Economics

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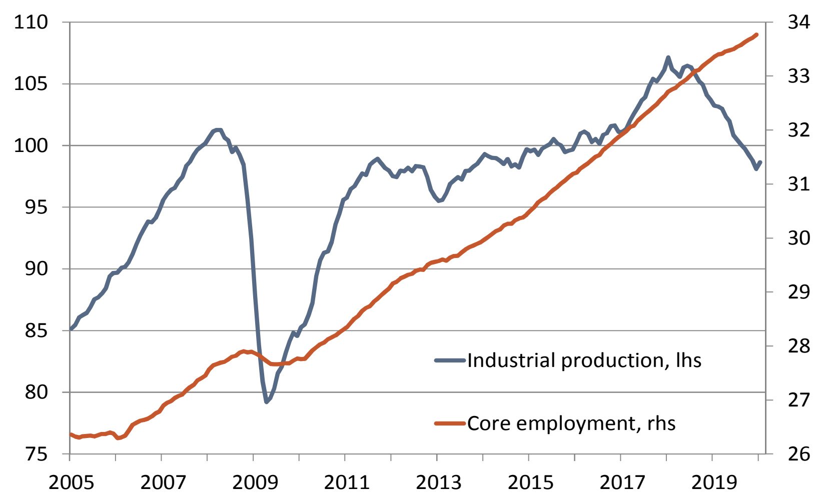
Coronavirus and oil: the policy reactions to the big shocks

- **The virus shock is huge – but the shock absorbers will need time to work:** Unlike some direct support measures, key macroeconomic shock absorbers work only with a lag. They can take effect only once we have more clarity about the underlying medical emergency. For markets, confidence and ultimately economic activity to turn up again, we will need clear evidence that the spread of the virus is being held back sufficiently to allow health systems to cope. The **near-term risks are heavily tilted to the downside**. Italy's decision last night to extend the Lombardy semi-lockdown to the entire country highlights these risks. Only if and when the shock recedes, possibly in late Q2 2020, can the delayed impact of the absorbers support demand. A rebound once lockdowns are eased will then help.
- **Shock absorber one – targeted liquidity support:** Plunging demand and interrupted supply chains can cause severe cash-flow problems for companies. Targeted measures to prevent companies and jobs from falling victim to such squeezes should be a top priority to forestall damaging second-round effects. A number of governments, including those of Italy, Germany and the UK, are now introducing or strengthening such programmes.
- **Shock absorber two – direct labour market support:** Targeted support for temporary underemployment on the job can limit the number of dismissals, even in a sharp downturn. Partly due to Germany's "Kurzarbeitergeld" subsidy for reduced working hours, German employment fell only slightly despite a record plunge in output in early 2009 (see chart). Germany is now making it easier to access this scheme. Other countries should follow.
- **Shock absorber three – monetary policy:** Liquidity injections to relieve financial stress and support bank lending to corporates can limit second-round effects. Rate cuts and assets purchases can limit market routs and stimulate demand once the virus shock has started to fade. After the 50bp Fed cut of 3 March, we expect a serious easing package from the European Central Bank on 12 March, a 50bp Bank of England cut in March and a new Fed cut by 50bp on 18 March, followed by another 25bp Fed move in Q2. If need be, the European Stability Mechanism and the ECB would have the tools to address negative feedback loops between banks and sovereigns.
- **Shock absorber four – fiscal policy:** Most advanced countries are easing fiscal policy. We expect the **UK** to announce a stimulus of c1.0% of GDP at its 11 March budget. **Germany** looks set to raise its slow-motion stimulus from 0.4% to c0.6% for 2020. The medical emergency gives countries including **Italy** space to raise spending and offer targeted relief to stricken companies and households. The plunge in most **sovereign bond yields** lowers financing costs for many economies and enhances the fiscal space of many governments. We also expect the **US** Congress to set partisan politics aside for once and pass a substantial fiscal package soon.
- **Shock absorber five – the oil price:** As in a J-curve, the immediate negative impact of lower oil prices on energy sector investment and corporate bond spreads shapes first market reactions. However, as in 2016, the positive impact on real consumer incomes will be more powerful in the end. Households will have more money to spend once confidence stabilises. A sustained oil price drop by €10 per barrel would reduce headline inflation by c0.3ppt within two months across much of Europe, adding to real incomes and spending power by the same magnitude. Lower oil prices also give the central banks more room to ease. That mitigates credit risks. The Fed and other agencies would act decisively if a limited debt shake-out threatened to morph into a big macroeconomic calamity.

The German example: how to shield workers and consumers from output shocks



Three-month moving average for industrial output index ex construction, core employment not subject to payroll taxes, in million, right-hand scale. Sources: Destatis, Bundesbank

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