Credit Guarantee Feedback Loop

51 – 22 June 2020

Key points

- The gap between the US and Europe on the pandemic front is getting wider – the US responds to market wobbles by more stimulus announcements.
- We explore the "feedback loop" between state guarantees to business loans and fiscal policy

The gap between the US and Europe on the pandemic front is becoming wider. True, large clusters continue to be discovered in the Euro area and the jump in the virus reproduction ratio in Germany calls for attention, but overall the decelerating trend continues. In the US the re-acceleration is spreading further. While the reluctance of political authorities to delay the re-opening of the US economy is crystal-clear, focus may shift from "top down" directives to decentralized decisions by businesses and behavioral changes by consumers.

Still, so far, every market wobble has been met by more policy support – we had another example last week with the Fed effectively moving to secondary market intervention for corporate bonds or the US administration mentioning yet another fiscal stimulus. In Europe policy-makers continue to show more restraint, but the success of the new TLTRO is a reminder of the extraordinary quantum of support provided by the ECB.

Government guarantees on business loans contributed to this success: state support has incentivized banks to lend a lot since the beginning of the pandemic, helping them to qualify for the most favourable conditions of the TLTRO. Still, even if we believe that pledging the governments' balance sheet was the right thing to do in the emergency to ensure businesses could survive, the medium-term consequences of those guarantees need to be explored. In the Euro area, a 1% decline in GDP generally results in a 6% rise in the non-performing loans ratio. Some of these guarantees will be triggered, complicating the already thorny public debt trajectory of some of the member states, in particular Italy given the high starting point for NPLs there. Still, we think this has created a situation in which "ordinary" fiscal policy will be constrained to remain accommodative as long as the guarantees are "live". Indeed, some of the benefit to public debt of converting to fiscal austerity could easily be lost to the resulting rise in non-performing loans the ensuing slowdown in growth would trigger.

Incentivising businesses to take more debt is no perfect substitute to traditional fiscal stimulus. On the EU's Recovery and Resilience Fund's front the "frugals" may be shifting to grudgingly accepting the principle of transfers, but focus is now on the allocation key and this could delay the finalization of the project even if a generic political agreement in July looks doable.

Covid contrast

The divergence between Europe and the United States on the pandemic front continues. In the latter, the number of states facing an acceleration in the propagation of the virus rose further (Exhibit 1), with California now very close to join this group on a seven-day basis. At the end of last week, the highest daily cases count since the start of the pandemic had been hit in 12 states. In Texas hospitalisations hit a new record at 3,409 on 21 June, more than twice the level seen at trough in late May.

Meanwhile, in Europe, while some clusters continue to appear, the speed of the epidemic is still markedly lower than when authorities considered it was safe to start re-opening the economy (Exhibit 2). There is no clear direction in the weekly fluctuations which would indicate a general re-acceleration, even from the currently low levels. In Germany the "reproduction rate" has risen a lot on 21 June (from 1.79 to 2.88) but at his stage this still seems to be a reflection of localised clusters triggering systematic "tracking and tracing". The UK continues to lag the continent in getting the pandemic under control but there as well progress is tangible.

Exhibit 1 – Covid re-acceleration is spreading in the US

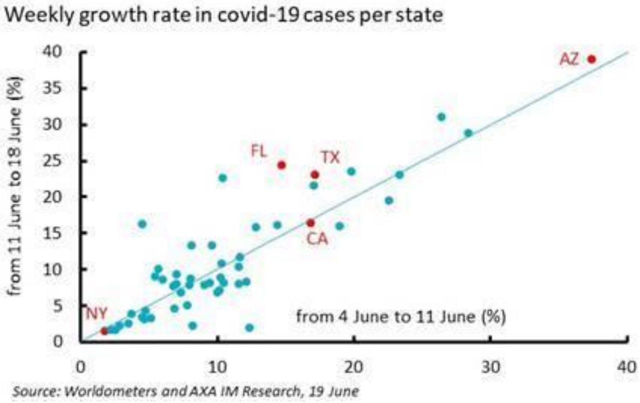


Exhibit 2 – Europe still not showing signs of relapse

Developments in the US (and to a much higher degree in Latin America) suggest that **we could look at the profile of the pandemic a bit differently than a month ago.** Then the consensus view was firmly that every country would be heading – with some lags – towards at least a pause in the pandemic in Q3. Focus was more on the risk of a "second wave" next winter. A risk now is that the re-opening in Q3 could be slower or less comprehensive than expected.

The reluctance of political authorities in the US to re-engage in severe lockdowns remained crystal clear last week again. Even in California where local authorities had been quick to impose a lockdown at the beginning of the pandemic, the Governor for now is reacting to the latest figures by calling for measures which have a limited impact on economic activity, such as mask-wearing. Still, what **may be at stake right now is less the "top down" directives and more the sum of decentralised decisions by businesses and behavioural changes by consumers.**

The equity market reacted on Friday afternoon to the announcement by Apple that it was closing its stores again in 11 locations in the south and west of the US. Local newspapers report more restaurants choosing to close again in Texas despite the further relaxation in the rules over the last week. While the market recently has started to pay more attention to "traditional" economic data again, saluting for instance some spectacular – albeit purely mechanical in our view – rebounds in retail sales, we suspect "real time" data will take the lead again in the next few weeks. **Restaurant bookings may be an interesting gauge of the reaction to the US relapse**. It is not easy to distinguish the noise from the signal over short periods of time, but in Dallas and Miami the normalisation seems to have paused in the last few days (Exhibit 3).

Even if the damage to the "mechanical" economic rebound is limited as long as no return to severe lockdown is underway in the US, and Europe still looks safe, the deterioration of the pandemic news flow would still matter, since this would impair business confidence and in particular the resumption of investment programmes.

For now, policymakers have always been able to respond to market wobbles triggered by bad news on the pandemic front by providing further support. For instance, last Monday the Federal Reserve (Fed) announcement that it would start intervening on the secondary market for corporate bonds provided the market with another "sugar rush". In truth such scheme had already been pre-announced in the 23 March package, but some investors might have feared that the Fed would be content with its approach so far (supporting the corporate bond market indirectly by purchasing Exchange Traded Funds). A news release from Bloomberg according to which the Trump administration was working on a USD1tn fiscal stimulus plan focused on infrastructure investment – thus providing more long-term support than the current emergency response – also helped.

Exhibit 3 – Watch this space for consumer behaviour

For now, the US fiscal response to the pandemic crisis is akin to "carpet bombing" while Europe's has been more restrained. The debate on "transfers versus loans" which is so central to the design of the EU's "federal" fiscal package should also start on the national measures. Indeed, as we highlighted last week already, governments in EU member states have been much more forceful on helping businesses deal with the crisis by taking more debt than with more traditional forms of stimulus.

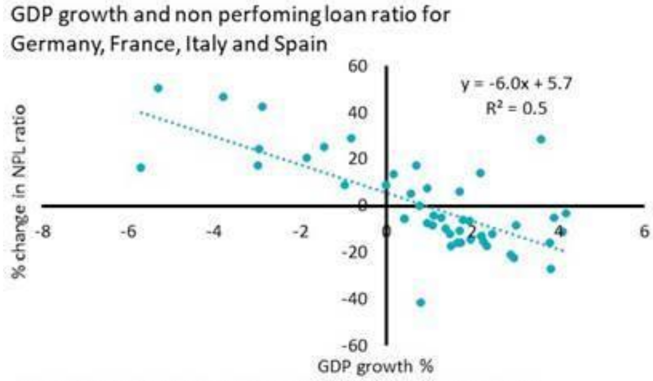
The credit guarantee feedback loop

The European Central Bank (ECB)'s new **targeted longer-term refinancing operation (TLTRO) was a success last week, with a net take-up of c. EUR550bn (when considering previous operations winding down).** The figure suggests that the take-up was not confined to the liquidity-poor banks in the periphery but that many credit institutions in core countries also took part. There is definitely no stigma attached to tapping this facility, which is good news. The ECB had decided on 30 April to bring forward to 1 March from 1 April the reference for the starting level of credit to businesses which would determine whether banks would secure the most favourable interest rate on their TLTRO borrowing (-1.0%). This ensures that the record-high flows of loans originated in March by banks will count towards their compliance with the benchmark.

The governments' guarantees on emergency loans were instrumental in allowing credit supply to respond to the unprecedented rise in demand stemming from businesses facing the disappearance of their cash flows. This was a necessary step at the trough in economic activity, but we also need to explore the medium-term consequences for the governments' financial position. We think **this has created a situation in which "ordinary" fiscal policy will be constrained to remain accommodative as long as the guarantees are "live". Indeed, some of the benefit to public debt of converting to fiscal austerity could easily be lost to the resulting rise in non-performing loans.**

Good, granular and comparable data on non-performing loans over a long enough period of time to estimate models do not come by easily. The ECB has started collecting and harmonising data on this since it took over banking supervision, but so far, they have not provided "back data" for the period before 2014. We used the International Monetary Fund (IMF) dataset. It is quite imprecise – there is no breakdown across sectors – but it is enough to provide a plausible order of magnitude. After taking out the 2009 point for Spain from the sample – the non-performing loan (NPL) ratio rose by more than 200% that year on the back of the housing crisis there – the correlation with GDP growth is strong. **A 1% decline in GDP would lift the NPL ratio by 6%** (Exhibit 4). This is in line with the more comprehensive analysis conducted by the ECB in 2013[1] which did not isolate the Euro area countries in their sample (they found an elasticity of 5).

Exhibit 4 – Strong sensitivity of the NPL ratio to GDP growth



Source: International Monetary Fund, Eurostat and AXA IM Research, June 2020

If we apply this elasticity to our GDP forecasts for 2020, the NPL ratio would then rise by between 30% and 50% across the four largest economies of the Euro area in 2020. Of course, since the elasticity is calculated as a percentage change, the starting point matters. The December 2018 NPL ratio stood at only 1.2% in Germany, 2.8% in France and 3.7% in Spain, which would probably make the expected rise in NPL triggered by the ongoing recession "problematic but manageable" in these countries. **But Italy would find itself in a difficult position, with an NPL ratio rising to 13.1% from the already high 8.5% of 2018.** Assuming the same proportion of delinquency rate is observed on the emergency loans covered by the state guarantee scheme, the Italian government could see its deficit rise by another 2.5% of GDP were the entirety of the envelope to be used (EUR450bn, i.e. 25% of GDP) with an average guarantee rate of 80%.

What would happen if post-covid the Italian government chose to embark on a fiscal austerity strategy to stabilize its public debt trajectory? In the current circumstances, a multiplier of 0.7 looks reasonable (a fiscal tightening of 1% of GDP reduces GDP by 0.7%). Accordingly, erasing the discretionary push of 2020 could lower the Italian GDP by 3.5% relative to a neutral policy stance trajectory. This would be spread across several years, but using again the same elasticity, cumulatively the NPL ratio would then rise further by some 20%, potentially adding another 1.5% of GDP to the Italian public deficit through the guarantee system.

Parameters and take-up of loan guarantee schemes across euro area countries

		Germany	France	Italy	Spain
Size of guarantee	€ billions	822	300	450	100
	% of 2019 GDP	23.9	12.4	25.2	8.0
	% of bank assets	9.9	3.2	12.1	3.7
	% of NFC loans (stock)	86.0	28.4	71.3	23.0
Loans approved	€ billions	47.8	101.1	13.1	69.0
	% of NFC loans (stock)	5.0	9.6	2.1	15.9
	% of envelope	5.8	33.7	2.9	69.0

Source: ECB Financial Stability Review, KFW, ICO, MISE, Bank of Italy, French Ministry of finance and the economy and AXA IM Research, June 2020

This would be another channel through which a post-covid fiscal consolidation could ultimately prove self-defeating. The immediate cost to growth would, as usual, offset some of the improvement in the discretionary component of the deficit since the cyclical component would deteriorate because of the economic slowdown but this time the rise in loan delinquency would add another source of "leakage" to the fiscal consolidation plan through the guarantee mechanism.

[1] See "Non-performing loans What matters in addition to the economic cycle?", Roland Beck et alii, ECB Working Paper # 1515.

The maths is straightforward. Relative to a no policy change scenario, a discretionary fiscal tightening of 5% of GDP, taking the form of tax hikes or spending cuts, would lift the *cyclical* component of the deficit by 1.75% of GDP (a 0.5 elasticity of current tax receipts/spending to GDP is very robust across European member states). With the loan guarantees adding another 1.5% of GDP to the government's bill, this means that **two thirds of the initial fiscal consolidation effort would be lost.**

We would be back to the same unhealthy spirals of the sovereign crisis. Then, the main cause of "leakage" was the level of interest rates. Markets imposing a high-risk premium on the peripheral countries' funding costs compounded the impact of fiscal austerity to trigger a double-dip recession which nullified the fiscal consolidation efforts. The ECB's massive support this time has insured us against that risk, but the loan guarantees add another hurdle to the fiscal trajectory of the most fragile states.

Guarantees may not be enough to lift credit origination

Of course, there are technical limits to our approach. The starting point of the NPL ratio reflects a stock of delinquent loans "at the point of observation" but these loans may have been originated a long time ago, at a high interest rate. So, **it may be wrong to assume that the same proportion of the new "emergency loans" – coming with concessionary interest rates – will turn delinquent. Still, the behaviour of banks in Italy would suggest that they are themselves expecting a high delinquency rate.** The take-up of these loans has been remarkably slower in Italy than in the other Euro area countries. This may reflect the fact that traditionally Italian businesses operate with a high level of cash buffers (cash at hand is equivalent to 75% of annual labour costs), but it is the case in France as well and there the take-up has been significantly higher.

If the entirety of the package is effectively originated, this would be equivalent to 71% of the current stock of loans to businesses in Italy. The level of guarantee provided by the state is high, but assuming an average of 80% (depending on the size of the loans it ranges between 70% and 100%), with a 13% delinquency rate banks would still be on the hook for the equivalent of 1.8% of their business loan portfolio. One would understand their appetite to lend more may be limited, especially since the capacity to "offload" the NPL out of their balance sheet by sales to specialised funds would probably be low in an environment defined by the pandemic-related uncertainty. We will monitor closely the data for credit origination in May to be released by the ECB this week to see if Italy is catching up with the other countries.

In a nutshell, where businesses were already very fragile pre-crisis and the banking sector under stress, governments are left with **an unpleasant choice: either bring the guarantees to 100% to incentivize banks to lend more, at the cost of a higher risk to their own debt sustainability conditions, or accept a low take-up of the scheme, with more cash flow pressure in the business sector**. The current discussions on established a specific "bad bank" to warehouse the loans turned delinquent because of the pandemic are welcome, but to effectively address the contagion effect on public debt dynamic in the most fragile states, some measure of mutualisation of any public guarantee at the European level would be necessary.

In any case, while we firmly believe those guarantees were the right thing to do at the worst of the pandemic shock, they cannot be perfect substitutes to "proper stimulus". Moreover, the feedback loop between those guarantees, growth and the fiscal stance in Italy is another strong argument in favour of a rapid implementation of the European Commission's "Next Generation" initiative.

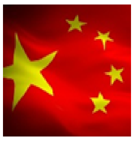
"Recovery Fund": let the haggling start

As expected, no decision was made at the EU council meeting last week on the Commission's "Recovery and Resilience Fund" but it clearly was on everyone's mind. Reassuringly, Angela Merkel's statement confirms that she is still on the same wavelength as Emmanuel Macron on the issue and that she is – uncharacteristically – ready to dramatize it, highlighting the depth of the crisis and the need for a swift EU-wide response. Meanwhile, the "frugal four" seem to be moving the goal posts. While the Swedish Prime Minister in a letter to the Financial Times at the beginning of the week was still re-stating the group's preference for loans over transfers ("*when we borrow money* *together in the EU, the fundamentally sound way to use that money is to convert it into loans for those who really need them*”), **Austrian Chancellor Kurz and Dutch Prime Minister Rutte have focused in their latest statements on the issue on the calculation of the allocation key**, as well as on macroeconomic conditionality.

In our first assessment of the Commission’s proposal in Macrocast #48, we made the point that the allocation key was more consistent with a giant “cohesion fund” fostering convergence across structurally unequal member states in the medium term than with a “quick response” fund geared towards the countries which are suffering the most from the economic consequences of the Covid crisis. Indeed, allocation would depend on each country’s share in the EU’s total population, controlled for the relative level of its GDP per head (countries with GDP/head above the EU average would receive less money) and for the relative level of unemployment (countries with an unemployment rate above the EU average, over 2015-2019, would receive more money). **By focusing on the allocation issue while opening the door to accepting more grants than loans, the “frugals” can find allies.**

Ireland expressed its unease with the allocation put forward by the Commission. It is understandable. This country has been badly hit by the Covid crisis, having reacted with an early and severe lockdown. However, under the Commission’s proposal it would become a victim of its own success in dealing successfully with the sovereign crisis in the previous decade, having rebounded nicely and taken its unemployment rate below 5% before the pandemic hit. In the current version of the allocation key, Ireland would a net payer into the Recovery and Resilience Fund to the tune of 4.5% of its GDP, a significant burden for a country which is facing a specific “hard Brexit” risk at the beginning of 2021 given its exposure to the British market.

The debate may well move away from “first principles” towards apparently technical, but in reality, very political issues. This would be consistent with a general agreement reached in July, but with many thorny details still left to negotiations, which would further delay actual disbursements in 2021.

Country/Region	What we focused on last week	What we will focus on this week
	• Number of virus cases begins to rise in US, Texas and Florida particularly worrying • Retail sales posts 17.7% rebound in May • Industrial production posts only 1.4% rise • Empire and Philadelphia Fed survey beat expectations in June, Philly to near 2-yr high • Fed Chair Powell warns of uncertain outlook	• Virus path in southern US • May's consumer spending in wake of solid retail sales bounce, more cautious rise likely • May's home sales for recovery in housing • Q1 GDP revisions • PCE inflation estimates for May
	• Strong net take-up by banks of €548bn at the TLTRO III.4 operation • INSEE is expecting a -17%qoq growth in Q2, with activity improving to -12% below normal in June, vs. -22% in May and -29% in April • German ZEW further increased, Banque de France retail sales were up 50%mom in May	• PMI, German IFO to further rebound in June • ECB minutes to shed some light on the discussion on the inflation outlook, in particular deteriorating medium term inflation expectations • M3 and lending data to show solid growth, watch out for Italian lending to NFCs
	• The BoE raised QE by £100bn in June. It suggested the H1 GDP fall would be 'less severe', but its annual scenario was bleak. • Retail sales bounced by 12.0% in May, we forecast Q2 GDP -20.0%qoq. • PM Johnson has met senior EU officials: Brexit negotiations will intensify from 29 June	• BoE's Financial Policy Committee summary • BoE's Haldane Thursday video conference for questions on his vote to dissent • Preliminary estimates of June's PMI readings • CBI industrial survey for June
	• The BoJ remains on hold but strengthened its forward guidance on the YCC. • June Reuters Tankan went down at -46 for the fourth successive month • May exports declined by 28.3%yoy while imports fell by 26.2%. • May CPI new core was up by 0.2pp to 0.4%	• June Manufacturing PMI Flash • May Chain store sales • June CPI Tokyo will a good proxy of inflation momentum after a surprising CPI "new" core (exc. fresh food and energy) up by 0.2pp to 0.4% on the nationwide level.
	• China is on path to resume growth in Q2, with May activity data pointing to a continued recovery	• The PBoC may lower the RRR soon following the call from the State Council to ease monetary policy
	• Bank Indonesia cut the seven-day reverse repo rate by 25bps to 4.25% and Brazil Copom delivered 75bp cut to 2.25%, both signalling room for more easing. • Russia industrial production -9.6% in May with oil production down 14.5% and natural gas production -16.6%yoy	• Central Bank meetings: Thailand, Philippines, Czech Republic, Turkey, Mexico. • Brazil IPCA-15 Mid-Month CPI (June).

Upcoming events		
	US:	Mon: existing home sales; Tue: new home sales, Richmond Fed, PMIs; Wed: FHFA index, mortgage apps; Thu: durable goods, goods trade; Fri: personal income, spending, PCE, Michigan cons. surveys
	Euro Area:	Mon: Ez cons conf; Tue: Ez, Fr, Ge PMIs; Wed: Ge Ifo surveys, Fr mfg survey; Thu: Ge GfK conf, Sp PPI, It non-EU trade, Fr jobless; Fri: Fr cons conf, Sp retail sales, It conf surveys, Ez M3, NFC loans
	UK:	Mon: CBI industrial trends; Tue: PMIs; Thu: CBI distributive trades
	China:	Mon: PBoC LPR; Sun: industrial profits
	Japan:	Tue: PMIs, BoJ core CPI; Wed: BoJ Summary of Opinions, CPSI, Leading index; Thu: all industries activity index; Fri: Tokyo CPI

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