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LOOKING FOR A CIRCUIT BREAKER

Berenberg Macro Flash

PANDEMIC UPDATE

- **Spread of the virus:** Confirmed infections continue to surge on both sides of the Atlantic, up 82% to 65k in Europe and 178% to 4.7k in the US since 14 March according to Johns Hopkins University data this morning. The situation in China remains stable with just one confirmed new local infection on Monday beyond 20 involving travellers from abroad.
- **Going Chinese:** Ever more countries are imposing ever harsher lockdowns. For example, French citizens have been told to stay indoors for at least 15 days except for most essential trips. As the harsher lockdown measures are only kicking in now, it may – perhaps - take two weeks to see whether they suffice to slow down the advance of Sars-Cov-2.
- **Policy response: more "whatever it takes".** Eurozone finance ministers last night pledged an "unlimited commitment" to contain the economic damage and restore confidence. EU fiscal rules are de facto being suspended for this purpose with a pledge to "make full use of the flexibility (of the rules) in all member states". If the situation worsens, we would not be surprised if the Eurozone decided to extend ESM credit lines to weaker members. If so, this could potentially even bring the ECB's OMT programme into play, that is the original "whatever it takes" programme.
- **An extreme emergency continues to meet an unprecedented policy response** (see Virus pandemic: the macro essentials). The risks to our calls for a 3.5% drop in Eurozone and a 2% decline in UK GDP in 2020 are heavily tilted to the downside.

LOOKING FOR A CIRCUIT BREAKER

The ongoing rout in equity markets raises an obvious question: what could break the circuit? Unfortunately, monetary or fiscal policy are less suited to break the circuit in a crisis of the real economy that stems from medical emergency than in a financial crisis. The pandemic and the lockdowns to contain it are delivering a shock to the real economy on a scale that seems unprecedented in peacetime. Because of the unknown trajectory of the virus, with case numbers surging and lockdowns being tightened, it may be more difficult than during a financial crisis to deliver a policy announcement so stunning that it would restore market confidence and put an end to the equity bear market.

Of course, a hypothetical central bank promise to buy almost unlimited amounts of equities and thus turn itself into a potential majority owner of a country's productive capital could end the equity selloff. But we do not expect policy makers to go for this hypothetical variant of "whatever it takes“ (see below).

However, monetary and fiscal policy, combined with regulatory adjustments, are capable of preventing a genuine financial crisis that could otherwise exacerbate the Covid-19 emergency, in our view. Policymakers across most of the world have taken big steps already, and are ready to do more. We doubt that one particular announcement of measures will have the immediate positive jolt to confidence to turn equity markets around for good. But as the measures accumulate to a scale that is probably as unprecedented in peacetime as the current shock to the real economy, chances are that these measures will also impress equity markets eventually. At some – not quite foreseeable - point in time, enough market participants should start to act on a conviction that – at the depressed market levels – the sum of all measures will indeed suffice to stop the rot.

Fiscal policy
By its very nature, fiscal policy is restricted in how it can react in a crisis. Parliaments can approve huge expenditures but they cannot simply print money. They cannot credibly promise a Draghi-style "whatever it takes" approach. In January 2009, a huge US fiscal stimulus helped significantly. But it took the Fed's promise to massively expand its balance sheet through bond purchases to end the post-Lehman debacle for good. No fiscal support programme for the euro-periphery stopped the euro crisis. Only Mario Draghi's famous words did so in 2012.

Upon dealing with the fallout from the Sars-Cov-2 shock to the real economy, the key task of fiscal policy is not to cut taxes or raise spending in order to bolster demand in a run-of-the mill stimulus programme. Instead, policy needs to intervene where a temporary shortfall of revenues could otherwise cause widespread job losses and bankruptcies. Targeted subsidies, tax deferrals, credit and credit guarantees are the instruments of choice to ease liquidity crunches and prevent dismissals of currently underemployed people. In terms of the overall sums involved, the more targeted approach will probably amount to a bigger 'stimulus' than the typical fiscal injections from tax cuts or investment spending did during a previous recession. Step-by-step, ever more countries are going down that route. While the judicious use of these tools can make the recession less bad than it otherwise would be, it may take a bit of time for such measures to add up to enough to sufficiently impress markets.

Monetary policy
Monetary policy is very powerful. However, monetary policy as we know it works through the financial system. It shies away from funding households and companies directly and from buying junk bonds. Standard monetary policies cannot save a liquidity-starved company from bankruptcy if that company has lost access to funding markets. Fiscal policy can prevent many bankruptcies, though. In this sense, we think that governments can do more than central banks to tackle the current crisis. Fiscal actions may need to be underpinned by monetary policy, for example through further purchases of public bonds.

Central banks still have a key role to play in order to contain the damage und underpin a subsequent recovery. First and foremost, they need to provide a huge liquidity backstop so that the unavoidable shock to the real economy from coronavirus is not deepened by an escalating liquidity crisis. For most healthy companies, their long run outlook for revenues may now be well above their highly discounted share prices or rising cost of debt. A market participant with a long run view should be buying such value stocks. But amid the current uncertainty and the severe near-term risks, taking such a long view does not come easy.

Central banks know how to stop the financial stress that can result from such a short-term focus on risks. With their huge liquidity injections, additional bond purchases, US dollar swaplines and other measures, central banks have already taken key steps to combat potential financial stress. By and large, we expect them to prevent financial stress from reaching proportions that could severely damage the economy on top of the severe hit from the virus and the measures to contain it.

Equity purchases by central banks?
The hurdles for such a hypothetical action would be high:

- Unlike bond and money markets, equity markets are not a prime channel to transmit monetary policy to the real economy.
- In the Eurozone, equity wealth effects play a smaller role than in the US and UK.
- Unlike the stability of the financial system at large, the stability of equity markets is not a first-order concern for central banks, although it does matter through the potential impact of unhinged equity

markets on the stability of the financial system and the overall economy. Central banks have other means to inject liquidity and underpin financial stability than buying equities.

- The politics of buying massive bundles of equities (exchange traded funds) could be difficult. "Bailing out equity markets" could be at least as unpopular as "bailing out the banks" was in the 2008/2009 financial crisis and the subsequent 2011/2012 euro crisis.

To a large extent, buying equities would be the equivalent to treating the symptom rather than its cause. If policymakers can put to bed the fears that a developing cash-flow crunch would turn into a credit crunch, equity markets will likely reward that eventually. For a discussion of credit crunch risks, see crisis basic: preventing a credit crunch.

As discussed before, we would not rule out Japan-style purchases of equity bundles by the ECB completely. But it would likely be a last resort. More likely, in a worsening crisis, the ECB could make it easy for national governments to inject liquidity or capital into companies through national investment funds financed by bonds which the ECB could buy on the secondary market.

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