

How green was my credit?

We're all being urged to be more 'green' and that includes the European Central Bank. So what would it mean for credit markets if climate considerations assume more importance in monetary policy? We've got some answers. We interpret recent ECB and Fed minutes. And don't stand so close to me! Why social distancing isn't as distant as it used to be

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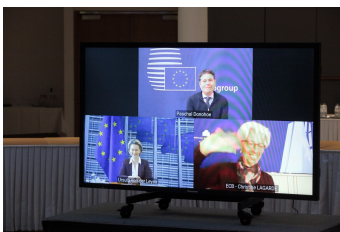
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To green or not to green: What it means for Credit if ECB becomes greener

The French central bank governor has urged the ECB to introduce a climate criteria for its corporate bond-buying program. We take a look at the varying options the central bank has to make climate consideration in monetary policy and what that would mean for credit markets



Source: Shutterstock

President of European Central Bank Christine Lagarde walks on path in front of the ECB building. Frankfurt, Germany

As it stands, the ECB holds 119 environmental, social and governance bonds under the corporate sector purchase programme (CSPP) and corporate purchases under the pandemic emergency purchase programme (PEPP). This accounts for roughly 7% of the ECB holdings.

But 60 of these bonds have been purchased after November 2019, accounting for roughly 10% of purchases since then. However, the ECB's eligible green bond universe is no more than 150 bonds thus far amounting to €122bn.

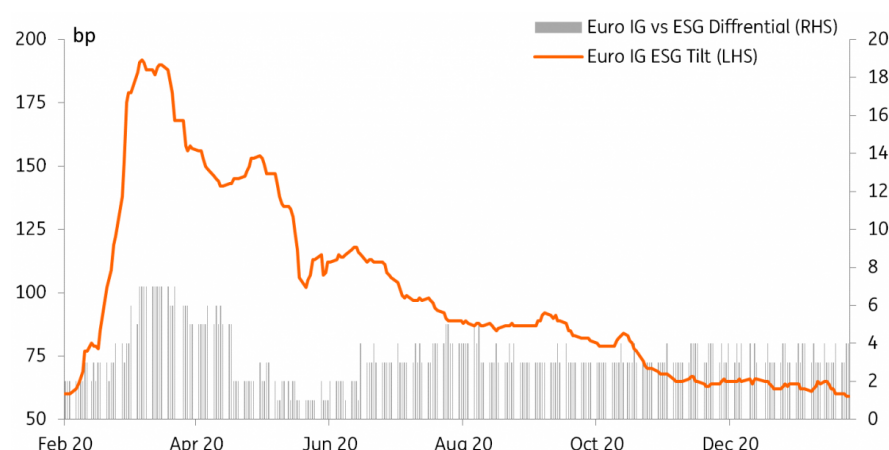
The French central bank governor, Francois Villeroy de Galhau recently said, "I propose to start decarbonising the ECB's balance sheet in a pragmatic, gradual and targeted manner for all

corporate assets”. In so calling for the ECB to tilt its purchases to limit issuers with poor climate performance. Villeroy acknowledged the proposed programme as “ambitious”, but we expect it, amongst other options, to be possible.

We break down some ‘options’ available to the ECB and elaborate on the effects they could have on credit markets.

- Option 1: Concentrate (not exclusively) on purchasing green and high ESG scoring corporates going forward
- Option 2: Future purchases are no longer in carbon-intensive corporates
- Option 3: Actively sell carbon-intensive corporates
- Option 4. Actively sell low ESG scoring corporates or sectors

Very little ESG outperformance thus far



Source: ING, ICE

1 Concentrate (not exclusively) on purchasing green and high ESG scoring corporates going forward

This may already be an element of the ECB’s strategy as they own a very significant portion of the eligible green universe.

Particularly, over the past 12 months, whereby the ECB has increased their holdings of the green eligible universe from 50% to 80%. (i.e. they now own 115 out of 150 bonds) However, according to our sources purchasing green bonds by the ECB does not add any extra firepower in the size of purchases compared to grey.

Effect on credit: The effect on spreads would be marginal. We may see some outperformance of green and ESG, particularly in more volatile times, although this is also market-driven as seen in the chart above. Taking the past year as a proxy, green tends to be more stable in times of widening and volatility.

For future purchases, no longer invests in carbon intensive corporates

As it stands, the ECB currently hold 140 bonds from oil & gas companies.

While the oil & gas eligible universe amounts to around 150 bonds, this would limit the effect. Additionally, it would mean no further purchases of these bonds would be possible in the future in the secondary market.

Effect on credit: The effect on spreads would also be marginal, although more severe than Option 1 for new issues from these companies. As the ECB is clearly in favour of purchasing in the primary market, this would be a significant demand decrease for any carbon-intensive companies.

3 Actively sell carbon intensive corporates

Carbon intensive issuers will indeed see higher spreads if there is action taken by the ECB to not just limit but actively sell these issuers, but overall this will be a small impact on the cost for these corporates. Looking at the European oil & gas names, their cost of debt only represents a 0.5-1.5% of their total costs. On top of this, the most international oil & gas players issue bonds in other currencies and could still easily access capital markets less attentive to climate change issues.

Effect on credit: The effect on spreads would be very significant for all carbon-intensive corporates and very sudden. Spreads would widen across the curve creating a large differential between green companies and 'dirty' companies. The severity of this option would lead to significant market distortion. With the market herd mentality already moving towards ESG, if the ECB join the herd the real green/ sustainable investors may begin to be crowded out.

4 Actively sell low ESG scoring corporates or sectors

Utilising ESG scoring system to dictate whether a company should be bought, held or sold by the ECB would certainly be the most drastic option. Indeed, carbon intensive corporates would have very low ESG scoring, as would sectors such as metals & mining, chemicals, autos and even the commodity food and agri sector.

Effect on credit: The effect on spreads would be substantial. We would see a nuclear reaction with the creation of a large differential between high ESG and low ESG scoring companies and sectors. We would, therefore, expect to see this as a catalyst for a permanent change in classifying valuations in credit markets.

This could then become as much of an important driver as ratings.

But there are some limitations

Having said all of that, there are some limits to how far the ECB can really go.

For instance, eligible supply is expected to fall significantly. Already we are forecasting lower supply of €350bn in 2021. However, within this we expect reverse yankee supply to increase up to €80bn and corporate hybrid supply to reach at least €50bn if not more. This leaves roughly just over €200bn in eligible debt supplied this year, a large decrease relative to last year which saw closer to €330bn of eligible supply.

If the ECB were to begin selling either carbon-intensive corporates or lower ESG scored companies, it would likely create an aggressive sell off in credit markets as a whole. Ultimately causing a permanent change in classifying valuations in credit markets. As mentioned. this could then become as much of an important driver as ratings.

Sometimes, things are easier said than done. The various options laid out indeed have benefits from an environmental perspective, but what does that mean for markets.

We remain sceptical about what the ECB can do in relation to green investments. The ECB, according to their own report, is the largest catalyst for the creation of the green bonds market, however, even after four years, only 7% of their portfolio is green. Therefore, we would like to see more from the ECB in terms of action for promoting green.

Going forward, we expect the most likely option will be to concentrate (not exclusively) on purchasing green and high ESG scoring corporates, with potentially the introduction of no longer investing in carbon-intensive corporates down the line. Actively selling either carbon-intensive corporates or low ESG scoring corporates remain unlikely options.

Safe to say, the more severe the option the more drastic the effect on credit markets will be. As it stands, the ESG market is in a slight limbo as the supply-demand balance is off, meaning there is a lot of inconsistencies in terms of the greenium - the premium for green bonds, where ESG curves trade relative to grey. Continuing down the path of focusing on purchasing more green and high ESG is unlikely to balance the ESG market.

In adding the no longer investing in carbon-intensive corporates option, the greenium will start being introduced and it will act as a catalyst, particularly in times of volatility or a bearish outlook.

Example of good ESG scored companies

Name	ESG Score
SAP SE	94.4
AstraZeneca PLC	94.1
Daimler AG	93.0
Unilever NV	92.5
Koninklijke Philips NV	89.1
Enel SpA	88.9
Unilever PLC	88.6
Bayer AG	88.5
Alstom SA	87.8
Legrand SA	87.7

Source: ING

Example of poor ESG scored companies

Name	ESG Score
HELLA GmbH & Co KGaA	55.2
Italgas SpA	54.7
Easyjet PLC	52.2
Smiths Group PLC	49.3
Buzzi Unicem SpA	47.4
ALD SA	39.0
Prosegur Cash SA	39.0
SES SA	33.7
Tauron Polska Energia SA	31.3
Prosus NV	24.3

Source: ING

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Eurozone: Backroom politics to the forefront

Last year was a good year for eurozone integration. But aside from the vaccination chaos, the potential political fallout looks much less spectacular this year. However, we think behind the scenes; some important next steps will be taken about the future of the eurozone in 2021



Source: Shutterstock

Italy's prime minister-designate Mario Draghi (3-L), ECB president Christine Lagarde (R), French president Emmanuel Macron (2-R), German chancellor Angela Merkel (3-R), president of the EU Commission Ursula von der Leyen (L) and Italian president Sergio Mattarella (2-L)

Desperate times called for historical measures

2020 turned out to be another testing year for the eurozone. Doubts about national governments' fiscal firepower to tackle the pandemic, enhanced by comments by ECB president Christine Lagarde that it wasn't the central bank's job to keep spreads narrow and she had no intention of her own whatever-it-takes moment, brought back euro crisis memories.

It took a while, but in all fairness, national fiscal stimulus, cheap funding for countries in need, the ECB's pandemic emergency purchase programme and finally the Recovery and Resilience Fund (RRF) marked an unprecedented policy reaction, both in terms of size and swiftness.

The most relevant and novel measures included:

- Creation of the recovery and resilience fund - a fund that disburses grants and loans for which the EU directly borrows from the markets. (672.5 bn euro)
- National fiscal stimulus worth on average 3.8% for the EU and even 11% of GDP for Germany.
- The unconditional use of the European stability mechanism loan facility for health-related purposes up to around 2% of GDP for eurozone economies.
- The SURE programme, which allows governments to borrow for short-time work scheme funding (100bn euro).
- The creation of the pandemic emergency purchase programme, in which the ECB allows itself to deviate temporarily from capital key, which is not a political decision and therefore beyond the scope of this note.

To remind you of what a difference a year makes, cast your minds back to October 2019 when the French president Emmanuel Macron called for a eurozone budget that was just 17 billion euro for all 19 eurozone members, spread out over seven years and not meant for stabilisation. A meagre sum that it could hardly count as a symbolic victory.

This year is unlikely to be as spectacular as 2020, at least not when it comes to new measures. However, behind the scenes, 2021 could be an important year to set the future course of the eurozone

After teething problems, the European response to the crisis led to positive reactions from the market with spreads between government bond yields narrowing and a strengthening of the euro exchange rate - a clear message of European solidarity and pricing out any break-up risk. Investors have been comforted by the EU's 'leave no country behind' policy, even if most measures have been explained as exceptional cases and one-offs. Investors seem to be taking the view that every permanent crisis-fighting tool starts with a 'one-off'.

However, this year is unlikely to be as spectacular as 2020, at least not when it comes to new measures but behind (and in front) the scenes, 2021 could be an important year to set the future course of the eurozone.

Just think of discussions on debt cancellation, fiscal rules review, implementing the recovery fund and national elections.

➔ Debt cancellation will be a no-go, but debt sustainability is on the table

- We can't see any argument for debt cancellation which would pursue any monetary policy goal or would not be monetary financing. Therefore, it won't happen, at least not at face value. Endless rolling over of purchased bonds would already come quite close to indirect debt cancellation by the ECB.
- **In our view**, this discussion simply shows that a time will come when debt sustainability will become an issue again probably when the escape clause ends or when higher inflation forces the ECB to normalize policy.

➔ The fiscal rules discussion on possible new revisions has just started

- Given that there is a strong need for further investments, fiscal rules could be changed again
- A longer or more flexible adjustment path for debt, more emphasis on the expenditure side rather than the revenue side of the budget as well as an off-budget investment vehicle could be high on the priority list

➔ The recovery and resilience facility could be an important driver of the eurozone's recovery

But it is more. The process has already started and there has been an active dialogue between the Commission and national governments on what to include in the national plans. But there are several high-alert challenges:

1. Investment projects need to be future-oriented and should not be old projects taken out from the drawer
 2. The European Commission will closely watch the proposals for structural reforms.
- Don't forget the weaker the ambitions on structural reforms and the less future-oriented projects the plans include, the higher is the risk of not only a delayed process of disbursement but also the risk that the RRF will be very short-lived and not a permanent instrument.
 - **In our view**, a successful combination of structural reforms and European transfers could become a permanent feature of the eurozone architecture. Together with the discussion on more fiscal rules revision, the old proposal of a European Monetary Fund could get new traction too.

➔ Elections in Netherlands and Germany scheduled for March and September

- Unlikely to see a surge in the Eurosceptic vote, which means the political attitude towards Europe is unlikely to change, however, the change of guard in Germany, with Angela Merkel leaving the political stage, will mark a new era.
- Also, with a high likelihood of long coalition negotiations and upcoming French presidential elections in 2022, the window for any significant additional integrational steps won't be open this year and will remain closed until the second half of 2022.

☑ The debt cancellation debate

The pandemic has not only put a lot of strain on the health system and the economy at large, it has also increased already bloated debt levels in Europe.

Public debt in the eurozone has grown by about 15 percentage points since 2019 and is now hovering around 100% of GDP, with some countries clearly above that level. At the same time, the eurozone needs to invest to counter the structural growth decline and realise its green and digital agenda.

[An opinion piece in Le Monde co-signed by more than 100 economists across Europe](#) calls for the write-off (or transformation in a 0% interest rate perpetual) of the almost 25% public debt held by the ECB. While they bravely state that "In full compliance with the law and contrary to what some heads of institutions – including the ECB – claim, cancellation is not explicitly prohibited by European treaties.", as cancelling the debt would effectively be monetary financing of public debt, which is not allowed according to ECB treaties, something that Lagarde was quick to point out.

Debt cancellation will therefore be a no-go, but debt sustainability is on the table

Needless to say that the German constitutional court, which was already very critical of the public sector purchase programme, would go berserk if the ECB ever thought of public debt cancellation.

Also, the European Court of Justice pointed out that bond purchases were only allowed for monetary policy purposes. So, it is hard to see that anyone could argue that cancelling the debt would benefit monetary policy.

It's all cosmetics

But even if the idea would come to fruition, it would not change that much. For starters, the central bank is actually owned by the government and within the monetary union, governments receive dividends from their national banks, which in turn receive their share of the ECB's profits. If the ECB exchanges interest-bearing debt on the asset side of its balance sheet with a zero-coupon perpetual, then, of course, the central bank's profits will decline in the future, especially when short term interest rates on the liability side of its balance sheet increase.

This will result in lower dividends for the governments in the future, so, this debt cancelling would pretty much amount to a cosmetic operation without necessarily changing public finances very much. Also, don't forget that the ECB has announced to roll over its bond holdings, reinvesting maturing bonds. If the ECB was to continue with this approach, it would already be very close to debt cancellation (though the ECB will have to make sure that its bloated balance sheet serves a monetary purpose). On top of that, the weighted-average interest rate on Eurozone debt is currently negative. Even for Italy, an important part of the yield curve is below 0% - in other words, currently, member states can borrow to finance the necessary investments while decreasing debt service costs.

Even if currently a common belief is that government debt could increase endlessly as long as interest rates are low and deficit-funded investments increase growth, a time will come when debt sustainability will become an issue again probably when the escape clause ends or when higher inflation forces the ECB to normalise monetary policy.

Debt cancellation will therefore be a no-go, but debt sustainability is on the table.

Stability and Growth pact - the elephant in the room

In our view, the discussion on debt cancellation and debt sustainability has to be seen in the broader context of fiscal rules.

Not only is the ECB conducting a review of its policy strategy, the European Commission last year announced yet another review of the eurozone's fiscal rules. Also, European governments will have to decide on possibly extending the so-called escape clause, at least until 2022 or perhaps even longer.

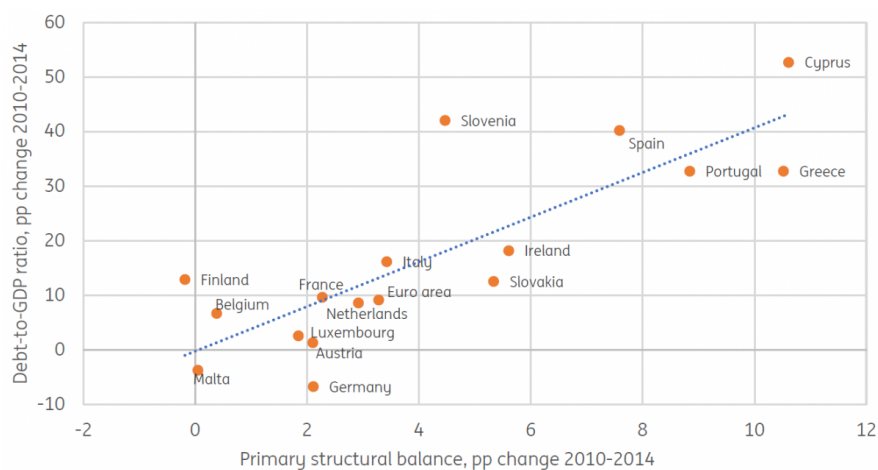
The escape clause was triggered last year which means countries temporarily don't have to adhere to the budget rules as the economy is in a severe downturn. In November 2020, the European Commission indicated that the clause will remain active in 2021 too.

However, given that we think Eurozone GDP is unlikely to return to pre-crisis levels before the end of 2022, in our view, it might be unwise to significantly tighten budgetary policy before. As the escape clause has to be approved by the Council and budget proposals have to be handed in by October, a heated discussion is likely to ensue as diverging opinions will grow as the crisis nears an end.

Here, the memories from the financial crisis should help European governments. After the financial

crisis, member states were too quick to bring public finances back on track and the austerity proved to be counterproductive as weakest member states saw their debt-to-GDP ratios rise on the back of tightening fiscal policy.

Countries with stronger austerity efforts saw debt rise more quickly in the euro crisis



Source: European Commission AMECO, ING Research

Fiscal rules and the stability and growth pact has already been reviewed and changed many times. The last time was after the financial crisis when the so-called fiscal compact was introduced, trying to tighten the rules and introducing constitutional debt brakes. The [IMF's Article IV report](#) also recommends it would be an opportune time for fiscal rules reform.

There are still weaknesses in the eurozone's fiscal rule. e.g. the debt sustainability criteria forces countries to diminish their debt at a speed which is determined by their actual debt ratio and the 60% debt-to-GDP threshold. However, with debt ratios rising significantly, this recommendation would actually lead to overly restrictive fiscal policies. A discussion about what sustainable public finances actually entail will have to be held and the answer might be different for each country.

In the past, issues like a possible expenditure-based rule or a golden rule allowing for more public investment over the cycle or more focus on reducing government debt have been discussed but there has never been a clear conclusion or preference for either a pure rules-based system or discretionary fiscal policy. A very practical problem has always been how to define investments or any such exemptions from the rules. While in theory, the principle of adjusting the fiscal rules to allow for more investments sounds very attractive, the experiences of the last twenty years (France, Germany or Greece) have illustrated how difficult any such definition or exemption can be in practice.

An elegant way out of the constitutional debt brake could be a temporary off-budget investment initiative

In our view, there will be room for looser fiscal rules and in this regard, the latest developments in

Germany are remarkable. Not only did the government decide on the largest fiscal stimulus package of all European countries by far, it also seems to have taken a more structural u-turn on fiscal policies. However, how difficult a significant shift of the next German government will be was illustrated by the recent discussion on the constitutional debt brake. A proposal by a close Merkel-ally to have a discussion on whether several years of triggering the escape clause should be preferred over changes to the debt brake was quickly closed. Still, we expect this discussion to resurface after the elections but admittedly, it is hard to see how any CDU-led government would officially give up on the debt brake. However, an elegant way out could be a temporary off-budget investment initiative.

At the European level, the discussion has only just started. Given that – similar to the German situation – there is a strong need for more investments, the fiscal rules could be changed again. A longer or more flexible adjustment path for debt, more emphasis on the expenditure side rather than the revenue side of the budget as well as an off-budget investment vehicle could be very high on the priority list.

Recovery and Resilience fund - one-off or start of a new era?

The most closely watched EU theme of 2021 will be the start of the recovery and resilience fund.

Proposals will be handed in by 30 April, so expect formal proposals to be rolling in from March. The recovery and resilience plans (RRP) will entail reforms and investment proposals that wrap up into coherent themes and show how much is requested in terms of investment and the reforms proposed. The plan will give a sense of how much stimulus will potentially flow to countries in the recovery phase of the crisis, but as the European structural funds' show, the take-up is often much lower than maximum reimbursements.

Expect the plans to have a heavy focus on digitisation and sustainability where each plan will have to have at least 37% of green initiatives and 20% digital investments, which make for a sizeable amount of total expenditure going into digital and green projects. This could prove to be a challenge for some countries and is likely to be the most politicized part of the RRF.

Expect the recovery and plans to have a heavy focus on digitisation and sustainability where each plan will have to have at least 37% of green initiatives and 20% digital investments and is likely to be the most politicized part

The Commission will assess the plans before 30 June and the European Council will approve before the end of July. At that point, we will find out if the Commission and EU leaders will just stamp the proposals or if there will be significant negotiation leading to delays in funding. This also sets the scene for the remaining three years as member states have the option to escalate progress concerns over other countries to the Council. This process has already started. There has already been a very active dialogue between the Commission and national governments on what to put into national plans and among the several high-alert challenges is not to include old investment projects from the bottom of the drawer as they need to fulfil the criteria of future-oriented projects.

Also, the European Commission will closely watch the proposals for structural reforms. The weaker the ambitions on structural reforms, the less future-oriented projects the plans include, the higher the risk becomes of not only a delayed process of disbursement but eventually minimising the chances of the RRF becoming a permanent instrument. If anything, the recent nomination of Mario Draghi as Italy's prime minister, bodes well in this regard, as Italy will be closely watched by some of the more hawkish member states.

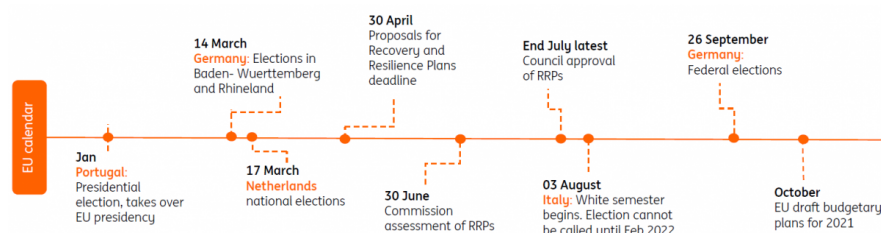
✓ European politics in 2021

The political calendar is relatively empty for the eurozone this year now that Mario Draghi has formed a new Italian government, and we think elections in Italy will only take place at the end of the legislature in 2023.

However, both the Netherlands and Germany have elections scheduled for March and September, which we think are unlikely to see a surge in the Eurosceptic vote, meaning that the political attitude towards Europe is unlikely to change. However, the change of guard in Germany, with Angela Merkel leaving the political stage, will mark a new era.

Also, with the upcoming French presidential elections in 2022, the window for any significant steps toward further European integration is unlikely this year and will probably remain on the back burner until the second half of 2022.

European political calendar for 2021



Source: ING Research

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Article | 18 February 2021

ECB minutes: ‘Financing conditions’ are the new ‘uncertainty’

The just-released minutes of the ECB’s January meeting confirm the ECB’s current preferred stance: maintain favourable financing conditions for as long as possible



ECB President, Christine Lagarde, with other European leaders last week

Financing conditions: the new ECB buzzwords

Some months ago, a keyword in ECB minutes was “uncertainty”. In the minutes of the January meeting, ‘financing conditions’ has become the new ‘uncertainty’. We counted 25 mentions of this phrase, confirming what the ECB’s preferred target is in the coming months.

Here are some other highlights from the minutes:

- “Looking beyond the first quarter, there were reasons for cautious optimism about the prospect of a recovery in the course of 2021.” The ECB stays optimistic but pointed out potential risks of a softer and delayed recovery on the back of slow vaccination progress.
- Will higher savings translate into high pent-up demand? One of the big questions for all forecasts these days. In theory, the strong increase in household savings could lead to a significant spur in private consumption once economies reopen. However, as the ECB points out “younger households were drawing more on their savings as their financial situation deteriorated, while older households were more able to save”. This could add to a more

- uneven recovery.
- As for inflation, the minutes provided more information than the press conference, pointing to a range of technical factors potentially pushing up headline inflation. However, the minutes said that that temporary inflation increases should not be taken as a sustainable increase.
 - With regard to the ECB's newest target, financing conditions, the minutes confirm the still supportive and favourable financing conditions. "Nonetheless, it was important to monitor the recent increase in nominal risk-free rates, which could be attributed to the spillover from the more substantial increase in US yields. Looking ahead, assessing the impact of upward pressure on nominal yields on the favourability of financing conditions would be an important task in the context of future updates to the inflation outlook."
 - Finally, the standard sentence that "all instruments needed to remain on the table" in our view illustrates the ECB's willingness to do more if needed.

The return of inflation and how to deal with it

The return of inflation should continue to be a hot topic for financial markets but also the ECB. Headline inflation should be pushed up in the coming months, mainly by a series of one-off factors. While in the short run, the base effect from higher energy prices should push up headline inflation, a reversal of deflationary trends in the sectors hit the most by the lockdowns once economies reopen will insert additional upward pressure. In the second half of the year, the full impact from the reversal of the German VAT reduction should be reflected in YoY inflation rates. Last but not least, changes in the underlying consumer goods basket and expenditure patterns will make year-on-year comparisons even more complicated.

An increase in headline inflation on the back of technical factors is the worst scenario for the ECB

As for inflation this year, there are currently at least three certainties: the only way is up; for the first time in years, the ECB's inflation forecasts will turn out to be too low, rather than too high; and interpreting these inflation numbers will highly complicated due to too many technical and one-off factors. Also, an increase in headline inflation on the back of technical factors is the worst scenario for the ECB. On the one hand, it could lead to financial markets pricing in higher inflation expectations and possibly even a policy reaction, while on the other hand, this inflation reduces purchasing power and will be undermining if not denting the economic recovery.

This complicated inflation story explains why the ECB has shifted its narrative away from 'returning inflation to target' to 'maintaining favourable financing conditions. The latter obviously gives the ECB enormous flexibility to react to higher bond yields, a higher exchange rate or other unwarranted developments, even if headline inflation stands above 2%. In our view, the ECB's preferred option is still to stay on hold for the rest of the year but the minutes of the January meeting suggest that it is clearly determined to do more if needed.

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US: Steady Fed - Not taper ready

The FOMC minutes did help glean a bit more on Fed thinking, but in a way these are minutes from an economy that was not running as hot as the one we see pushing through the gears now. The Fed is calm in the face of inflation upside, and no taper signals as of yet. Until there are much clearer signs that the Fed is prepared to take its foot off the accelerator, we believe the current dollar rally is a bear market correction and that it does not need to push too much further ahead



Source: Shutterstock
Federal Reserve

The FOMC minutes - Leaves the back end unprotected from inflation risks ahead

The central tenet from the Fed's minutes is no material change in tone – still dovish. At the same time the Fed has nodded approval for the December stimulus, and on the likely positives coming from vaccine effects on the economy in due course. The Fed has shown no panic on inflation as of yet, acknowledging the likelihood for a “spring jump”, but also noting that the economy is far from where it needs to be. There is also no material evidence that the Fed is considering a near-term tapering, with conditions not likely to be met for some time, they suggest.

Not a whole lot for bonds to get excited about here. But at the margin there is a strong tint of a Fed that is indeed likely to take some inflation risk ahead, not seeing it as worrisome at this juncture,

which reduces protection for long end rates, and should allow them to test higher. The impact effect has seen the 2yr ease lower in yield, acknowledging the ongoing dovish signal from the Fed. Longer tenor rates are showing a tendency to edge higher. Back end protection from the Federal Reserve is minimal at this juncture, even with a pop in inflation and a better economy.

At the margin there is a strong tint of a Fed that is indeed likely to take some inflation risk ahead, not seeing it as worrisome at this juncture, which reduces protection for long end rates, and should allow them to test higher.

There was an interesting reference to front end liquidity conditions. The Fed noted that reserves were projected to rise rapidly through the summer reflecting the ongoing QE program, but also the Treasury choosing to spend chunks of the \$1.7bn sitting on the Fed's balance sheet. Our note is that this will add liquidity to the system, placing downward pressure on money market rates. The Fed alludes to the rate on excess reserves (IOER) and repo as a means to ensuring that the effective funds rate remains above zero.

This, in fact, is code for a potential IOER rate hike. Such a move would be purely technical, but is added evidence of the need for more work to control the excess of liquidity in the system.

FX: Minutes provide no fuel to the dollar rally

The dollar headed into the release of these January FOMC minutes on the strong side. The strong January US retail sales release earlier in the day had been the driving factor and a market running core short dollar positions was bracing for some fresh input from the Fed.

But we think dollar bulls will struggle to find much from the FOMC minutes to support their cause. True, the Fed had more confidence in the medium-term outlook based on vaccine progress. But there were no signs of the Fed, at this stage, being concerned about the economy running too hot.

And it looks like the Fed was already preparing for the communication challenge of inflation pushing above 2% in 2Q21. Here 'participants emphasized that it was important to abstract from temporary factors affecting inflation – such as low past levels of prices dropping out of measures of annual price changes or relative price increases in some sectors brought about by supply constraints or disruptions – in judging whether inflation was on track to moderately exceed 2 percent for some time.'

We think dollar bulls will struggle to find much from the FOMC minutes to support their cause

Until there are much clearer signs that the Fed is prepared to take its foot off the accelerator, we believe the current dollar rally is a bear market correction and that it does not need to push too much further ahead.

Indeed, the performance of EM currencies this year – where many EM high yielders have even matched the dollar advance – is impressive. We therefore suspect that many investors will take advantage of any near term dip in cyclical currencies, including the EUR, and position for an advance against the dollar resuming in 2Q21, when further evidence of vaccine rollouts and lockdown unwinds emerge.

Although the minutes come after a run of strong data, a consistent theme in recent weeks

The FOMC minutes came against a backdrop of an exceptionally strong retail sales number – up 6% in January; that's practically an annual change in one month. A typical monthly rise would be in the region of 0.4% (includes inflation). The big driver was low income households, indicative of the real effects of the December stimulus. It shows how important such stimulus has been both to the US economy, and to the households in question that were forced to hold back in December. We also had the latest producer price inflation reading for January, which showed core producer prices at 2% above last year. Not only was this double the Street estimate, but in a flash we have a 2% pipeline inflation economy; no sign of deflation here.

The FOMC minutes did help glean a bit more on Fed thinking, but in a way these are minutes from an economy that was not running as hot as the one we see pushing through the gears now. The US 10yr could have used these data as an excuse to push on higher. But, as we have noted in the past day or so, there has been a decent enough move to the upside over the past week. Too fast too quick would be unsettling for risk assets, risking a self-correction for bonds.

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Eurozone: voluntary social distancing weaker in second wave

In addition to official measures, voluntary social distancing played an important role in reducing mobility during the first wave of the Covid-19 pandemic. The higher the number of cases, the stronger the voluntary response. We find that this is still the case in the second wave, but to a much lower degree. The weaker voluntary response reduces the short-term economic effect of the virus and plays a role in the smaller hit to GDP in 4Q. The long-term impact is less certain, as this also increases the risk of longer or stricter official lockdowns



GDP growth in the fourth quarter of 2020 remained surprisingly strong despite a second wave of the coronavirus. Eurozone GDP fell by just -0.7%, while Germany, Belgium and Spain even posted positive growth rates. The smaller drop in GDP compared to the first wave is related to a variety of factors. The rest of the world was more open in the second wave, industry and construction was kept open in some countries, online solutions were adopted where possible and the decline in mobility was smaller. The latter was strongly correlated to GDP in the first wave, as we showed [here](#). In this piece, we will focus on how less voluntary social distancing has caused mobility to hold up better in the second wave thus far.

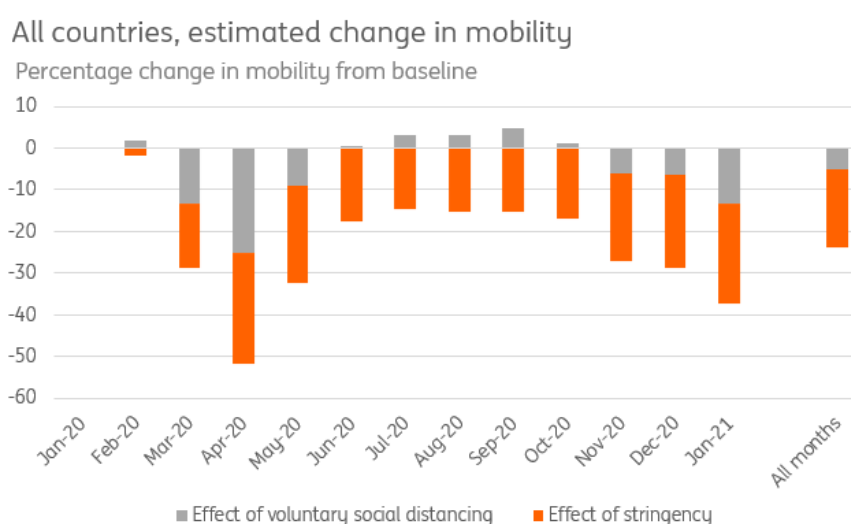
Voluntary social distancing became much weaker as the pandemic progressed

The economic impact of the virus is related both to government measures as well as behavioural changes in response to the virus. In April, the IMF [found](#) that voluntary social distancing – reductions in mobility in excess of lockdown measures – was responsible for a slightly larger decline in mobility in advanced economies than the official government lockdown measures themselves. Where and when the virus flared up, there was a strong decline in mobility, beyond what could be explained by government measures.

Especially during the first wave, mobility was strongly related to GDP, so this indicated that a significant part of the historic economic contraction in the first wave could be attributed to voluntary distancing. In a crisis so novel, a few more months' worth of data, including the start of a new wave, makes the world of difference and allows us to revisit the relationship between mobility and the virus. This analysis can help to explain the current impact of the virus on the economy and provide insight into the economy for the period in which the virus has not been contained.

Looking at eurozone data, we take a slightly adapted approach to the IMF's to allow for a longer time period of testing (please see the annex for detailed methodology, data and results). With this, we find similar results as the IMF for the first lockdown, though a somewhat larger effect for lockdown measures than the IMF finds. Significant drops in mobility during the first wave are related to both the effect of restrictive measures and voluntary social distancing in roughly equal parts for March and April. The relationship is far from steady as the pandemic unfolds though, and we find that voluntary social distancing in the second wave has declined compared to the first wave. So, people are now more active in the second wave even if similar restrictive measures are in place.

Voluntary social distancing is lower in the second wave



Source: ING Research

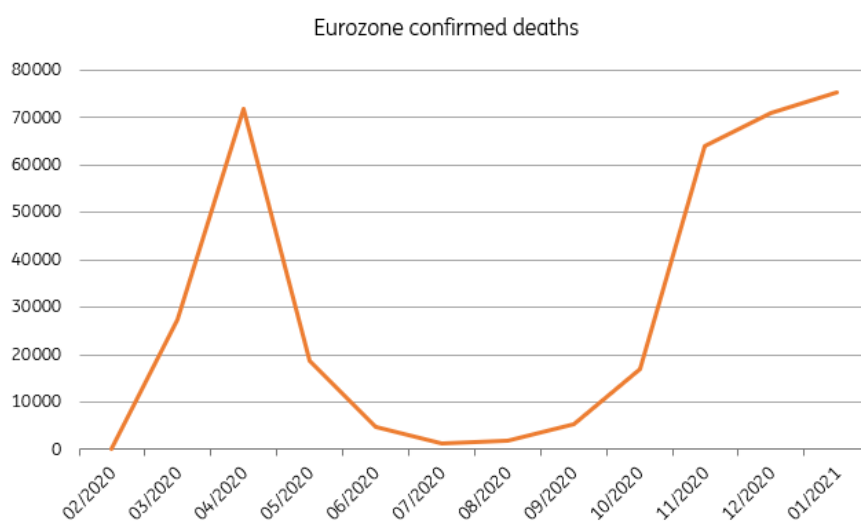
What happened over time?

As the first wave subsided, we find that voluntary social distancing declined, and even contributed positively to mobility between June and October. While there were still restrictive measures in

place over the summer months, mobility remained relatively high. This helped the surprisingly strong recovery of the economy as domestic demand returned quickly.

As the second wave progressed, voluntary social distancing increased again, but by a lesser extent than in the first wave, while the rise in deaths, and restrictiveness of lockdowns, have been similar to the first wave. November and December were both months with less voluntary social distancing than March, April and May. For January, we do find stronger voluntary social distancing again, but this effect is still much smaller than in April, despite a similar severity of the virus. We do have to be careful with January data as we only have partial data for the month included in our model.

Severity of the virus as measured in new deaths has risen again during the second wave



Source: University of Oxford, ING Research

Less voluntary social distancing can therefore partly explain the smaller decline in mobility, and therefore in part economic activity, observed over the second wave so far. That also adds to the stronger economic performance in the second wave. The downside to this smaller reduction in mobility is that it means the virus is less easily contained. Therefore it may require a longer period of lockdowns or stricter measures if governments want to achieve a similar decline in cases compared to the first wave. A more contagious mutation would of course increase the required measures even further.

What is voluntary distancing?

We use the same term as the IMF, voluntary social distancing, to describe changes in mobility that are not explained by lockdown measures. This happens because of a variety of factors, but for the largest swings in mobility, it will relate to 'fear of the virus'. Think of people visiting the supermarket less, people not going to shop for clothes even though stores are open or people working from home even though there are no restrictions on workplace visits. This adds to declines in mobility and (usually) has economic consequences.

What does this mean for the remainder of the pandemic?

Weak and unpredictable voluntary social distancing hurts the economy unevenly

While vaccines provide light at the end of the tunnel, eurozone countries are currently still experiencing problematic case counts. Also, mutations of the virus make the near-term outlook very uncertain. Less voluntary social distancing than in the first wave means that the economy continues to record higher levels of economic activity with similar lockdown measures in place, but these higher levels of activity also mean that cases are not coming down as quickly as in the spring. This increases the risk that strict lockdowns will be extended.

Continued weak voluntary social distancing is not a given though. The relationship as we find it for the past year is not stable over time. The relationship could weaken further, for example once the most vulnerable have been vaccinated. On the other hand, we could yet see mobility driven down further by voluntary social distancing due to fear of the virus mutating. That could result in quick decreases in mobility and therefore also contribute to another sharp GDP contraction on the back of the mobility declines. Finally, it is also hard to predict what would happen to voluntary social distancing if the spread of the virus is much larger than currently seen. All in all, this leaves the impact of the virus on mobility rather uncertain for the remainder of the crisis, in turn confirming large uncertainty around the eurozone economic outlook.

Reopening will be a tightrope exercise for policymakers

There are also noteworthy conclusions for the period of reopening. We find that voluntary social distancing reemerges as cases flare up again. This suggests that while the pandemic continues, opening up economies will not result in a complete recovery in economic activity. When the virus retreats enough, however, a lack of voluntary social distancing could push up mobility again, as we saw during the summer months. That would help the economy to bounce back quickly but also poses a risk. It could result in mobility returning too quickly, adding to risks of a third wave of the virus if vaccinations have not yet resulted in herd immunity.

A true tightrope exercise awaits policymakers with large implications for the path of economic recovery. They will have to manage the reopening of the economy while keeping restrictions tight enough not to be surprised by 'negative voluntary social distancing' effects at the end of the second wave that could increase the risk of a new wave of infections.

Appendices

Methodology

To assess the impact of the coronavirus on mobility over the course of the past year, we use a panel regression with cross-country information on changes in mobility, the scale of the outbreak (proxied by number of deaths), and lockdown stringency, to isolate the changes in mobility (and therefore economic activity). By estimating the mobility corrected for contribution of the stringency index we isolated the changes in mobility that can be thought of as 'voluntary' – and how this has changed as the pandemic has progressed.

Our equation is an adapted form of the [IMF](#) equation as described in Chapter 2 Annex 2.3. This equation allows for a decomposition of mobility changes into an isolated lockdown measure effect

and an effect that captures voluntary social distancing.

The specification below details the precise equation, which differs from the IMF's in the measure for scale of the outbreak, where we use deaths in place of cases. As testing has become more widely available over time, there is a huge difference in reported cases between the first and second wave that does not reflect the scale of the outbreak. We have therefore chosen new deaths as the variable tracking the phase of the outbreak, which has been tracked more consistently over the course of the crisis.

Data

As a proxy for mobility, we use the [Google COVID-19 Community Mobility Reports](#), which tracks visits and lengths of stay for different types of places to a baseline taken from 3 January to 6 February, 2020. We take an average of the data for grocery & pharmacy, retail & recreation, transit stations, and workplaces as our dependent variable in our specification.

For the restrictive measures to proxy the state of the lockdown that countries have imposed, we use the Stringency Index from the Oxford Covid-19 Government Response Tracker. This index consists of a range of containment and closure policies taken, which has been quantified to allow for country comparison.

To proxy the stage of the pandemic, we use new deaths caused by Covid-19 from the [Oxford COVID-19 Government Response Tracker](#). As mentioned above, we have chosen new deaths as a measure of the stage of the pandemic to allow for more consistent tracking over time compared to new cases which have been hugely influenced by testing capacity. New deaths do occur with a lag compared to the new cases used by the IMF, but running the regression with a 14-day lead for new deaths did not give significantly different results from the ones reported in this note.

We limit this study to the eurozone economy, which means that we create our panel dataset for all eurozone economies, excluding Cyprus for which Google mobility data is not available. For those 18 countries, we have data for the period 15 February, 2020 to 24 January, 2021.

Specification

To assess the dynamic response of mobility to the developing pandemic, we estimate the following panel regression:

$$mob_{i,t} = \alpha_i + \tau_t + \sum_{p=0}^P \beta_p \Delta deaths_{i,t-p} + \sum_{p=0}^P \delta_p lock_{i,t-p} + \sum_{p=1}^P \rho_p mob_{i,t-p} + \varepsilon_{i,t}$$

Mob is the Google mobility average for country i at time t ; deaths is the log of daily Covid-19 deaths, which is used to track the stage of the pandemic; and lock is the index measuring lockdown stringency. The specification also features lags of the dependent variable to account for pre-existing trends, and country and time fixed effects to control for country characteristics and global factors. The estimation includes a week worth of lags to account for pre-existing trends. Standard errors are clustered at the country level.

Results

The results from the panel regression that we have performed generate strong significant results for the stringency index and for the state of the wave represented by the new deaths variable. Both show the expected sign as an increase in stringency and new deaths result in a decline in mobility. We also find that the lags of mobility are very significant while that is not the case for the lags of the two other independent variables, which confirms that existing trends are relevant and which therefore rightly reduces explanatory power from the stringency and new death variables.

For the results presented in Chart 1, we use the coefficients from the panel regression below and use the monthly data for the respective independent variables to estimate the decomposition of the mobility into a lockdown stringency and a voluntary social distancing effect. We have also estimated the monthly effects using an interaction effect with a dummy variable for each month and the stringency index which yielded similar results. We also split the sample into quarters, which also gave similar results to the ones presented here.

VARIABLES	(1) Mobility
Mobility -1 day	0.290*** (0.0379)
Mobility -2 days	0.153*** (0.0158)
Mobility -3 days	0.109*** (0.0270)
Mobility -4 days	0.0977*** (0.0261)
Mobility -5 days	0.0611*** (0.0203)
Mobility -6 days	0.129*** (0.0256)
Stringency index	-0.242*** (0.0426)
Stringency index -1 day	0.0164 (0.0292)
Stringency index -2 days	0.0457 (0.0475)
Stringency index -3 days	0.0384 (0.0541)
Stringency index -4 days	0.0550 (0.0473)
Stringency index -5 days	-0.0319 (0.0280)
Stringency index -6 days	0.0650* (0.0333)
New deaths -1 day	-0.00529*** (0.00156)
New deaths -2 days	9.44e-05 (0.00154)
New deaths -3 days	-0.00117 (0.000943)
New deaths -4 days	0.000489 (0.00125)
New deaths -5 days	0.000461 (0.00102)
New deaths -6 days	0.00242 (0.00143)
New deaths -7 days	0.000949 (0.00209)
Constant	-0.229 (0.599)
Country fixed effects	YES
Time fixed effects	YES
Observations	5,803
Number of x	18
R-squared	0.893

Discussion

Cases and deaths

As described above, we use the daily change in confirmed deaths to proxy for the stage of the pandemic in our equation. New cases rise before deaths, so we check to see if the two-week lead of new deaths changes our results. We find similar effects for voluntary social distancing in this specification.

Multicollinearity

Lockdowns and their severity are a response to the stage of the pandemic, as is the 'voluntary' element of any change in mobility. News about the pandemic is likely to reach people through lockdown announcements as well as the number of deaths. In practical terms, the two variables are correlated and this adds uncertainty to our estimates. There is no easy solution, but [other approaches](#) have also found a significant role for voluntary social distancing.

Seasonality

Our dependent variable, mobility, is measured relative to a pre-pandemic baseline, the median value for a five-week period between 3 January – 6 February, 2020. Even in the absence of the pandemic, seasonal variations in mobility, such as holidays, will cause changes in mobility on this measure. Because Community Mobility Reports have only become available in 2020, there is not enough data to correct for the seasonal variation that therefore remains in our dependent variable.

We use time fixed effects in our regression to control for global shocks, but some effects may work differently for the countries in our sample. Think of summer holidays for example, increasing mobility in countries that experience net inflows of tourists and reducing it in countries with net outflows. As a robustness check to seasonality, we also estimated the monthly effects using individual monthly samples, which generated similar results to the ones presented above. We also split the sample into quarters, which also gave similar results to the ones presented here.

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Podcast | 19 February 2021

Listen: The rise and fall of voluntary social distancing

In economic terms, the second wave of the pandemic in Europe has been less severe than the first. One reason for this: lower levels of voluntary social distancing. In this podcast, ING's Bert Colijn discusses whether the trend will continue in the face of new virus strains and a relatively slow vaccine rollout



Economic growth in the eurozone contracted by just 0.7% in the fourth quarter of last year compared to an 11.8% fall in the second, even as coronavirus infections hit new records.

EU Economic Commissioner Paolo Gentiloni said containment measures have been less harsh and more targeted than in the spring, with construction and industry remaining open, along with many European schools and kindergartens. But ING research shows other forces may be at work, too.

Voluntary social distancing has also slipped relative to the first wave. And while that's helped to limit the economic damage, it also brings risks. [In this podcast](#), ING's Senior Economist Bert Colijn tells Senior Editor Rebecca Byrne whether this trend is likely to continue and what it means for Europe's economy this year.

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UK Chancellor's four budget challenges

Expect the UK budget to be tailored more towards the hardest-hit service sectors, as the government prepares for a fairly gradual exit from social distancing measures over the spring and summer



Source: Shutterstock

Just a few months ago, UK Chancellor Rishi Sunak would have hoped that his spring budget would be an opportunity to move the economic agenda away from Covid-19, and back towards the government's 'levelling up' commitment. But as he prepares to announce his latest set of measures on 3 March, the reality looks very different.

That's because it's becoming increasingly clear that it could be some time before Covid-19 restrictions are removed entirely, despite the considerable progress on vaccinations. The good news at least is all priority groups (including over 50s) will likely have received their first dose by Easter, and that combined with the strong impact lockdowns are having on cases, it will lower hospital pressure considerably by May.

For the Chancellor the main takeaway is that Covid-19 is set to linger

That's likely to justify reopening most sectors around the same time, but it'll probably take until

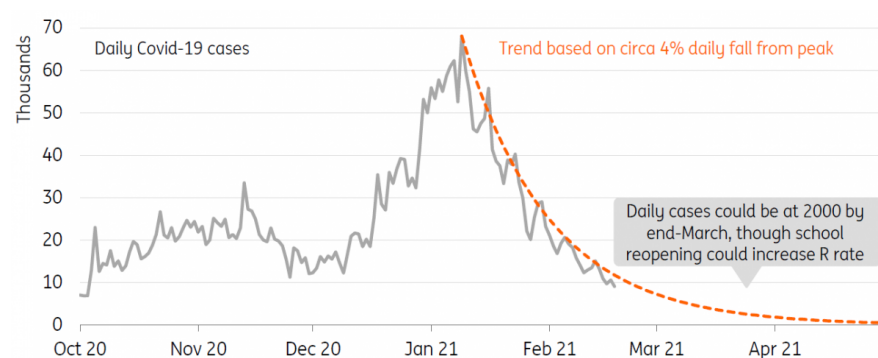
late June/July at the earliest for all adults to receive their first dose, assuming supply capacity can increase to accommodate both first and second doses.

In the meantime, community transmission will likely rise again among the younger population. The government's new concern is that this could drive the spread, or even development, of vaccine-resistant strains, and that implies some social distancing measures are likely to stay in place (limits on mass gatherings as an example).

The extent of these will depend on how far the reproductive number, or R number goes above one, which is intrinsically linked to the effect vaccines have on transmission (**early signs are relatively encouraging**). This will determine how quickly social distancing can end entirely, or indeed if certain restrictions need to be temporarily brought back.

Either way, for the Chancellor the main takeaway is that Covid-19 is set to linger, and that poses a number of potential challenges.

UK Covid-19 cases have fallen rapidly despite high prevalence of new variant



Source: Macrobond, ING

Trend line based on average percentage fall in cases between peak on 9 January and now. Note this is based on recorded cases, rather than estimated prevalence

1 Extending furlough

This is undoubtedly the most pressing issue, and some form of extension of wage support seems inevitable. The current furlough scheme, where employees can receive 80% of their normal wages if unable to work, expires at the end of April. It feels like the hospitality sector (and possibly others) won't be open by then.

The Chancellor may be tempted to focus the policy to areas where social distancing is still restrictive

But beyond an extension of a few months, the challenge when tapering the support will be to limit job losses to roles that are definitely no longer viable.

Premature removal of support for sectors still covered by social distancing restrictions potentially

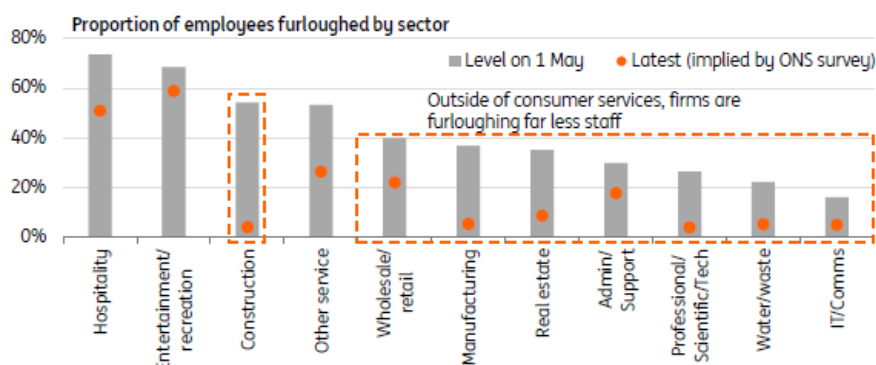
risks amplifying redundancies - which is what we started to see last September ahead of the original furlough expiration date.

The fact that there were still 1.3 million jobs 'fully furloughed' back in October before restrictions tightened again, suggests there are potentially hundreds of thousands of roles that fall into this category. To help mitigate all of this, the Chancellor may be tempted to focus the policy on areas where social distancing is still restrictive. We've already seen an uptake of furlough become ever-more concentrated in the hardest-hit consumer-services sectors, while elsewhere usage has fallen (see chart).

In practice, we could see the Treasury either restrict 'full furlough' to sectors formally covered by social distancing rules, or by means-testing the scheme by revenue loss. The latter is perhaps more efficient but probably more logistically challenging to get right. A pre-announced strategy, if restrictions are reintroduced in certain sectors, may also help businesses to plan for the summer months.

For sectors no longer covered by restrictions, the government will presumably revert to the plan it first formulated last autumn. The Job Support scheme, which never actually came into effect, gave wage subsidies where staff were only able to work a fraction of their usual hours.

Furlough usage now more concentrated among fewer, hard-hit sectors



Source: HMRC, ONS, ING

Latest ONS percentages based on 'Business insights and impact on the UK economy' wave 23. May data from official HMRC statistics

2 Supporting struggling cashflows

Aiding firms cashflow is also going to be key for the jobs market. The furlough scheme can only protect jobs as long as firms are strong enough to support them in the recovery phase. And again, the picture is unsurprisingly very sector-specific.

At an aggregate level, firms' cash holdings have risen through the pandemic, no doubt linked to the flurry of financing activity through the middle of 2020. But in the hospitality sector and among other consumer services, the alarm bells are starting to ring.

Over half of these firms are now reporting they have less than four months cash in reserve, according to the Office for National Statistics. While it's hard to know how these figures compare to pre-pandemic norms, the fact that a third of hospitality firms say they have little or no confidence

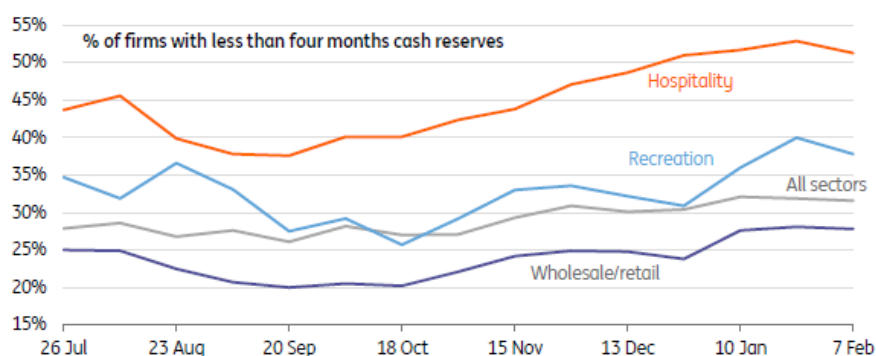
they can survive the next three months is striking.

A third of hospitality firms say they have little or no confidence they can survive the next three months

Limiting the wave of business failures through 2021 will therefore be key. To some extent a rise is inevitable, given that [company insolvencies were lower than in previous years](#). But it's likely that many of the measures designed to aid cashflow will continue, and perhaps be bolstered. There's likely to be a renewed focus on grants, which unlike furlough, are already targeted directly at businesses that are closed. Many are also expecting the government to delay the time when firms will need to repay their deferred VAT payments, as well as extend business rates relief (a tax based on premises' value).

We might also see a further extension to the guaranteed-loan programmes, though given the current cashflow crunch appears more concentrated in smaller firms and in specific sectors, this potentially risks storing up issues for later. Higher debt levels could feasibly constrain hiring and investment in years to come.

Half of hospitality firms have less than four months cash reserves



Source: ONS, ING calculations

Data from ONS 'Business insights and impact on the UK economy' surveys - wave 9 to 23. Proportion of firms reporting 'no cash reserves', 'less than one month', or 'one to three months'

3 Unlocking pent-up demand

One piece of better news for the Chancellor is that there's a good amount of consumer firepower available once the economy reopens. Involuntary savings have risen substantially, and the challenge is to make sure some of this is spent.

The benefit of policies like 'Eat Out To Help Out' over conventional policy levers like VAT tax cuts is that it directs consumer savings

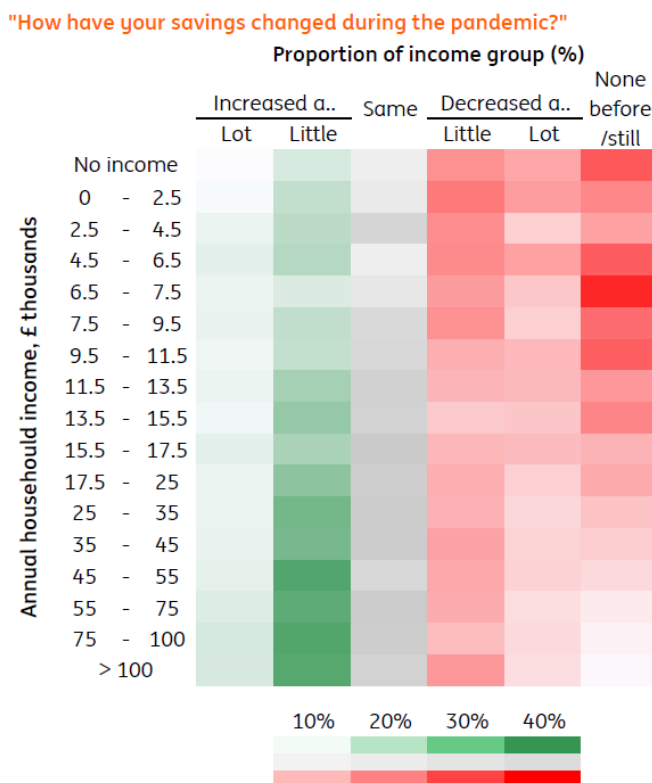
to where the money is most needed

One option would be to look at policies like ‘Eat Out to Help Out’ again, which subsidised meals out in August 2020. The benefit of this sort of thing over conventional policy levers (e.g VAT cuts) is that it directs consumer savings directly to where the money is most needed, but it’s not clear if this is compatible with the wider Covid-19 containment strategy. Consumer confidence is going to be key this summer, and the government is likely to remain wary of introducing policies that risk pushing up the number of cases and therefore prompting more cautious behaviour.

Instead, the bigger issue is that the rise in involuntary savings has been unequally distributed across income groups. Lower earners have typically seen savings fall, according to Bank of England survey data (see chart), and this is tied to higher rates of furlough and redundancy.

Ensuring these workers get back on their feet will be key to the consumer recovery story. That has been neatly demonstrated in the US, where spending in [low-income areas spiked by 20% in January](#) days after stimulus payments were received, while expenditure was largely flat in high-income neighbourhoods.

The rise in savings has been concentrated among higher earners



Source: ING analysis of Bank of England NMG survey

Full question: "As a result of any changes in income or spending due to the coronavirus pandemic, would you say that your household's total savings have increased, decreased, or stayed the same?" Data is from the Bank of England/NMG survey, taken from 25 August-15 September 2020

Managing borrowing

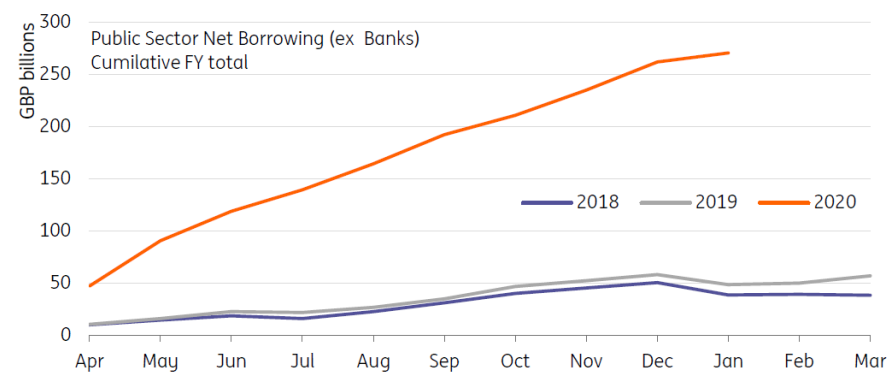
Finally, the outlook for Covid-19 and the previously-discussed policy measures means the deficit in the next fiscal year will remain in the high single digits (down from around 13.5-14% for 2020/21). Unemployment is also likely to rise this year, while pandemic-related expenses (e.g test-and-trace) will also continue to be felt through most if not all of next year.

Arguably this shouldn't come as much of a concern. Government borrowing costs are at record lows, and that means the pressure to look at balancing the books is pretty minimal, to say the least.

Nevertheless, we suspect there is likely to be a renewed discussion about this later in the year, and we may therefore see some renewed focus on tax rises this time next year, to help finance higher spending on the government's (non-Covid) election priorities.

We'll be taking a more detailed look at what all of this implies for UK gilt markets next week.

Borrowing has hit £270bn so far in 2020/21 (12.8% of 2020 GDP)



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