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Research & Strategy Insights

Pushing with a longer string

57 – 31 August 2010

Key points

- The European covid relapse is a concern, but the US example suggests the pandemic can be curbed with less mobility loss than in March/April. A weaker "swoosh shape", rather than a "W shape" trajectory, is our baseline.
- The Fed strategy change may not provide massive support now but creates another headache for the ECB.
- As governments cannot relax remaining mobility restrictions as quickly as expected, fiscal action should provide support to the supply-side of the economy, not just to demand.

The bad news on the pandemic front in Europe are offset to some extent by the recent experience on the other side of the Atlantic. There, in the late spring hotspots, the propagation of the virus has been curbed again with a much smaller contraction in mobility than in March and April. This makes us reasonably confident that a "swoosh shape" recovery, rather than a "W shape" stop and go trajectory, should remain our baseline. Still, the pace of normalization has slowed down, and although the generic, upward direction of the "swoosh" is still intact, a further moderate downward revision in GDP projections, especially in Europe, is probably warranted.

This puts the magnitude and the content of the policy stimulus even more in focus. The Fed has provisioned for some further deterioration of the outlook by shifting to "average inflation targeting", pledging to tolerate above target inflation for a while after years of under-delivering. However, in the current circumstances it is plausible that the direct effect of monetary policy is limited. This is akin to "pushing with a longer string". Traction now comes primarily from fiscal policy, and it is unclear if the Fed's move has provided more space to public finances. Actually, since a curve steepening has been the immediate market reaction to Powell speech, government funding costs at the long end of the curve have increased.

At the same time, the Fed has created another headache for the ECB. By "out-doving" again its European counterpart, the Fed has added fuel to the euro appreciation. While we do not believe in the end of the dollar as the world's dominant reserve currency (an increasingly popular theme), the current bout of euro strength – although not spectacular in a historical perspective – is not coming at a right moment for the export-dependent Euro area. While its impact on inflation and growth is small in comparison with the pandemic shock, it is yet another headwind, and we don't think there is a politically realistic "quick fix" at Christine Lagarde's hand.

The *content* of any fiscal stimulus programme needs attention as well. As governments are postponing the relaxation of the remaining restrictive measures, and in a few cases re-imposing some, the supply-side of the economy will remain impaired for longer than expected, with productivity probably declining. This calls for ensuring that supporting demand is not the sole guide of fiscal policy.

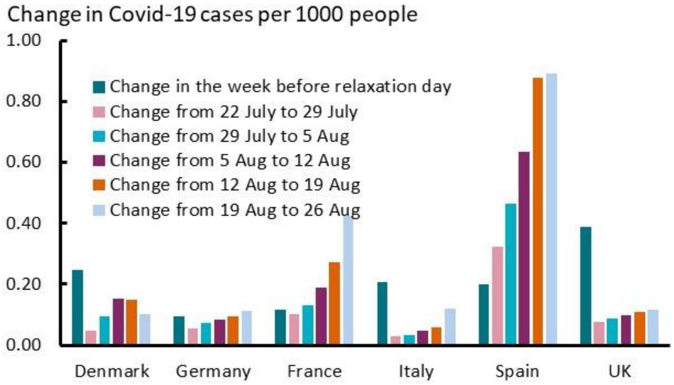
Lower sacrifice ratio?

Since our last issue in late July the covid-related news-flow on the European front has taken a turn for worse. In many continental countries the speed of the virus propagation is exceeding the levels observed just before lockdown measures were relaxed last spring. This is spectacular in Spain, but the French trajectory is also quite concerning. Germany and Italy have been doing a much better job at keeping the pandemic in check, but even their propagation has been creeping up (Exhibit 1). Europe was expecting a better summer than the US as it had waited to curb the virus deeper before relaxing. This has not been entirely successful.

Still, European governments are extremely reluctant to return to the form of stringent lockdowns which were imposed in early spring. The fact that this time the capacity of healthcare systems remains high – the rise in infections is for now hitting younger people, with lower morbidity and mortality – has probably changed the terms of the sanitary/economic trade-off. While intra-EU borders are hardening again, intra-national mobility remains essentially unimpaired.

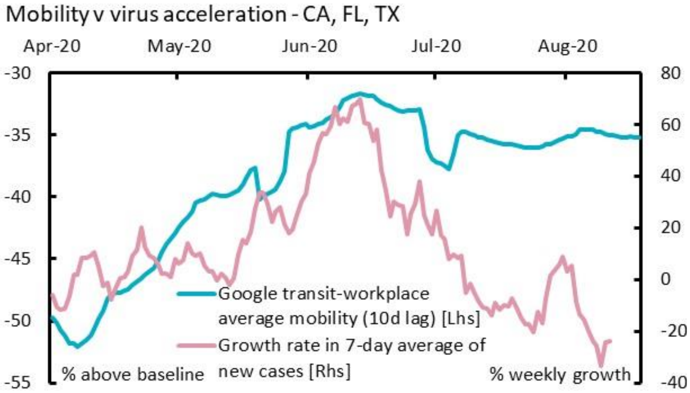
The recent experience of the US may contribute to the European "pro-mobility" choices. Indeed, on the other side of the Atlantic the pace of the pandemic has slowed down again this summer without a generalised return to stringent lockdown measures. The "growth sacrifice ratio", i.e. the quantum of economic activity that needed to be lost to take back control of the pandemic has been much lower this summer than during the March/April peak (Exhibit 2). Taken together, and allowing for a 10-day lag, **the three late spring US hotspots (California, Florida and Texas) managed to bring the pace of infections in August *below* the April through after only a limited relapse in mobility** (as measured by Google). This would suggest that targeted measures – e.g. early closing time for bars – or prophylactic measures which do not have any direct impact on mobility (e.g. mask wearing) could be enough.

Exhibit 1 – No "European exception" after all



Source: World Health Organisation, National sources and AXA IM Research, 27 August 2020

Exhibit 2 – Less mobility loss to curb covid in the US hotspots



Source: Google, USA Facts and AXA IM Research, 27 August 2020

The US experience is certainly reassuring, but swift replication in Europe is not a done deal. The case of Spain provides a counterexample. There, the Google mobility index (average of the "transit" and "workplace" components) has relapsed by more than 10 points relative to a peak in mid-July, a bigger decline than in the US hotspots, without observing the same deceleration in cases, quite the opposite (Exhibit 3). Moreover, it is possible that the decline in the "sacrifice ratio" in the US was helped by weather conditions. As people congregate indoors again in the winter, the propagation of the virus may re-accelerate for the same quantum of mobility restrictions.

Gauging the magnitude of the activity relapse is however daunting at the moment. Indeed, as we already mentioned in Macrocast, a serious shortcoming of these real time indicators is that they are not adjusted for seasonal effects. We can be relatively confident that they provide useful information of the state of the economy – in the US the average of the transit and workplace components of the Google mobility report is quite tightly correlated with the Federal Reserve (Fed)'s Weekly Economic Indicators Index (Exhibit 4) which itself follows quite well the year-on-year change in GDP. But some of the recent decline in Spain could merely reflect a seasonal effect.

Exhibit 3 – Spain's relapse

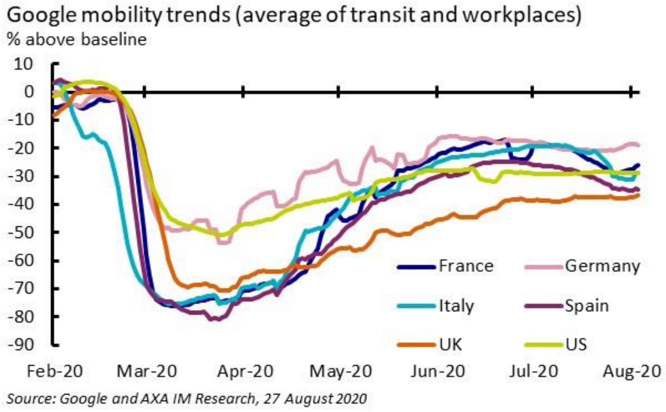
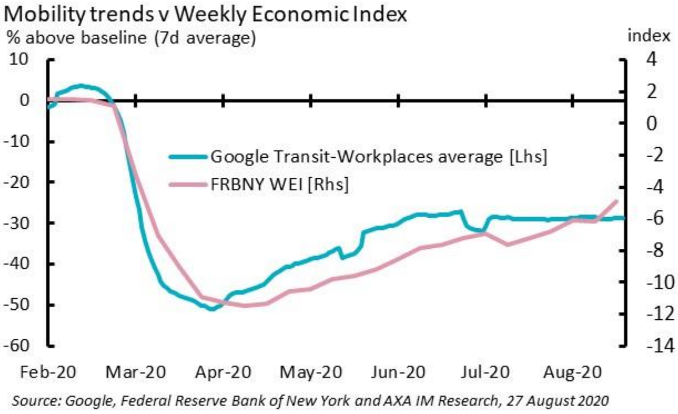


Exhibit 4 – Mobility is a decent proxy for growth



In any case, governments are faced with a symmetric policy choice, with the two extremes probably excluded: first a return to stringent lockdown, given the associated economic costs and the fact that so far the healthcare systems are coping; second, relaxing restrictive measures again, given the speed and magnitude of the relapse in infection rate the first time this was attempted. This may not be up to the governments. There may a kind of feedback loop between administrative measures and people behaviour.

The UK is interesting from this point of view. There the government has continued to relax its restrictions on mobility – apart from some cities affected by too many clusters – and is actively calling on firms to normalise their activity and bring back their employees to the workplace. However, it seems that a high proportion of the population – higher than on the continent - prefer to continue working from home, at some cost to the transport industry and some segments of the retail trade sector. It may well be that the trauma of the high mortality observed last spring and doubts on the government's strategy at the time – in particularly the time it took to opt for virus containment instead of pursuing a "herd immunity" approach – is having a persistent impact on individual attitudes. This may not be specific to the UK. "Forcing" a full-on normalisation while sanitary conditions deteriorate may simply be ignored by the public.

Support supply as well!

This leaves many developed countries in a "grey area". In a "clean exit" from the Coronavirus crisis, restrictions to mobility or workplace occupancy would be fully lifted, cancelling the impact on the economy's supply-side conditions. The world would still need to deal with the delayed demand-side shock (e.g. consumer spending being dented by a rise in unemployment) but with a sustained albeit traditional form of fiscal stimulus, a gradual correction of the currently massive output gap would be within our grasp.

The alternative scenario there is the "W shape" outlook in which the economy is regularly stopped in its tracks by a need to return to stringent lockdowns. This is always a plausible outcome of course, especially if we need to get through the entire next winter in the Northern hemisphere without a vaccine, but again this probably would be executed only in last resort. The developments of the last three to four months should call our attention to **a variant of the "swoosh" trajectory in which some degree of supply-side restrictions would linger for longer than initially expected. This would be consistent with a moderate further reduction in our growth forecast in Europe** (shaving off around half of a point each from our current +5.9% in 2021 after -7.2% this year) **and would normally call for more sophisticated forms of stimulus, supporting both supply and demand.**

Let's start with some very basic issues. Lockdowns trigger a collapse in productivity. Unless businesses immediately adjust their volume of labour to the restriction to output – which would destroy demand – output per head falls massively. Emergency fiscal support, which is precisely there to avoid a catastrophic rise in unemployment, offsets some of the ensuing increase in unit labour costs (e.g. through "in work" part-time unemployment benefits). However, to deal with the lingering pandemic, businesses won't move in a straight line from lockdown to normal operational conditions.

Persistently stringent workplace occupancy rules will generate additional costs and restrict productivity for a long while, impeding the normalisation of supply. The entertainment industry may provide an easy illustration. Demand for new TV products is currently very high, while streaming platforms and traditional networks are starting to run out of fresh content. Production is re-starting, but with severe restrictions (e.g. actors need to work in "bubbles", moving between locations is curtailed etc…). The ensuing rise in cost per minute is dealt with by shortening shooting time, resulting for instance in reducing the number of episodes in a series. Restaurants provide a less glamourous but perhaps equally striking example: restriction to capacity is inherently consistent with a rise in unit labour costs (the possibility to "spread" fixed costs on many tables is curtailed). On construction sites, the need to avoid "crowding", together with rules on sharing tools, complicate work coordination.

It may be that rampant restrictions to mobility would not affect the productivity performance of sectors which have been able to swiftly adapt to a working from home model, but evidence on this is scarce and contradictory. The OECD collated research on this in July[1], and one study reports an improvement in productivity, while another one suggests that output is maintained through a stealth increase in actual working time (so productivity per head improves and productivity per hour falls). There are probably massive differences across industries, but one cannot rule out the possibility that the relationship between WFH and productivity follows an inverted "U" shape. Initially, as firms and employees scramble to deal with technical issues and reorganise, productivity falls, Then, as those issues are solved, it rebounds, possibly even exceeding the normal level. But over time, the impact of the disappearance of informal workplace networking starts kicking in – especially when firms do not merely seek to maintain their existing activity but are moving to new projects.

Higher final prices are the natural outlet for supply-side restrictions. Businesses can offset the rise in their unit labour costs by passing it to the final consumers**. Of course, this option is not efficient/practicable if at the same time demand is impaired.** The result would be an overall decline in output. This would support the option of "over-stimulating" demand. In this approach, fiscal support would go beyond merely compensating consumers for the decline in their labour income to give them additional space to allow businesses faced with rising Unit Labour Costs (ULCs) to restore their profitability – in clear by boosting income enough so that consumption can absorb the pass-through from higher production costs.

A risk however is that the "trickling down" of demand support to restoring supply-side conditions may be severely curtailed. Our key concern at this stage is a rise in savings – or an incomplete correction of the forced savings accumulated in the first half of the year – as households brace themselves for deteriorating employment prospects.

Governments may want to pursue dual strategies, providing supply-side support on top of demand stimulus. This can be targeted to some sectors – such as the government subsidy to restaurant meals in the UK – but there may be a case for some blanket approach as well, e.g. a cut in labour tax. Leakage risks also exist on this side – the extra cash this may generate could end up merely hoarded by businesses or used to buy back equity – but this could still mitigate the risks of a "demand only" strategy. The French approach – with a planned cut in production tax paid by businesses to the tune of 0.8% of GDP cumulatively in 2021 and 2022 is another solution.

Fed pushing on a longer string

The stalemate on the bi-partisan discussions on a new US stimulus package suggest that constraints on fiscal policy are finally appearing. This is to some extent offset by the Fed's willingness to provide even more support. J. Powell has just officially announced the Fed's shift to "average inflation targeting". In practice it means the Fed will tolerate inflation above 2% for "some time" without tightening monetary policy, focusing instead on the labour market. On the latter, there is a semantic change which is not innocuous: The Fed will focus on "shortfall" from the maximum level of employment, rather than on "deviations" from this level. This sends the signal that they would see unemployment below equilibrium as an anomaly they would need to correct (presumably with more monetary

[1] *Productivity gains from teleworking in the post COVID-19 era: How can public policies make it happen?* OECD, 15 July 2020.

stimulus) while they would be tolerant of situations where employment is above equilibrium. In a nutshell, the Fed has become asymmetric on labour market developments.

This sounds dovish and it definitely is. They could have been even more dovish through by shifting to proper "inflation level targeting" where they would have pledged to offset the entirety of the accumulated inflation "deficit" over the last few years. There is no such pledge here. They reference the below-par inflation of the recent period, but do not hint at fully offsetting it. The exact wording is *"following periods when inflation has been running below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time"*. They have given themselves some flexibility here – and symmetrically reduced the market's visibility on the future monetary policy strategy.

On the margin it may help to deal with "inflation accidents". If because of some erratic movements (e.g. in oil prices of because of some FX changes) inflation temporarily moves above 2% earlier than expected, the market will have less reason to freak out and re-price the curve in a brutal way. But we also think that if inflation were to settle above 2% for more than a few months, reflecting changes to the domestic economy, the Fed would be under strong pressure to change its communication again. This is the limit of forward guidance over a long horizon, which the Fed's new choice of words ultimately is. Investors need to be sure that the future FOMC will have the same reaction function as the current one.

Fundamentally, we don't think the benefit of this shift for our current predicament should be overstated. In the current situation, with real interest rates already in negative territory on most of the US yield curve and the Fed providing active support to firms' refinancing through credit market support, it is unclear what additional monetary stimulus can provide. **Monetary policy is often compared to "pushing on a string" beyond a certain point and cynics could argue that Powell has just found himself a longer string to push on.** But traction in the current circumstances has to come from fiscal policy and it is not obvious that the Fed's move has provided that much additional space on this. Actually, the immediate reaction of the market has been to re-steepen the yield curve, resulting in higher funding costs for the government on the long end of the curve. This makes sense for the market to demand protection for future inflation by lifting long term nominal yields today, while investors may also anticipate that the new approach will ultimately force the Fed into a faster and bigger monetary tightening down the road to respond to inflation getting out of control after a period of overshooting.

Another headache for the European Central Bank

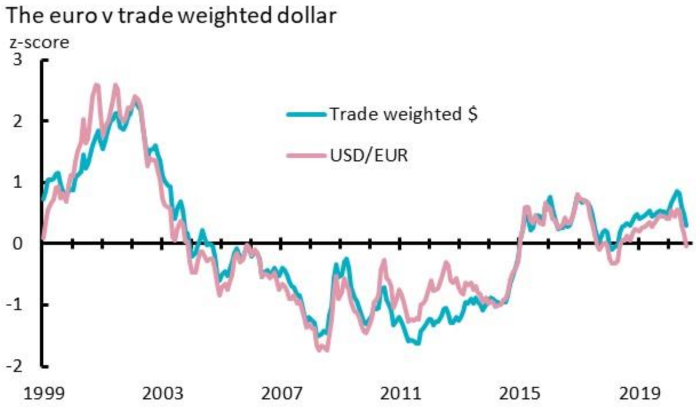
The Fed's announcement creates a headache for the European Central Bank (ECB). The euro exchange rate continued its appreciation, which will add to the downward pressure on inflation and GDP growth. The order of magnitude of this is relatively small in comparison of the pandemic shock, but it is not going to help. By converting to average inflation targeting the Fed has – again – "out-doved" the ECB, which is consistent with a weaker dollar. The current strength in the euro also reflects the retreat in existential concerns over the monetary union after the delayed success of the Recovery and Resilience Fund. The specific vigour of the euro is illustrated by the fact the dollar has depreciated more against the European currency than in overall trade-weighted terms (Exhibit 5). Although when measured against the pandemic shock the impact of the 5% appreciation in the euro in trade-weighted terms observed since May is small – roughly 0.2% on growth and inflation after one year, using the ECB's own alternative scenarios – this is another headwind the ECB needs to contend with. The September batch of their growth and inflation forecasts will have to take this on board.

There is no easy solution to the ECB's predicament. Its most obvious anti-appreciation weapon is the deposit rate. Arguably, now that Targeted Long-Term Refinancing Operations (TLTROs) come with a lower interest rate than the deposit rate, it has become easier for the ECB to take it further down without harming the banks too much, but the central bank itself – through the voice of Isabel Schnabel – has been keen to recognise that credit institutions are likely to face additional hurdles in the months to come as a rise in non-performing loans is probably unavoidable. There must be little appetite in Frankfurt for yet another blow to banks, even a relatively small one.

Of course, the ECB could try to emulate the Fed and, upon releasing its own strategic review, opt for "average inflation targeting" as well, but we think this would be quite a mountain to climb politically. The Governing Council has been able to break more taboos in the last few months to deal with the extraordinary challenge of the pandemic. But changing the very nature of the ECB's sole target – price stability – would have implications far beyond the current crisis. No doubt Christine Lagarde will be asked about this in the next press conference. She could use the language Mario Draghi introduced, hinting at de facto average inflation targeting, such as making it plain that the ECB would need to be satisfied inflation is "robustly" pegged back to its goal before tightening monetary policy – which could be construed as allowing inflation above 2% for a while – but we would not expect as clear-cut a change in approach as what Jerome Powell gave us this week.

If the trajectory of the Euro area economy deviates too much from what the Governing Council was expecting before the summer, an option would be to re-increase the pace of bond buying. With market pressure abating these last months the central bank has been able to "recharge" a bit by reducing its quantum of weekly purchases. Re-accelerating – even without any market pressure that would need attention – within the current "envelope" would send a dovish signal on the willingness and capacity of the ECB to continue to fine-tune the quantum of stimulus depending on the circumstances. But this would not directly address the exchange rate issue.

Exhibit 5 – Not such a big correction by historical standards



Source: Federal Reserve, Datastream AND AXA IM Research, 27 August 2020

Rumours of the dollar's death are exaggerated

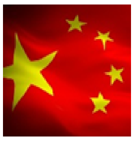
Now, there is a massive difference between envisaging a further a downward correction in the dollar and claiming its status as the world dominant reserve currency is being challenged, and actually, when taken with some historical perspective the current level of the dollar is not particularly low. Still, we have seen quite a few distinguished commentators cross that Rubicon with gusto (e.g. the fixed income strategists from Goldman Sachs). Two different types of argument are used to defend that view. First, the fact the US administration is increasingly keen to use the reserve status of the dollar to advance its geopolitical objectives, for instance via economic sanctions. Properly protecting property rights is a crucial attribute of a strong reserve currency, and the attractiveness of the dollar may be falling from this point of view. Second, that the dollar is falling prey to "debasement" as the Fed continues to engage more and more deeply with unconventional monetary policy.

We find the first argument valid, but we wonder if this is a permanent issue. We may need to see the outcome of the November US elections for this. Judging by the current polls, it is plausible that the US could move back to a more multi-lateral approach to world affairs. This could change again the international perception of the US currency.

We profoundly disagree with the second argument. Quite the opposite, **we think that the capacity and willingness to rapidly and convincingly provide ample liquidity in times of crisis is another key attribute of a strong reserve currency, a characteristic that gold - which supply is dependent on changing physical production capacity – or cryptocurrencies – which are often characterised by built-in scarcity, e.g. bitcoin - do not share.** The current gold rally probably makes sense given the high level of uncertainty and the increase in the quantity of reserve currency worldwide, but it cannot replace the dollar. Any nostalgia for the gold standard should be weighed against the number of brutal financial crises which this system triggered or worsened in its time. When the Fed this year reactivated and enhanced its dollar swap lines with foreign central banks, the message it sent to the rest of the world is that it takes its global role very seriously.

True, combining those two criteria, the euro looks appealing as a more powerful alternative to the dollar. The EU's record on protecting property rights and allowing free circulation of capital is strong, and the ECB has also demonstrated its capacity to provide ample liquidity in times of need. The European central bank is increasingly assertive in discussing the international role of the euro (see for instance a recent speech by board member Fabio Panetta). The political agreement around the EU's Recovery and Resilience Fund is paving the way for the emergence of a significant joint "reference risk-free asset" denominated in euros with the EUR750bn the EU will issue. **We would however point out that this would still stand at only 1/17th of the size of the US federal bond market. This is far from the unified, deep and liquid market the US offers. There is still a way to go for the euro if it really wants to challenge the dollar as the "go to" reserve currency.**

We would add a point we have already made last year in Macrocast. It is not obvious that it would be in the interest of the Euro area to see its currency turn into the dominant reserve currency. This would create a permanent demand for euros, colliding with the zone's current account surplus. It is not unusual for reserve currencies to be structurally in surplus, but the Swiss experience of the last 20 years suggests that there is a price to pay in terms of monetary policy independence, if one wants to avoid the deleterious consequences of a permanently strong exchange rate on the export sector.

Country/Region	What we focused on last week	What we will focus on this week
	• Fed introduced average inflation target at Jackson Hole. • Q2 GDP revised to -31.7% from -32.9% saar (-9.1%qoq from -9.5%). • Protests after police shooting of Jacob Blake • US and China reiterate commitment to Phase One trade deal. • Republican Convention	• August's payrolls, our view consistent with 1.5mn consensus estimate. ADP and jobless claims additional gauges of labour market. • ISM manufacturing and non-manufacturing indices watched for virus-related softening • Fed's Beige Book
	• Strong take-up of EU SURE Mechanism at EUR87.3bn (Hungary still pending) • Germany extends the maximum duration of furloughing to 24 months until end 2021 • EA credit growth to NFCs remained elevated in July at 7%yoy • EC Business sentiment recovers but consumer confidence stalls in August	• France to unveil details of its EUR100bn fiscal package • Final PMIs likely to show below 50 reading in Spain, following the rise of Covid-19 cases • EA retail sales to post modest increase in July, as most of the catch-up effect is already behind • EA Flash inflation to drop to 0.2%yoy
	• BoE Gov Bailey speech suggests BoE not out of ammunition • UK virus cases continue to edge slowly higher, reaching 1.5k – a May high • CIPS report firms not stockpiling ahead of transition end; HMRC only just started testing post transition trade software	• BoE members in widespread addresses at TSC and CEBRA meetings. • July lending data expected to show rebound in mortgage activity • Potential meeting between Frost and Barnier over post-transition trade agreement
	• PM Abe resigned due to worsening health. He will remain PM until Liberal Democrat Party elects a new PM. • August Tokyo CPI surprisingly declined to +0.3% yoy from +0.6%.	• July industrial production should show some improvements • Retail sales may have slowed in July after retracing very fast in June (-1.2%yoy) • July Urate and jobs/applicants ratio are likely to worsen a bit • August Services PMI
	• Industrial profit growth accelerated, auguring well for a self-sustaining recovery	• August PMIs to show manufacturing expansion continued at a solid pace
	• BoK kept the policy rate unchanged at 0.5%, but remains its current dovish stance. • Mexico GDP contracted 17.1%qoq in Q2.	• Central Bank meetings: Colombia, Chile. With inflation rising, maintaining the current accommodative monetary policy will be a challenge. • Emerging Markets PMIs releases expected to remain in recession territory.

Upcoming events		
	US:	Tue: mfg ISM; Wed: ADP employment survey, factory orders, Fed Beige Book; Thu: non-mfg ISM, trade balance, productivity, weekly jobless; Fri: non-farm payrolls, unemployment, earnings
	Euro Area:	Mon: Ge, It, Sp, HICP, final It Q2 GDP; Tue: Ez CPI, Ez, Ge unemployment, final Ez, Fr, Ge, It, Sp mfg PMIs; Thu: Barnier address at IIEA; Fri: final Ez, Fr, Ge, It, Sp services PMIs
	UK:	Tue: final mfg PMI, mortgage approvals, net lending, consumer credit; Wed: Nationwide house prices, BoE's Bailey appears at TSC; Thu: final comp, servs PMIs; Fri: construction PMI
	Japan:	Mon: industrial production, retail sales; Tue: final mfg PMI, business capex, unemployment, jobs/applicants ratio housing starts, construction orders
	China:	Mon: official mfg, non-mfg PMIs; Tue: Caixin mfg PMI; Thu: Caixin servives PMI

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