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EU CRISIS RESPONSE: FOLLOWING THE UK EXAMPLE?

Berenberg Macro Flash

On both sides of the Atlantic, authorities are scaling up their attempts to slow down the spread of the corona virus. In a way, it is bad news that the US sees a need to ban all travel from Europe (except the UK) into the US for 30 days and that Italy is hardening its lockdown rules further with widespread shop closures. But that authorities are trying to slow down the spread of the virus with unusual, if sometimes crude, measures also contains a kernel of good news: they are taking the issue very seriously. Despite near-term disruptions, slowing down the rise of Covid-19 cases would be worth a lot. Ultimately the course which the disease takes will matter more for the global economy and markets than any monetary and fiscal action.

Macroeconomic crisis response: UK sets an example
The UK set an example yesterday. Its three-pronged response to the Covid-19 pandemic with a 50bp rate cut, a fiscal stimulus of c1.3% of GDP and a cut in the capital requirements for banks that may allow them to raise lending by up to £190 billion is impressive even if some aspects raise concerns about the UK's longer-term fiscal outlook.

Other countries in Europe will not fully copy the UK example. But the newsflow and some interactions with officials in Europe suggest to me that relevant policy makers and regulatory authorities in Brussels and Frankfurt and EU member states are not just on high alert. They will (continue to) take initiatives on all relevant policy fields to contain the damage from the medical emergency. By and large, they strike me as well informed and ready to talk to each other. They are considering various scenarios and seem to be receptive to ideas, including out-of-the box thinking.

The pandemic is dealing a severe external shock to all member states, even if currently to different degrees. As a result, the usual "frugal North versus spendthrift South" or other clichés mar the discussions within the EU and the Eurozone less than usual. This is one of the many ways in which the situation differs somewhat from that in the post-Lehman financial crisis and very much from the euro debt crisis of 2011/2012. We are not facing a replay of those crises.

As in the UK, we look for significant (further) EU/Eurozone action in all three areas, monetary easing, fiscal damage control and regulatory adjustment.

Monetary policy
We expect the ECB to announce a substantial package today. The package will likely include a cut in the deposit rate, a more generous tiering system for bank deposits at the ECB, additional asset purchases focused on corporate bonds and liquidity injections designed to incentivise banks to provide more loans especially to small and medium-sized enterprises.

Fiscal policy

The fiscal response at the EU and national level will serve three distinct purposes:

1. Countries can and will spend whatever it takes to tackle the medical emergency.
2. They will take targeted steps to strengthen their usually quite powerful automatic stabilisers, ease cash-flow problems of enterprises and limit the number of dismissals and bankruptcies.
3. National and EU packages will also include genuine discretionary fiscal stimuli to raise aggregate demand. But this support for aggregate demand will be smaller than in the US and UK.

Although the EU level will act as well (think of the €25bn which the European Commission pledged on Tuesday), most of the fiscal initiatives will be on the national level. The EU helps by allowing countries to "make full use of the flexibility" of fiscal rules and by setting aside its usual reservations against state aid to companies in need.

All in all, the panoply of fiscal measures will be less headline-grabbing than in the UK and – probably – the US. As a rough guess for the Eurozone, the total discretionary fiscal stimulus may reach c0.5% of GDP this year. However, combined with the effects of the automatic stabilisers which are stronger than in the US, the overall contribution to aggregate demand will probably be at least two thirds of what we see in the UK and expect for the US. In practice, the difference may be even smaller than that. In terms of their impact on consumer confidence, the automatic stabilisers and the modest but targeted measures to ease cash flow problems and limit dismissals and bankruptcies tend to be highly effective. Additional discretionary fiscal stimulus spending, which will probably account for much of the difference between the US/UK and the mostly smaller EU/Eurozone fiscal responses, often kicks in only with a lag and may thus be felt only once the crisis is over.

Regulatory changes

Financial regulations can have a damaging pro-cyclical effect by forcing banks to be more stingy in risky times, for instance through a need to set more capital aside when default rates are rising and ratings for assets are falling in an economic downturn. On the microeconomic level, it makes sense for each individual bank to be extra cautious in a crisis, and for regulators to force them to do so. However, such behaviour by the financial sector as a whole can make an economic crisis worse.

I expect a temporary relaxation of capital requirements and/or an easing of other regulations to make it easier for banks to keep up the flow of credit to companies. Most of this will probably come from the EU/Eurozone level, some of it may be on the national level, for instance in the realm of macro-prudential tools. As suggested by a Reuters report yesterday, bank supervisors may outline some key elements of their actual (or) potential crisis response right after the ECB's monetary policy decision today.

Not the circuit breakers
None of these potential shock absorbers can fix the underlying medical emergency. As the reaction to yesterday's UK measures has shown once again, economic tools are not the ultimate circuit breaker in a crisis that reflects a medical emergency. But the judicious use of these instruments can limit second-round effects and see to it that, once the medical outlook has become clearer, economies are in a better position to recover from the current severe shock to supply and demand.

The tool box is not empty
The discussion above refers to the likely EU/Eurozone policy response to roughly the current state of affairs. If the pandemic and the resulting economic damage develop largely in line with our base case scenario, namely that it will get worse though April but start to improve at some time in May, this will largely be it. By now, this base case is probably close to a best-case scenario, though.

In a hypothetical bad case scenario with worsening damage instead of some recovery in the second half of this year, policy would likely react more forcefully. Over time, current taboos could then be breached. More extreme policy responses could potentially include:
- ECB purchases of equities in the form of exchange traded funds;
- a serious increase in issuer limits for its bond purchases; and
- injections of public money into a significant number of non-financial (and financial) companies to keep them going.

For now, we need to watch the spread of the virus to see to what extent our base case may or may not unfold. Near-term, the risks remain tilted to the downside.

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