Job protection and demand management

52 – 29 June 2020

Key points

- With some US states rolling back on the relaxation in covid containment measures, the mechanical rebound in economic activity may be less spectacular than expected.
- This can be offset by more policy stimulus but shifting from blanket emergency support to long-haul demand management will raise thorny economic and political issues. How to best protect jobs will be a key debate.

Some states are starting to roll-back on the relaxation of the containment measures in the US. They are still very far from a return to a stringent lockdown, but the change in mood is noticeable. So far, the market has been able to take bad news on the US pandemic front in its stride as policy-makers were always ready to provide more stimulus. The absence of "new news" on this on Friday probably explains why there was no late rally, contrary to what had happened at the end of the previous week.

In our baseline, more stimulus will come, but it may be slower to show up than the emergency "carpet bombing" of last spring. Governments – and not just in the US – need to shift from "freezing" the private sector with blanket support preserving the chances of later resuscitation to long-haul demand management, and this will raise delicate macroeconomic and political questions. Dealing with the job market will be crucial in this. We take the example of France where the government is changing the part-time unemployment scheme, offering long-term support to the worst-hit sectors.

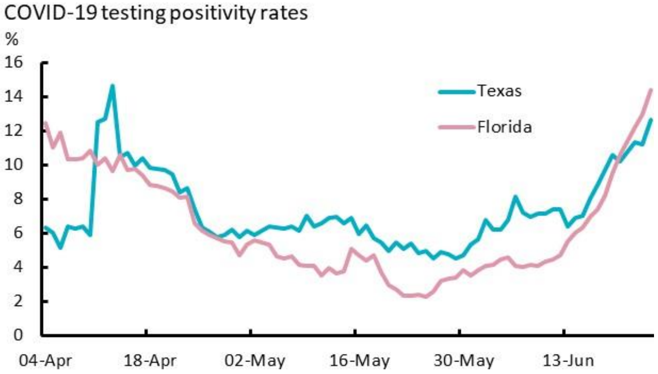
Of course, "over-protection" could impair creative destruction, i.e. the re-allocation of capital and labour from sectors with less demand and productivity prospects to more dynamic activities. The current situation is ambiguous though. Lockdowns don't follow economic logic. Prolonged supply-side disruption can destroy perfectly viable and productive businesses. In addition, reallocation is even more difficult when aggregate activity is weak, since even dynamic sectors can't absorb as many workers shed by the "obsolete" sectors as they should, which could trigger a self-perpetuating negative spiral on demand.

A damage control approach is a necessary, but not sufficient condition to foster a lasting recovery. The economy will need strong signals to revive animal spirits. Public investment is a promising avenue here. Meanwhile, the private sector may have to "fly solo" towards the end of 2020 as the emergency schemes expire and long-term demand support is not yet fully available. They will need strong liquidity buffers. Fortunately, the latest data on credit origination suggests these are being built in the Euro area.

US re-opening on pause?

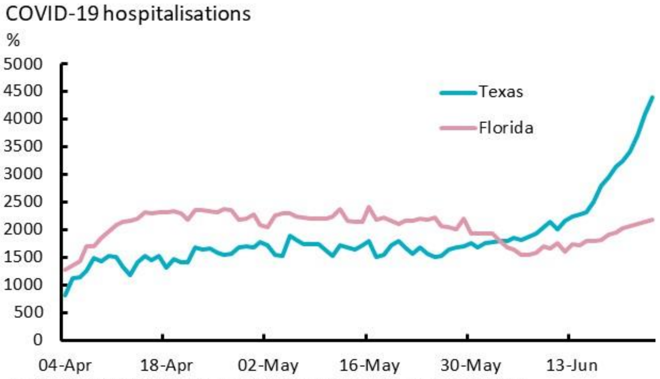
The re-acceleration in the covid pandemic continues in the US. The daily number of new cases in Texas and Florida has reached levels seen in New York State – the first epicentre in the US – in mid-April. The positivity rate (number of new cases / number of new tests) continues to rise in those states, as well as hospitalisations (especially in Texas), providing more evidence that the new outbursts are not a mere reflection of more intensive testing.

Exhibit 1 – The new cases to new tests ratio continues to rise in the states stuck in the "first wave"



Source: TXDHS, Covid Tracking Project and AXA IM Research, as of 26 June 2020

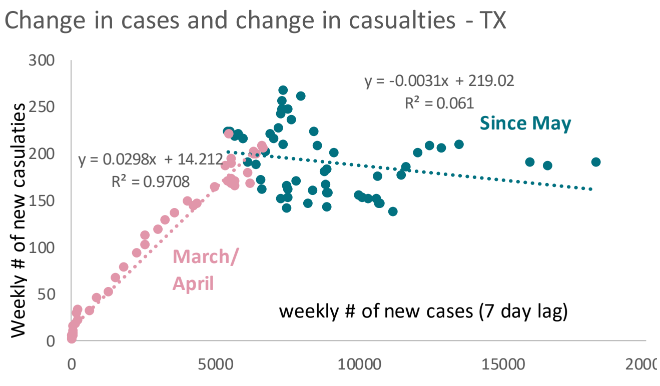
Exhibit 2 – Hospitalisations up as well



Source: TXDHS, Covid Tracking Project and AXA IM Research, as of 26 June 2020

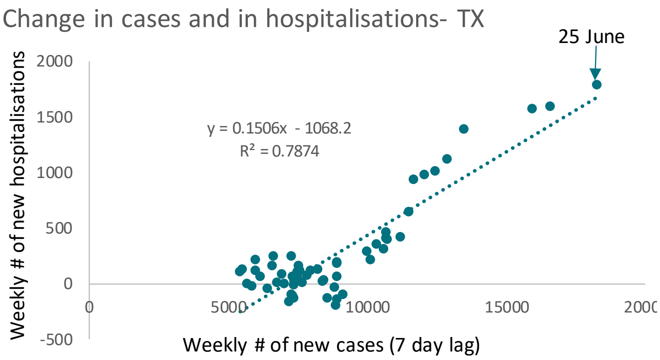
A welcome but puzzling feature of the ongoing re-acceleration is the low level of lethality so far. The cumulative number of casualties in Texas relative to the growth in the number of cases is low: in the 7 days to 25 June, 191 covid-related deaths were recorded in Texas compared with 19,204 new cases in the seven days to 18 June, i.e. 1%. In New York State, the first epicentre of the crisis in the US, the relationship between lagged new cases and casualties has been very stable with a high predictive power (R2=0.91). Throughout the epidemic, 12 new cases would be consistent with one new death a week later. In Texas, the relationship, initially quite tight, has become very weak (R2= 0 since the beginning of May, Exhibit 3).

Exhibit 3 – Relationship between new cases and new casualties broke up in the "new hotspots"



Sources: TXDHS, AXA IM Research, June 2020

Exhibit 4 – But the relationship between new cases and new hospitalisations holds



Sources: TXDHS, AXA IM Research, June 2020

We don't know what explains the gap (available explanations range from a higher infection rate among young, healthier people, better treatment strategies, higher awareness of the symptoms triggering earlier medical response…) but **from an economic point of view, what matters is whether the shape of the epidemic is triggering a delay in the re-opening of activity, and since the start of the pandemic it is more the level of pressure on the healthcare system, rather than lethality per se, which has forced a curtailment of social interaction**. Unfortunately, the relationship between new cases and hospitalisations has been quite strong in Texas: since May, seven new cases have been consistent with 1 hospitalisation a week later (R2=0.78, Exhibit 4). Another signal that the outburst is not a by-product of more testing.

The first instructions from Governors to reverse some of the re-opening measures have come at the end of last week. In Florida and Texas, bars have been closed again. In Texas, restaurants were ordered to scale back to 50% of normal occupancy, from 75%. These are still limited measures, very far from the “stay at home” instructions which had been common in Europe until recently. The reluctance to jeopardize the economic recovery is still very much here. But the normalisation is still delayed. One crucial aspect of this is the decision by North-Eastern States to impose quarantines on travellers coming from parts of the country facing a viral re-acceleration. While implementation may well be problematic, this would be another dent in the normalisation of the transport and hospitality sector in the United States.

So far, the response is far from unified, and to some extent contradictory. The announcement for instance by American Airlines that they would raise the occupancy rate of their flights, providing less opportunity for social distancing, came the same day as the “re-opening roll-back” in Florida and Texas is an example of the lack of coordination. The US is very far away from a return to the March/April conditions, and the latest real time indicators such as Apple’s mobility reports (which are less precise and a bit more timely than the Google ones) are not yet reflecting a generalised relapse in activity in the US, but the rebound in Q3 may be less spectacular than expected.

A crucial issue for the markets is whether a slower pace of normalisation in Q3 in the world’s largest economy can be offset by more policy stimulus. Indeed, if US supply cannot be normalised this summer as comprehensively as hoped, income will need to be protected for longer and businesses will need more help to survive. But looking ahead, slower growth in 2H 2020 could give way to a stronger growth in 2021 if demand is stimulated further. This explains **why equity markets seem to able to take in their stride bad news as long as they hear that more fiscal support is on its way**. This is what stopped the first market wobble two weeks ago. No similar news came last Friday, and no late rally came to offset the knee-jerk reaction to the announcements in Texas and Florida. Our baseline remains that more fiscal stimulus will come, but it may become more difficult to design than under the emergency last spring, for both economic and political reasons. This is not specific to the US.

How to best protect jobs?

Governments everywhere reacted to the collapse in economic activity by resorting first to generous and broad-based support schemes, favouring simplicity of access. The simpler and the least conditional they were, the faster employee income would be supported without getting bogged down in administrative bottlenecks. In many cases the measures were prone to free-riding. We even argued in Macrocast that the US Pay check Protection Programme provides the wrong incentives, since the strongest companies facing little pandemic-related risk, with a low probability of reducing their headcount, would benefit from a subsidy while weaker firms would be left with more debt. Still, given the brutality of the crisis, those shortcomings probably had to be tolerated.

The natural slope for a second phase would be to reduce the generosity of those broad emergency schemes, as exiting lockdown allows the supply-side of the economy to normalise, while government support would be maintained on the demand-side by resorting to more traditional, long-haul fiscal stimulus (e.g. through public investment programmes). Maintaining emergency support as it was operating at peak lockdown would stretch the fiscal capacity of governments too much, even in the current configuration of extraordinary monetary support. Moreover, even if governments had infinite policy space, some of these schemes may become counter-productive, impairing the normalisation in supply. Looking at the US again, when the federal government chose to “top up” the states’ unemployment benefits schemes with a USD600 weekly premium, they brought median benefits on par with median labour income. While “freezing” income during the lockdown made a lot sense, prolonging the scheme for too long would not nudge workers back to work.

An issue with this phased approach is that all sectors are not equal in the face of pandemic. Some industries will continue to be affected for longer than others. Another problem is that some sectors have been hit so deeply that even with a quick normalisation in general supply conditions they may not survive. A generic, long-haul demand stimulus would be too late, too little for them.

An option is to direct to these sectors at risk enough financial resources to help them go through their rough patch, but as we argued last week, loans, even at concessionary rates, are not a perfect substitute for "proper stimulus" since saddling challenged businesses with more debt to offset a contraction in output will put a further strain on their cash flows after the "grace periods".

The latest announcements in France on changes to the part-time unemployment benefits can be seen as an attempt to deal with these issues. Indeed, from 1 October onward the "general" scheme will be made less generous, but businesses faced with lasting difficulties will be able to benefit from long-haul support (up to two years).

The details are still being negotiated, but under the new scheme (APLD[1]) employees in these challenge businesses would see their working time reduced by up to 40%, but they would still earn 84% of their initial hourly wage (after social contributions) on this unworked time. The government would indemnify firms to the tune of 80% or 85% of this "unworked pay", depending on how quickly they manage to negotiate a deal with their local unions, a condition for accessing the scheme. This suggests that in the cases in which working time would fall by 40%, the government would pay roughly a quarter of the total wage bill.

The impact on public finances could be significant at first glance. There are currently 4.6 million workers effectively covered by the current part-time unemployment scheme. If they all shifted to the APLD with a working time reduction of 40%, this would result in a cost to the government of 1.2% of GDP. **However, one needs to think in terms of net costs. A number of employees who would be covered by the APLD would lose their job altogether without the scheme.** In France the average replacement rate of the traditional insurance benefit system stands at 70% (i.e. on average the benefit is equivalent to 70% of the initial monthly wage, and can last for up to two years), 2.8 times the cost to public finances of APLD per worker under the assumptions above. In other words, from a fiscal point of view, avoiding one fully unemployed worker would justify 2.8 APLD beneficiaries.

Beyond the fiscal angle, a key macroeconomic issue this type of schemes raises is how they could affect potential growth. Indeed, "over-protection" could result in impairing creative destruction, i.e. the re-allocation of capital and labour from businesses and sectors with less demand and productivity prospects to "younger", more dynamic activities. We are in an ambiguous situation though. Lockdowns do not follow an economic logic. Prolonged supply-side disruption could destroy perfectly viable and productive businesses and industries. Concerns over "zombification" are not necessarily warranted. Allowing those viable sectors to be "wiped out" could even deteriorate potential growth, if purely by chance the surviving sectors happen to be the least productive ones.

So far, the pandemic-related recession has disproportionately hit industries with lower-than-average productivity (e.g. hospitality, which is one of the most labour-intensive sectors). But some highly capital-intensive industries are faced with potentially protracted activity slumps (aerospace for instance). Ultimately, governments will have to make a judgement call, with the usual risk that they fail to spot the "winners" and "losers".

Demand management

The debate on the impact of these schemes on potential growth may be rife for some time, but in our view long-haul protection of employment may be an essential plank in demand management over the next year or so. Labour re-allocation is a messy process at the best of time (skills mis-matches across industries are one of the key impediments), usually involving significant friction temporarily depleting GDP growth. **Smooth reallocation would be even more difficult in a situation of depressed aggregate demand**, since even the dynamic sectors would not be in position to absorb as many workers shed by the "obsolete" sectors as they should. Slowing down the "release" of workers from the worst-hit sectors would make sense in such a configuration. The alternative – allowing hard-hit sectors to shed labour very quickly - could trigger a self-reinforcing spiral in which the rise in the aggregate unemployment rate would fuel even more precautionary saving, further depressing final demand.

[1] *Activité partielle de longue durée*

We note that in the French APLD companies would not be barred from reducing their total headcount while they benefit from the scheme (unlike in the old "blanket" part-time unemployment scheme). But this would be part of the negotiations with the unions. The idea there probably is to organise the work-force reduction in an orderly, gradual way, rather than triggering a brutal flood of laid-off workers on an already depressed labour market. French labour market institutions are of course highly specific, but beyond the arcane technicalities, we think similar policy proposals will pop up across all advanced economies.

We think such damage control approach is a necessary, but not sufficient condition to foster a lasting recovery. The economy will need strong signals to revive animal spirits. We have been expressing our conviction for a while now in Macrocast that private capex would be a key victim of the pandemic, given the lingering uncertainty it has created. This may call for fiscal initiatives focusing on public investment, drawing on the current low to negative cost of long-term government funding. A side-benefit of such approach is that in the countries dealing with complex political configurations, it may be easier for competing parties to agree on public capex than on other instruments of fiscal stimulus. In the US, so far Democrats and Republicans in the divided Congress always managed to agree quickly on the fiscal stimulus schemes so far, but debates will be fiercer when focus moves away from emergency support to long-haul demand management. For instance, Democrats are advocating continued direct support of household income by maintaining generous benefits, while Republicans favour an indirect approach by cutting payroll tax. These positions are difficult to reconcile because they are at the heart of an "allocation debate" with significant consequences for the social groups the two parties target. Agreeing on more freeways or 5G networks may be easier.

Even more liquidity buffers

Economies may have a thorny moment in the last months of 2020 – irrespective of whether a "second wave" comes to derail the "swoosh-shape recovery" to turn it into a "W shape" one. Indeed, it is likely that some of the generous emergency support measures will have expired before the long-haul sectoral schemes, or the traditional demand-side fiscal support are fully deployed. In Europe national authorities may wait for the full availability of the Recovery and Resilience Fund before finalising their own projects. **The private sector may have to "fly solo" for a few months. Much will depend of their financial position by then.**

Fortunately, at least in the Euro area, the liquidity position of both households and businesses continue to be strong. Last Friday the ECB released the monetary data for May. The flow of loans to corporates was smaller than in April (Exhibit 5) but it was still much larger than the historical average. Meanwhile, businesses continue to "hoard cash" with the flow of new deposits maintaining the very strong clip seen in March and April. In three months, they have accumulated more than EUR300bn (2.5% of annual GDP).

Exhibit 5 – more loans, more deposits by corporates

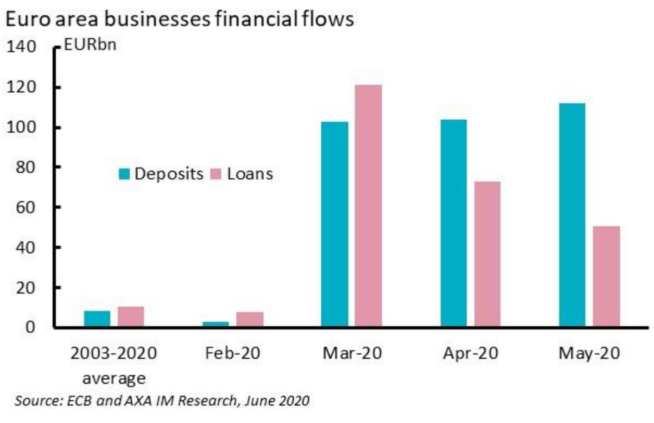
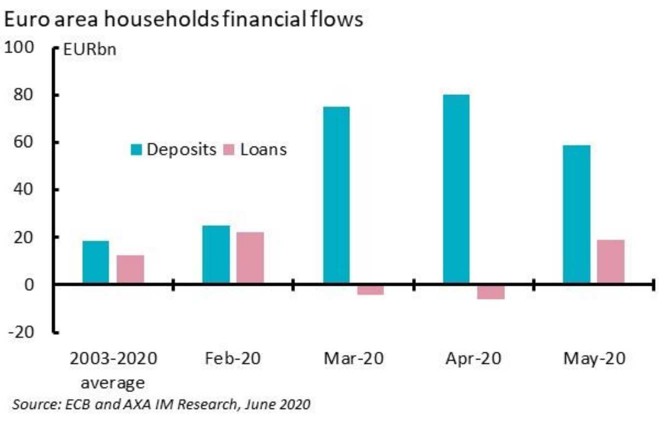


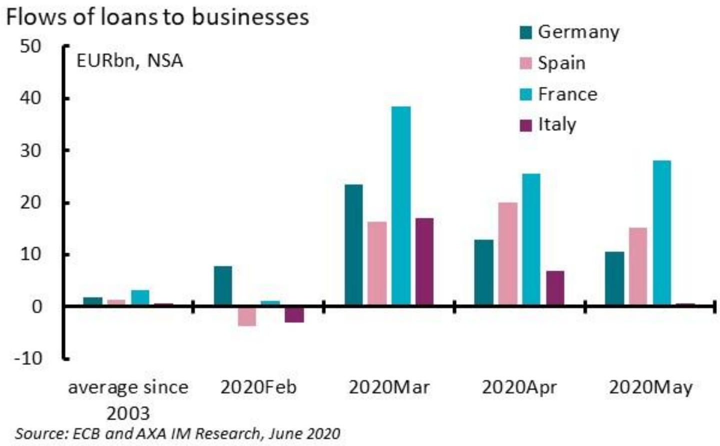
Exhibit 6 – Households keep on hoarding cash



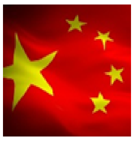
Cash hoarding continued for households as well in May, and quite surprisingly, after two months of mild deleveraging – the were paying back loans more than taking new ones – credit origination took off as well (Exhibit 6). Mortgage take-up has been surprisingly brisk in France (EUR8.9bn) and Germany (EUR7.7bn). There was some anecdotal evidence of a tightening in credit standards by banks on mortgages, but at least in the two largest economies of the Euro area this has not been too much of a deterrent. We note however that mortgages entail long processes and the May figures may simply reflect a catch-up after operations were "frozen" at the peak of the lockdown.

Still, the aggregate figures suggest there is no sign that monetary policy transmission via the banking channel is impaired. We see one exception however: Italy. We discussed last week in Macrocast in some details how the take-up of state-guaranteed loans had been disappointing. We mentioned that it may be the result of mere technical "teething" issues around the schemes, but we also explored the possibility that it may reflect hesitations in the banking industry to take more risk, even considering the government guarantees, given the country's history with non-performing loans. In April, the slowdown in business loan origination from March was acute in Italy, but the flow was still noticeably above the – weak – historical average. In May however flows were barely noticeable in Italy (Exhibit 7).

Exhibit 7 – Italy is still the "odd one out"



Corporates and banks were not completely inactive in Italy, as the net stagnation in loan origination is the product of a significant drop in short-term loans offset by longer-term debt. This is positive for the future management of cash flows, but this leaves the Italian productive sector in a weaker position in terms of aggregate liquidity buffers if the economic rebound is slow or volatile.

Country/Region	What we focused on last week	What we will focus on this week
	• Record number of new virus cases, with Southern states driving worsening. Some states pause re-opening, demand sagging. • GDP unrevised at -5.0% (saar) Q1 • Jobless claims at 1.48mn vs 1.54mn last (continuing claims down 750k). • Banks pass Fed stress tests	• Virus path in southern US • June's payroll report, markets see a 3mn jobs gain (we see risks lower) and jobless rate 12.5% from 13.3% (risks higher) • FOMC minutes, look for details of forward guidance discussion • ISM indices expected to rebound
	• German IFO and PMIs across euro are were better than expected. • ECB minutes acknowledged inflation is likely to remain low over the medium term. • M3 accelerated by 8.9%yoy and lending data to Non-fin by 7.3%yoy.	• June CPI is expected to be stable at 0.1%. • EC surveys such as business climate, economic sentiment or consumer confidence are likely to rebound. The order of magnitude of the rebound will be key. • Unemployment rate • June final PMIs should confirm the rebound
	• UK announces next stage of lockdown easing from 4 July, including pubs openings and social distancing reduced to 1mn from 2mn. • PMIs rebound strongly in June, manu to 50.1 from 40.7, servs to 47.0 from 29.0. • Labour sacks Shadow Education Sec over anti-semitic tweet, may spark broader cull	• Final estimate of Q1 GDP expected unrevised, but details national accounts • May lending data to see household borrowing fall, M4 money growth strong • Final estimates of June PMIs • PM Johnson rumoured to give speech hinting at fiscal infrastructure boost
	• June Manufacturing PMI Flash declined to 37.8 from 38.4 with output component fell at an accelerated pace(most severe since 2009) • May Chain store sales bounced by 1.3%yoy • June CPI Tokyo decreased by 0.1pp to 0.3%yoy while the core component also went down by 0.1pp to 0.1%yoy.	• May IP and June final PMIs • May unemployment rate and jobs/applicants ratio to assess the employment program and the trend • Q2 Tankan surveys and June consumer confidence to gauge companies' and households resilience
	• Growth of COVID cases in Beijing slows as the city reintroduces partial lockdowns and conducts sweeping virus testing	• Expect the PMI to level off slightly, but remain above 50
	• Monetary policy easing ongoing: -100bp in Russia to 4.5%, -50bp in Mexico to 5%, unexpected -15bp in Hungary to 0.75%, -50bp to fresh low 2.25% in the Philippines. • At odds with expectations, both Turkey and Thailand central banks stayed on hold. • Poland's unemployment rate rose to 6% in May from 5.8% in April.	• Korean export numbers to be released, we expect slight improvement from May, but overall weakness to remain • Central Bank meetings: Colombia • First round of the presidential elections in Poland. • Poland June inflation rate and PMI surveys through emerging markets

Upcoming events		
	US:	Mon: pending home sales; Tue: Case-Shiller HPI, Chicago PMI, Conf Bd cons conf; Wed: ADP employment, mfg ISM, FOMC minutes; Thu: payrolls, earnings, trade balance, factory orders
	Euro Area:	Mon: Ge, Sp CPI, HICP, Ez surveys; Tue: Ez, Fr, It CPI, HICP, Fr cons spend; Wed: Ge retail sales, unemployment, final mfg PMIs; Thu: Ez, Sp unemployment, Ez PPI; Fri: final comp, servs PMIs
	UK:	Mon: mortgage approvals and lending, consumer credit, M4, 5th round of EU negotiations; Tue: final Q1 GDP, current account; Wed: final mfg PMI; Fri: GfK cons conf, final comp, servs PMIs
	China:	Tue: official mfg, non-mfg PMIs ; Wed: Caixin mfg PMI; Fri: Caixin composite, services PMIs
	Japan:	Mon: retail sales; Tue: jobs/apps ratio, unemployment, industrial production, construction orders, housing starts; Wed: Tankan indices, final mfg PMI, household conf; Fri: final servs PMIs

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