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Daily Observations

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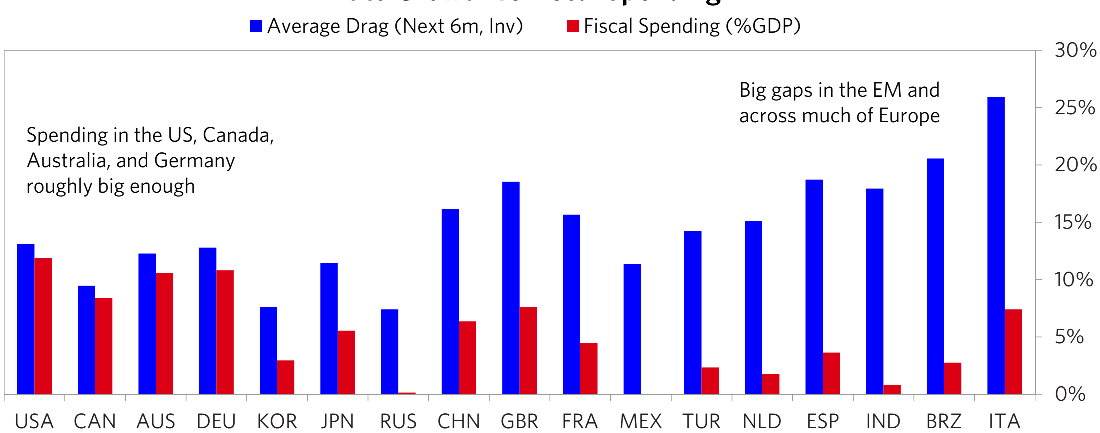
Will Fiscal Policy Prevent a Falling Income and Spending Spiral? The Answer Will Differ Across Countries.

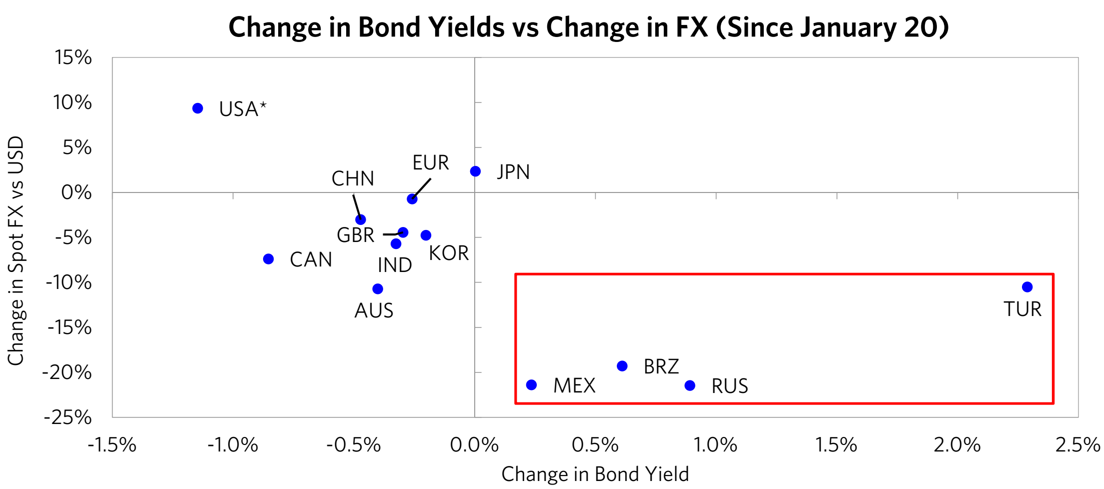
No amount of fiscal or monetary policy can offset the massive first-order contractionary effects of the pandemic. What policy can do is prevent material collateral damage to households, businesses, and the financial system from falling incomes leading to falling spending, defaults, etc. In this crisis, fiscal policy is both the optimal tool and the only tool available to get money to those in need as they face an unprecedented income drop. Monetary policy is playing a secondary role, with QE funding the massive fiscal expansion, keeping rates low, and ensuring that illiquidity and forced selling doesn't make a bad situation much worse.

In these *Observations*, we describe the offsetting support we are seeing across countries. The differences are vast. In most of the developed world outside of Europe, the response has been about as fast as one could have expected from a tool that is inherently politicized. And for the most part, we have seen fiscal packages that are close to enough to plugging the income hole for the next couple of months. Still, more will be needed by the summer. Many of the pipes being used are new, and there are questions and risks around making sure the money is getting into the right hands quickly enough. Italy and Spain stand out as economies that are not doing enough and that face the additional challenge of not controlling their own currencies. Most emerging economies have done even less, and their insufficient response is leading us to materially downgrade our forward-looking expectations for growth (which were dismal to begin with). The market action—falling currencies and rising yields—clearly implies that these countries won't be able to follow the path of much of the developed world. Money from the IMF may help, but there are limits to how much developed countries can help at a time when they are also facing historically high deficits. Many emerging markets' inability to stimulate to prevent an income spiral will only compound the substantial difficulties they face managing through this crisis. The chart below shows the average hit to GDP over the first six months of the year, along with the size of the fiscal spending that has been announced so far. Comparing the amounts isn't perfect (relative timing and who gets the money still matters), but it helps give an indicative sense of whether the spending announced so far comes close to what is needed. We have ranked the economies from those that are closest to meeting the income gap to those where the spending is least adequate.



One reason some countries aren't doing more is that they are likely limited by their circumstances. The market action to date is consistent with some economies being more able to avoid a self-reinforcing downturn than others. For many emerging markets—like Mexico, Brazil, Russia, and Turkey—the currencies have sold off at the same time as bond yields have risen. An attempt to stimulate more and print could lead to a currency/inflation spiral. Meanwhile, as developed world bond yields have fallen, most of their currencies have sold off by less against the dollar. Of course, flows to haven currencies and commodity price action have also impacted some currencies. The scatter plot below shows this relationship well—with emerging market economies for the large part clustered together.

EM currencies down and bond yields up—market action consistent with EM governments failing to ease sufficiently



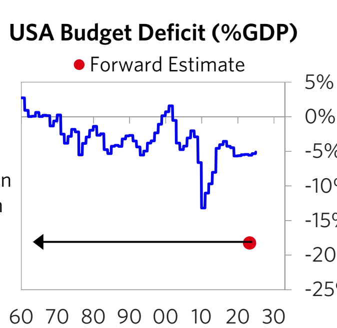
USD shown vs trade-weighted index

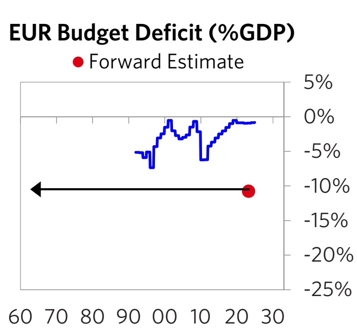
EM economies looking to borrow will likely have to look to institutions like the IMF. At present, the IMF doesn't have the resources to completely fill the hole in incomes in the EM (they have about $800 billion in unencumbered quotas and commitments, which is a small number relative to the needs of every emerging economy), and there are practical concerns about their ability to quickly get money to the economies that need it. We will have more information after their meeting later this month.

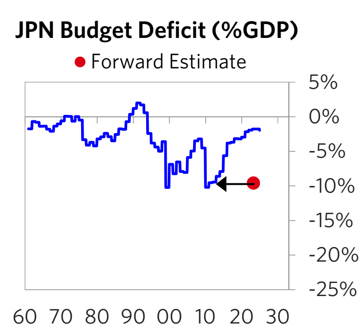
Economies That Have Announced Large Spending Packages Face Historic Deficit Expansions

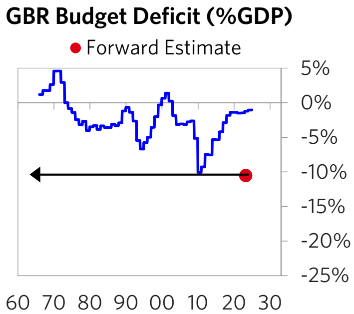
The collapse in economic activity is going to lead to huge increases in deficits. Additional stimulus will be a drag on top of that. Below, we show estimates of the deficit expansion across the major developed world economies. These estimates aren't precise because there is a lot we don't know now, but there is little question in our minds that the deficits will be historically huge. Financing these deficits (particularly any large, proactive fiscal spending) will require significant printing to prevent yields from rising. This is more achievable in countries where the storehold of value isn't questioned and where they don't have significant external currency debt. It is harder for economies that must access foreign funding.

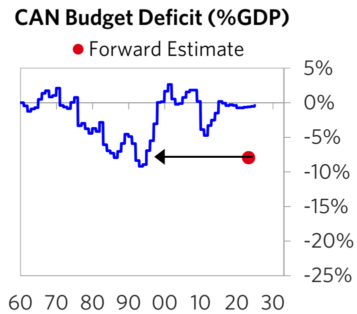
Budget deficits will expand dramatically. Note that these estimates are based on spending to date, with more expected from some countries (e.g., Japan and the US).

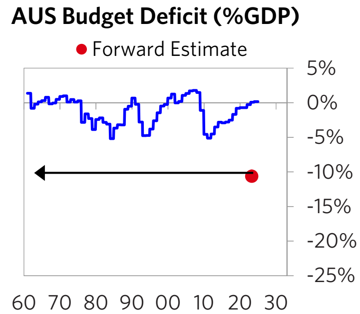












The size of the programs really matters, but it is also necessary to see if they are designed well enough to get money to all those who need it. Over the next couple of pages, we take a closer look at which players the massive increase in spending is targeting. What we think is necessary is a) a huge amount of proactive fiscal transfers and spending and b) thoughtful use of many channels to make sure that you don't have permanent damage to those hit hardest. On the household side, cash transfers play a huge role, with some countries sending checks broadly and other focusing on unemployment mitigation. On the corporates side, the spending is split between loans and grants (often, as in the case of Germany, as a means to allow companies to keep and pay workers instead of laying them off). Some sectors, like airlines, are receiving direct bailouts. In this environment (at least in the very short term), direct spending is more limited to medical spending. Bigger infrastructure projects will be more challenging until economies come out of lockdown; given where China is with the virus, this is one of the channels more open to them. We skip the emerging world, because by and large they haven't done much relative to their needs, so a breakdown would not be as useful. Lastly, keep in mind that countries like Italy and Spain have much more significant economic hits than countries like the US (in part because of the more severe virus hit and also because of larger second-order effects from collapsing exports).

Where Are Economies Focusing Their Spending?

		USA	DEU	AUS	CAN	GBR	ITA	CHN	JPN	FRA	ESP
	Total Spending (%GDP)	**11.9%**	**10.8%**	**10.6%**	**8.4%**	**7.6%**	**7.4%**	**6.3%**	**5.5%**	**4.5%**	**3.6%**
Directed at Households	Cash Transfers	✓✓✓	✓	✓✓✓	✓✓	✓	✓	✓	✓✓✓		
	Unemployment Expansions	✓✓			✓						
	Sick/Paid Leave	✓				✓	✓				
	Interest Deferrals	✓					✓✓				✓✓
	Tax Deferral for Households	✓✓			✓✓						
Directed at Corporates	Corporate Bailouts	✓	✓								
	SME Grants	✓		✓		✓		✓		✓	
	SME Loans			✓	✓✓		✓	✓	✓		
	Corporate Loans	✓✓✓	✓✓✓	✓	✓	✓✓✓	✓	✓	✓✓	✓✓✓	✓✓
	Support for Self-Employed		✓			✓					
	Short-Term Work	✓	✓	✓✓	✓	✓	✓	✓		✓	✓
	Corporate Tax Change	✓		✓		✓					
	Tax Deferral for Corporates		✓✓✓		✓	✓	✓	✓		✓	✓
Direct Spending	Direct Spending	✓✓✓	✓✓		✓		✓		✓	✓	✓
	Infrastructure		✓					✓✓			

The US is making large direct transfers to households

Germany is supporting employment through wage subsidies to corporates

- **US:** The US has had the strongest fiscal response to date. It looks as though the US will spend enough to fill the hole (at least for the next few months), and more spending is on the horizon. The US is transferring more money directly to households than any other economy, which should be a meaningful support. Much of the package relies on creating new spending channels, so there are practical constraints that could prevent money getting to people who need it quickly. We covered this in our March 26 *Observations*.
- **China:** A combination of direct spending and other funding channels is helping to fill the gap in incomes. China's direct fiscal spending alone has so far been a bit below what's needed, but the government has supplemented direct spending with ways to provide credit to small businesses and households through different funding channels (bank loans, bond issuance, etc.). These policies should provide very targeted

and leveraged support. The risk of this approach is that it requires very strong coordination between fiscal, monetary, and regulatory policies during the crisis to get credit to those in need.

- **Europe:** Most of Europe is spending far below what is needed, and there are practical constraints to ramping up government spending further, particularly in the periphery. It looks as though European leaders are now moving toward providing support at the Europe-wide level. We will know more soon, but the numbers being discussed, while not small, are still not large enough relative to the size of the economic hit.
    - **Germany:** Germany's spending appears sufficient to mitigate a self-reinforcing spiral. Their package is targeted at impacted corporates, which the government has pre-existing pipes to, making spending faster. For example, we see their employee retention program being a direct and meaningful support to holding up employment. It's a path that may work better than unemployment benefits in keeping companies and the economy intact until a reopening is possible.
    - **France:** France has been hard-hit and has not spent enough to offset the drag. Their package is mostly made up of corporate loans and lacks supports that flow directly to households, who need it most.
    - **Italy:** Italy has been hard-hit and their fiscal stimulus is inadequate. Given the time that has elapsed, avoiding damage may be challenging as they wait to work through how any stimulus will be financed (i.e., will they take on the debt? Will it be mutualized? How much would the ECB buy? Etc.).
    - **Spain:** Among the hardest-hit countries, Spain's fiscal response has been the weakest. The bulk of their package is limited to interest deferrals and corporate loans, which we don't expect to be enough to alleviate hits to incomes and spending. We have the same questions as we do about Italy in terms of how the needed spending will be financed.
- **Japan:** While Japan has not yet spent enough, they have focused on cash transfers to those most in need—a meaningful way to prevent a self-reinforcing decline. They plan to spend more in the coming days.
- **UK:** More is needed. The UK has spent a sizable amount, with cash transfers to households in need and loans for corporates to stay afloat until containment measures are lifted. The UK virus hit is likely underreported (given the slow ramp-up in testing) and delays in getting shutdowns in place.
- **Canada:** Spending is in the ballpark of what is needed. The government is providing support across players through large wage subsidies to corporates and cash transfers to households, which we expect to be nearly adequate supports. Provinces have also stepped up with significant direct transfers but face the added pressure of commodity price drags on producers.
- **Australia:** Australia looks as though it will spend enough. Their package has targeted households with a lot of direct cash transfers and corporates with short-term work provisions, which should be meaningful supports.