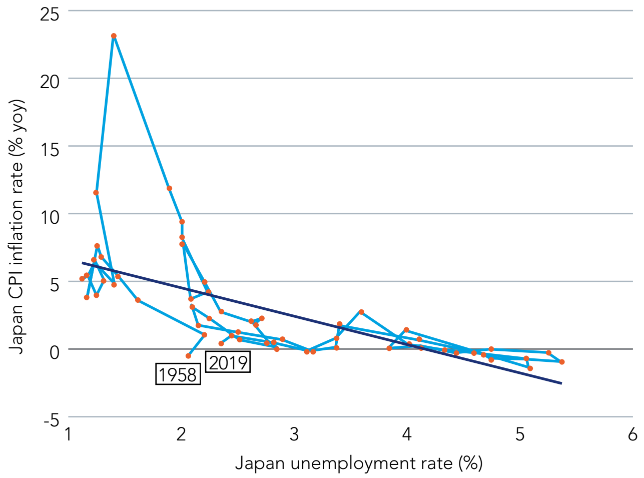
Nominal GDP re-based to Q1 1995 (=100). Grey blocks denote US recessions



Source: Refinitiv Datastream, based on national data

Chart 8. Sustained wage increases *would* probably knock on to the CPI

Shows fitted trade-off between Japan's unemployment rate (%), & CPI inflation (%yoy)



Source: Refinitiv Datastream, based on Ministry of Internal Affairs & Communications data

Euro-zone

With recession, delayed fiscal expansion, and the UK opening the EU trapdoor, the main challenge may be avoiding political contagion, as populism and reform-fatigue build.

The ECB, *"expecting significantly reduced inflation"*, is now running QE at over €100bn per month, up from €20bn pre-virus, and faster than the €80bn during 2015. It also pledges flexibility on issuers' buying limits, though opposition to do more will remain within the Governing Council and Germany's Constitutional Court. QE's effectiveness hinges on capping long rates, and, with two thirds of private borrowing long-end driven, stimulating demand. But, while attacking the symptom, deflation, the solution – securing the economic union that a monetary union demands – needs more. After nine years of austerity, voters' enmity was visible even before the virus. For them, governments need to take back the baton from the ECB, increasingly incentivised by parties offering populist mandates.

Fiscal autonomy within euro-friendly limits…

After lagging the US and UK, the fiscal box is now opening. Further budget amendments in Germany, France, and Italy suggest they'll have to 'stomach' 2020 deficits closer to The European Commission's projected 7.0%, 9.9%, and 11.1% of GDP. These could be 1.5%, 4.0%, and 5.6% in 2021. But, while encouraging, implementation at the EU level will be slower. EU Leaders' €540bn (4.3% of euro-zone GDP) of loan and guarantee recommendations in April are aimed at supporting governments, workers and firms.

But, their accompanying €750bn 'Recovery Fund', targeting grants and loans averaging 2%-of-GNP toward the most affected states, may yet be too controversial to those members (*e.g.* Austria, The Netherlands, Sweden) wary of debt-sharing. In practice, though, struggling, highly-indebted members like Italy and Greece, vulnerable to rising debt-service costs, have especial interest in resisting a *volte face* that destabilises the euro.

Also, it should now be easier for fiscally-prudent Germany to permit some zone-wide fiscal largesse as a counterweight to QE 'conservatism'. Austerity from 2010 sliced the euro-zone's budget deficit from 6.2% of GDP in 2009 to less than 1%: easily below the 3% Maastricht test. Germany's own coalition had been eying a fiscal sweetener (infrastructure, childcare) before Chancellor Merkel steps down by 2021, on top of €54bn of climate-change measures by 2023. If debt-financed (which at negative yield must be attractive), it also helps an ECB nearing its limit of holding no more than a third of Germany's debt (currently 28%). Admittedly, absence of a single fiscal-agency complicates the process. But, if deficits now rise broadly together, it shouldn't preclude autonomy within agreed, euro-friendly limits.

The good news is that competitiveness has been improving, with shortfalls versus Germany reducing. Spain (chart 9) turned painful austerity and bank-support into an improved external position, recording its first full-year surpluses since the mid-1980s. France's competitiveness has seen three phases (chart 10). First, strong gains just after 1992 when the Maastricht tests offered policy discipline. This allowed it in 1999 (with Luxembourg/Finland) to pass them. Then, inside the euro, discipline waned as it did for Greece. And, third, since 2010, austerity and Mr Macron's reforms improved its position.

But, boosting competitiveness via austerity rather than productivity carries economic and social costs. Euro-economies are still too disparate, and future debt-restructurings (*e.g.* Greece) look inevitable. As does the dilemma between minimising debt-costs within the euro, or exiting it to reclaim GDP. Hopefully, a co-ordinated fiscal approach would help restore growth, preserve competitiveness, and avoid *"monetary fragmentation"* (Lagarde, April 2020).

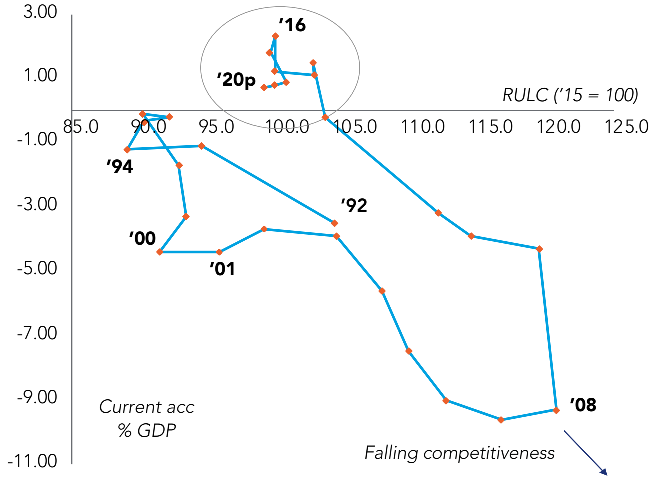
May 2020 consensus projections (p). April's are in parentheses

% yoy unless stated	'15	'16	'17	'18	'19	'20p	'21p
Real GDP	2.0	1.9	2.7	1.9	1.2	-7.9 (-5.7)	6.2 (5.4)
Private consumption	1.8	1.9	1.8	1.4	1.3	-8.3 (-6.3)	6.9 (6.2)
Fixed investment	4.7	3.9	3.7	2.3	5.5	-11.5	7.6
Industrial production	2.6	1.7	3.0	0.7	-1.5	-10.6	9.7
Consumer prices (HICP)	0.2	0.2	1.5	1.8	1.2	0.3	1.1
Unemployment rate (%)	10.9	10.0	9.1	8.2	7.6	9.7	9.2
Govt budget balance (% GDP)		-1.5	-1.0	-0.5	-0.6	-7.8	-3.8
Govt gross debt liabilities (% GDP)*					84.1	97.4	95.6
10-year Germany bond yield (yr-end %)		0.1	0.4	0.2	-0.2	-0.5	-0.3
3-month Euro rate (yr-end, %)		-0.3	-0.3	-0.3	-0.4	-0.4	-0.4

Source: National data, IMF*, & Consensus Economics (May 2020)

Chart 9. Spain (& Italy's) competitiveness has been improving rapidly...

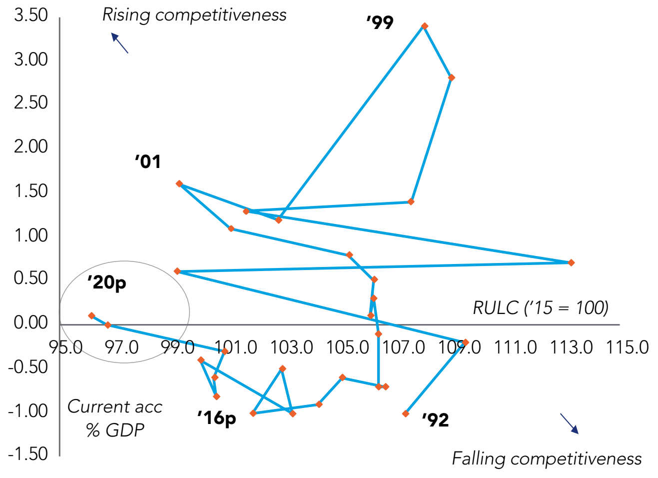
Relative unit labour costs (RULC), vs current account as a % of GDP. Years in bold



Source: Federated Hermes, based on OECD data

Chart 10. And even France has been moving in the right direction

Relative unit labour costs (RULC), vs current account as a % of GDP. Years in bold



Source: Federated Hermes, based on OECD data

United Kingdom

With the biggest GDP-hit since 1709, rates already on the floor, and the fiscal rules now abandoned, the virus lays down at least three challenges to BoE Governor, Bailey: of fanning demand-inflation, trying to ease the distortions from QE, and, given increasing QE and the PM's 'policy-grab', protecting "*...all the time*" BoE independence (Bailey, August 2019).

As a back-up to smooth out market distortions, for example, the Bank's expansion of the Treasury's 'Ways and Means' facility is a logical step, as it was in 2008. But, telling would be if it's extended indefinitely, thus inevitably blurring the operational distinction between the fiscal and monetary authorities as gilt issuance and QE escalate.

The loosest policy-mix, probably post War...

With one foot in recession, the policy reaction has been striking, especially on the fiscal side. Nuance since the Brexit referendum had been a gentle fiscal loosening relative to plans, with a lighter touch in last September's *Spending Review* forewarning the pledge of keeping the structural deficit sub 2% of GDP in 2020/21 would be broken. This was confirmed in Chancellor Sunak's March Budget, inferring a 3% deficit in 2021/22. This had smacked of deferring the bigger sweeteners till the 2024 election, and till Brexit dues are negotiated. But, what's happened since rips up these projections.

Most visibly, the OBR estimates that extension of the 'furloughing' scheme from July to October, even with contributions from firms, could take job-retention costs from £63bn to £84bn (3.9% of GDP). And even if not, taking all virus measures together, their expectation of £118bn extra spending and a £17bn tax-revenue hit in 2020/21 suggests a fiscal outlay of some £123bn (and probably £133bn), assuming the spending itself generates extra revenue of about £13bn. On this basis, the headline deficit balloons to £298bn in 2020/21 (15% of GDP, its highest since 1944) – versus 'just' £55bn (2.4% of GDP) expected in March.

With this in mind, chart 11 maps out the overall policy mix. We use the 'structural' budget deficit here to adjust for one-offs, and give a better guide to government actions (as with the US, page 5). On the monetary side, we estimate the QE-adjusted Bank rate using the BoE staff's 2009 simulations, and our assumption of £400bn QE in 2020, £100bn in 2021. It suggests a *de facto* policy rate as low as -6%, or -8% in real terms, and confirms the loosest stance in three decades of data (probably post-War). There is little correction in 2021.

And, while the US is following the same path (page 5), this offers little sustained upside for sterling when virus effects dissipate and Brexit's cloud lifts. Our analysis suggests that prior to the virus, no major economy since 2000 had loosened policy more, and, given the inflation premium, there's probably little coincidence the pound underperformed other major currencies (chart 12). The MPC will be wary of 'squandering' what ammunition it has, ideally preferring to use QE, rather than more visibly taking Bank rate into negative territory, to avoid hurting banks and re-stoking house prices. But should Brexit prove troublesome, this last resort cannot be ruled out.

Then there's Brexit itself, with clarity needed on whether an extension period will be called by 30 June. Our suspicion remains that the process may take years to ultimately secure a 'satellite' alignment with the EU (*e.g.* Norway) and/or part-access to the Customs Union (Turkey) or Single Market (Canada). And, even if a deal can be fast-tracked, it would likely be a precursor to then sorting out the various legal, trade, and regulatory systems, during a period that could extend way beyond 2020.

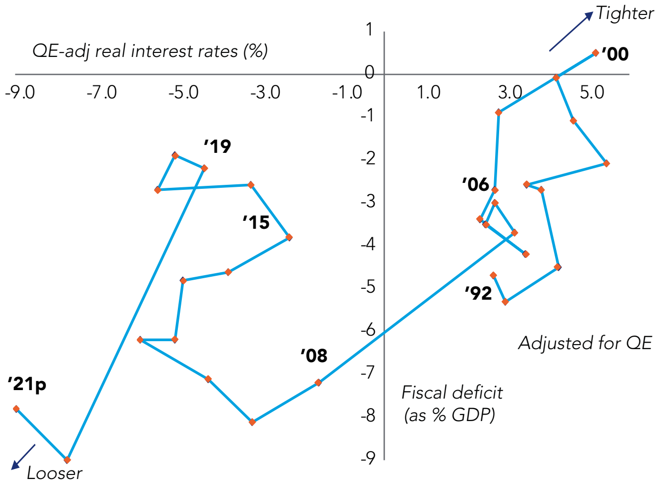
May 2020 consensus projections (p). April's are in parentheses

% yoy unless stated	'15	'16	'17	'18	'19	'20p	'21p
Real GDP	2.4	1.9	1.9	1.3	1.4	-7.9 (-5.4)	6.1 (4.7)
Household consumption	2.9	3.8	2.3	1.6	1.1	-8.5 (-5.8)	6.2 (4.3)
Fixed investment	3.7	3.6	1.6	-0.2	0.6	-14.2	6.3
Manufacturing production	-0.1	0.2	2.3	0.9	-1.5	-9.2	6.3
Consumer prices	0.0	0.7	2.7	2.5	1.8	1.0	1.4
Unemp, ILO rate (3m av, %)	5.4	4.9	4.4	4.1	3.8	7.6	6.7
Govt budget balance (% GDP)		-2.8	-2.7	-1.8	-2.2	-10.6	-6.8
Govt gross debt liabilities (% GDP)*					85.4	95.7	95.8
10-year Govt bond yield (yr-end %)		1.2	1.2	1.3	0.8	0.3	0.6
3-month rate (yr-end, %)		0.4	0.5	0.9	0.8	0.3	0.3

Source: National data, IMF*, & Consensus Economics (May 2020)

Chart 11. The UK's macro policy-mix with emergency measures

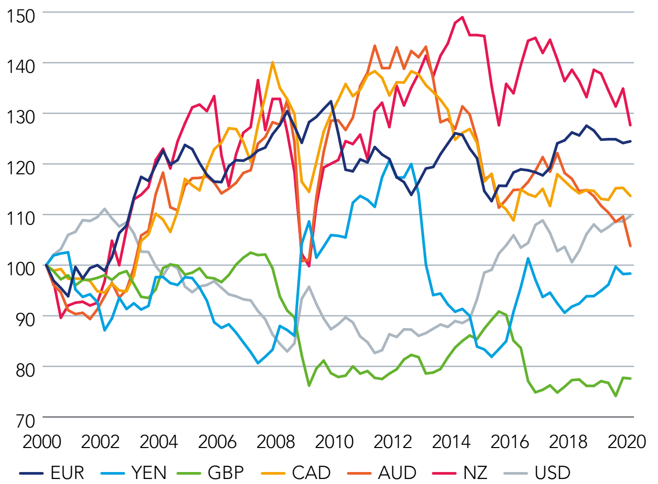
Using QE-adjusted Bank rate, CPI, & cyc-adj fiscal balance as % GDP. Unch rate in 2021



Source: Federated Hermes, based on OBR, OECD, & Bloomberg data

Chart 12. Loose macro policy helps explain the pound's relative weakness

Trade-weighted exchange rates, re-based to Feb 2000 (= 100)



Source: Refinitiv Datastream

China

While remaining vigilant to any second wave from the virus, the main focus is now on accelerating government support, setting new growth targets, and compensating for the ill-winds of beggar-thy-neighbour policies.

Providing both a negative demand and supply-shock, the virus has provided a hit to H1 activity that the authorities will have been loathe to fully acknowledge. Q1's -6.8%yoy GDP – the first fall since 1976's ending of The Cultural Revolution – echoes private, production estimates (chart 13), in a year when GDP-growth of at least 5.5%yoy was needed to double 2010's GDP level and *per capita* income. A core aim since 2015, this is now deferred, with May's abandonment for the first time of an explicit GDP-target. The NPC's +5.4%yoy nominal GDP assumption suggests just +2%yoy real GDP in 2020. Fiscal stimulus is following. And, with inflation (latest 3.7%yoy) edging back toward the PBoC's 3% *"predictive target"* as supply returns, there's more scope for monetary loosening.

Damage limitation for Xi into 2022's Congress…

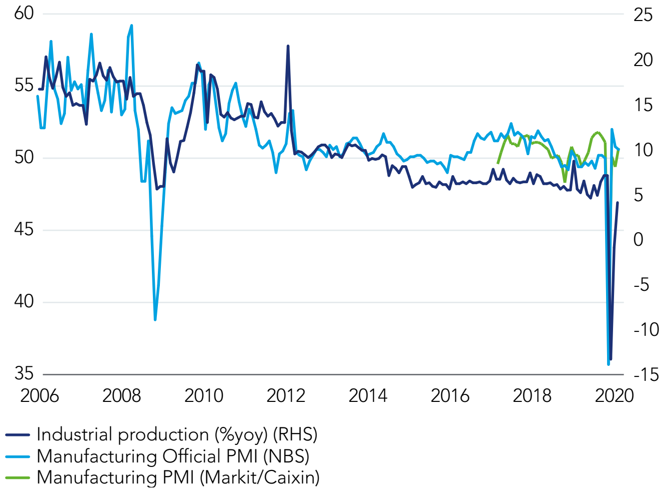
Pro-growth officials support a sizeable shift from the supply-side reforms of 2016-2017. Yet, the key pro-reformers, such as President's Xi's Economic Adviser, Liu, and the PBoC, are limiting the spending stimulus to 3.6% of GDP. Officials believing China is ahead in the pandemic cycle are also wary of repeating 2008's 13%-of GDP (CNY 4trn) 'shock and awe' stimulus, which raised overcapacity and leveraging. Xi's strengthened hand does allow him to address the risks flagged at annual Central Economic Work Conferences, of limiting asset bubbles, taming debt, and managing shadow banking. But, with the economy slowing even pre-virus, as 2017's credit tightening and trade-restrictions fed through (chart 14), bolstering GDP is important.

Onus will thus remain on China's traditional levers for keeping growth close to target, including agricultural subsidies and bringing forward infrastructure projects. But, other measures include direct transfers/subsidies, unemployment insurance, tax reliefs and breaks, as well possibly as banks being 'required' to use their lower reserve-requirements to purchase government Special Treasury Bonds. Fortunately, with GDP averaging +6.1%yoy since 2015, there's some room presentationally to record further virus effects. Though, given the GDP foregone, this reduces scope later for addressing the financial risks, and beefing up the renminbi. During trade tensions, the latter looks remote. The impulse from allowing money rates to fall by 350bp since 2017 has been reinforced by taking 550bp off small banks' reserve requirement ratios. These cuts had looked obvious 'sweeteners' ahead of the US trade talks, but more of the same would give further aid to SMEs again facing an upturn in real borrowing rates (chart 15).

Meanwhile, scope for the 'Phase I' US trade deal to break down and weak prospect of a Phase II deal on industrial policy keep us cautious. China's concessions on IP and pledge to double US goods purchases come as it is slowing. And, should trade tensions escalate, the PBoC will only reluctantly weaken the renminbi, given risks of imploding corporate and banks' balance sheets most exposed to USD debt. Yet, forwards implying an only 4% USD/RMB fall three-years out may be complacent. In which case, currency depreciation, lower reserves, selective defaults, and a lower growth target may prove damage limitation for Xi into the twentieth National Congress in 2022, especially if he can blame them on the US!

Chart 13. China can use traditional levers to pull growth back up…

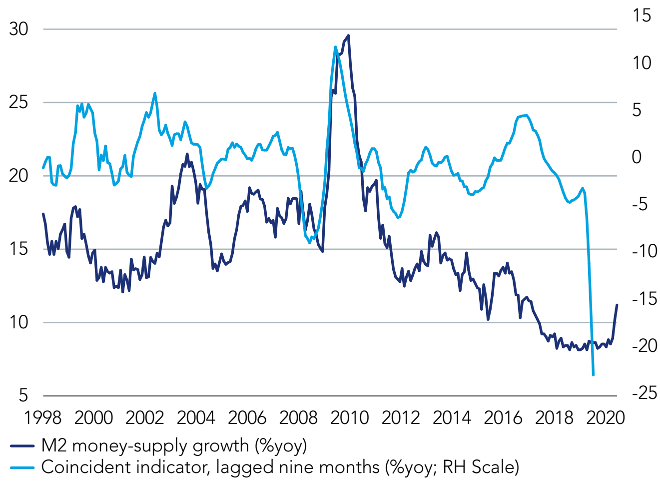
Industrial production data (%yoy), & official/private manu surveys



Source: Refinitiv Datastream, based on NBS, & Markit/Caixin data

Chart 14. And money growth will have to be accelerated again…

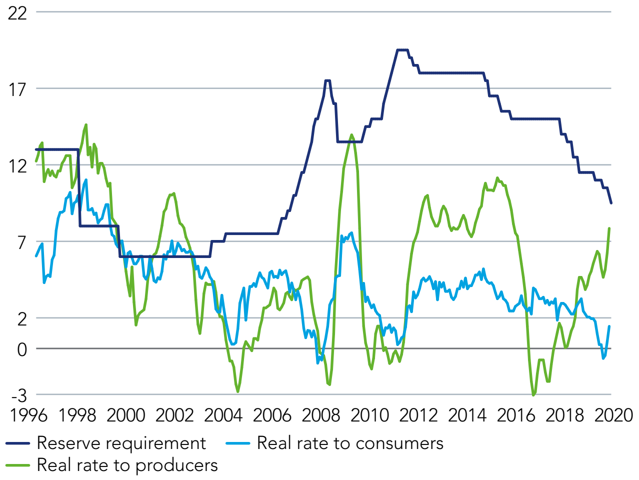
Shows coincident indicator lagged nine months, & M2 money-supply growth (%yoy)



Source: Refinitiv Datastream, based on NBS, & PBoC data

Chart 15. Offering scope for further monetary loosening

China's 3-5yr lending rate deflated by CPI/PPI, vs RRR for small banks (%)



Source: Refinitiv Datastream, based on NBS, & PBoC data

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