

## June Economic Update: Hope returns despite the huge challenge ahead

The worst may be over for the global economy, but the recovery looks set to be slow and turbulent



THINK Economic and Financial Analysis

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### US: Hints of a V, but don't get carried away

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- 

### Eurozone: Bottoming out

- *With the easing of the lockdown measures, growth is picking up in the eurozone albeit very gradually. Additional fiscal stimulus is being put in place but inflation is still going nowhere. The ECB has increased the size of its bond-buying programme, but we think it'll still be insufficient and a further increase in the second half of this year looks likely.*
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### China: PBoC's mixed message

- *The People's Bank of China has sent mixed messages about its monetary stance. Here's what we expect for June*
- 

### Asia: Still slowing

- *The release of May Purchasing managers indices provides a helpful snapshot of where Asian economies stand following the sharp declines in April, which marked the first full month for many of these economies under movement controls, and in some cases, picked up on the early stages of re-opening.*
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### CEE: The worst seems to be behind us

- *CEE economies are bracing themselves for a slow recovery. But as unemployment is set to rise and high inflation isn't an issue any longer, more monetary easing is on the way. In FX, RUB prospects remain bright while CZK remains our favourite CEE low yielder. Poland central bank's aggressive steps should translate into a further steepening of PLN swap curve*
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### Dollar Hoarding: It's hard to let go

- *As the dollar bear trend starts to gain momentum, questions will be asked about all those dollars hoarded in March - an exercise associated with an 8% dollar rally that month. Delving into some new data on the amounts and the participants involved, we look for clues as to when these dollar hoarders might be prepared to let go*
- 

### Rates: Why the yield curve should do its own thing

- *The best-case scenario would be no yield curve control. The Fed sets the funds rate and engages in quantitative easing rather than moving rates into negative territory.*

*That's artificial enough, let the yield curve do its own thing beyond that. That said, if pushed, yield curve control would likely start on the front end and move out the curve*

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#### **Brexit: Four scenarios for trade talks and UK markets**

- *We still narrowly expect the UK and EU to sign a free-trade agreement this year, albeit a basic one. But the chances of an extension to the transition period beyond 2020, which could have given businesses more time to prepare, looks unlikely. Expect some initial disruption to supply chains at the start of 2021 as Britain formally leaves the single market*
- 

#### **Why we don't expect negative rates in the US or UK... yet**

- *While President Trump likes the idea of negative interest rates, it's clear the bar is set relatively high for the Federal Reserve to adopt them. We are perhaps more likely to see sub-zero rates in Britain, but even here we think policymakers will be much more inclined to use quantitative easing for the time being*
- 

#### **Eurozone: Debt monetisation by stealth**

- *While the European Central Bank is not allowed to monetise debt formally in the wake of the Covid-19 crisis, there seems to be some scope to do so, without fear of galloping inflation. It might even be needed to hit the inflation target*
- 

#### **Stagflation - not coming to an economy near you**

- *Some analysts suggest that the pandemic and lockdowns will lead to a return to stagflation, last seen in the 1970s and very early 1980s. We don't agree, which in some ways is a pity, as it might not be all that bad an outcome if it did happen.*
- 

#### **Eurozone: Periphery in peril**

- *The initial shock to the eurozone economy from the Covid-19 pandemic was very symmetric as all countries went into lockdown at roughly the same time. But the pace of recovery will be far more asymmetric, with many peripheral economies at risk of a longer lasting slump.*

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Chris Turner  
Peter Vanden Houte



## Hope returns despite the huge challenge ahead

**'I know that I know nothing' is a saying attributed to the Greek philosopher Socrates by his most famous student, Plato. Some 2500 years later, this paradox continues to resonate deeply, especially in economic forecasting during the Covid-19 crisis. There is a lot that we have learned in recent weeks but also a lot that we still don't know**

Let's start with what we know and have learned about the global economy over the last four weeks. GDP data for the first quarter showed that even just two weeks of lockdown was enough to bring most Western economies to their knees, recording contractions last seen during the financial crisis. More recently, with the first hard data for April coming in, the risk of further downward revisions to growth for the second quarter has increased. The fact that German industry was down some 30% in April compared to the first quarter made us shudder. We try not to imagine what the GDP figures for the second quarter would look like without any rebound in May and June but they would surely exceed even the most negative expectations.

Luckily, there is increasing evidence that all economies have been gaining momentum as lockdown measures have eased. In early June, some European economies have already returned to far more than 80% of their activity levels seen in February, while some Asian economies, like South Korea, are already back to 100%. At the same time, the US is lagging behind somewhat. The European countries with the strictest lockdown measures have returned to some 70% of their January activity levels. Adding to these hopes are available confidence indicators, which all rebounded in May. But let's not be carried away. Judge for yourself but my very subjective observations of everyday life show that many aspects of social distancing remain in place. Shopping streets, restaurants and transportation are all still running significantly below full capacity.

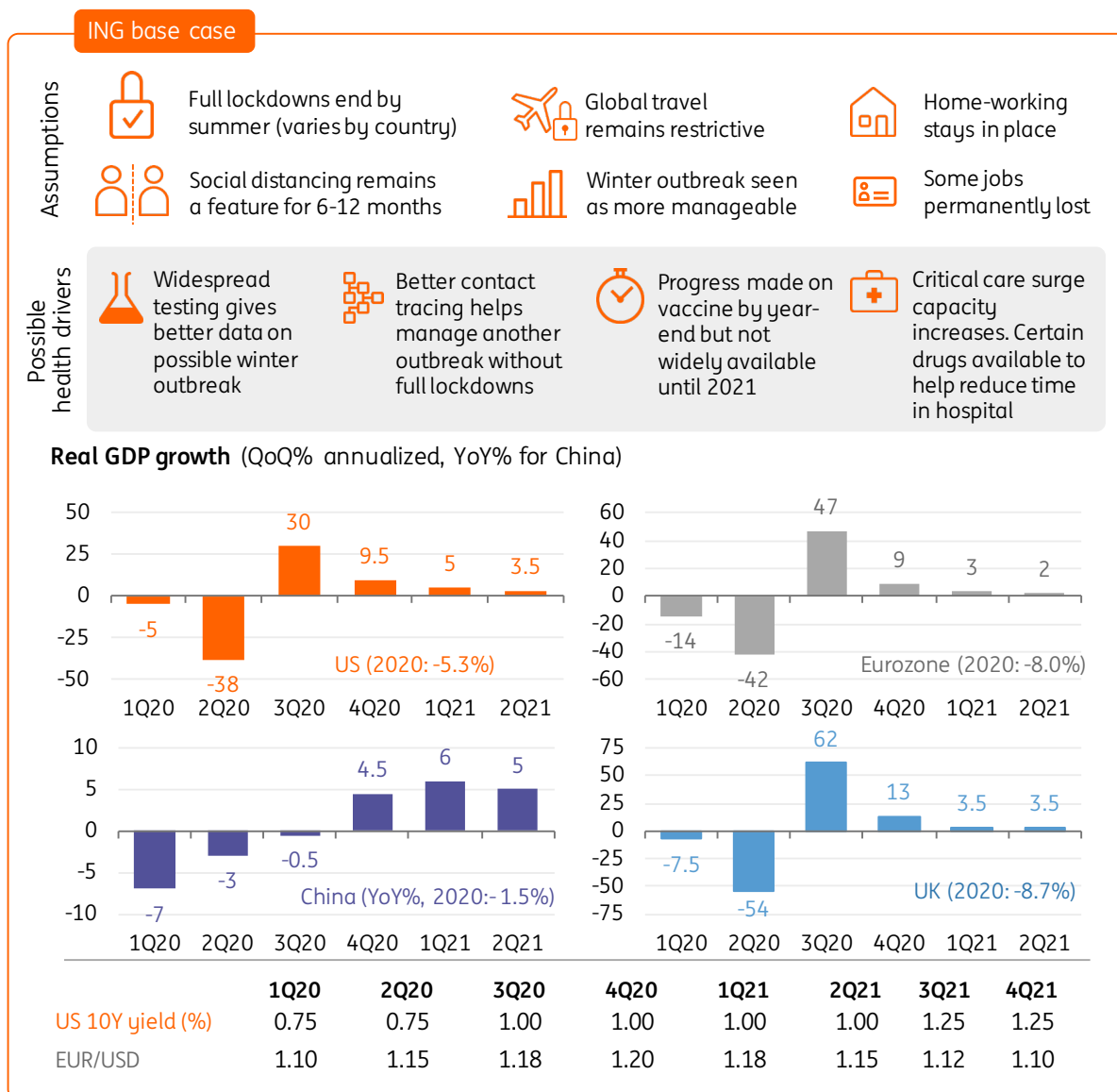
What we also know is that Europe has seen remarkable breakthroughs in recent weeks, including a proposal for a European Recovery Fund, supported by France and Germany, another impressive fiscal stimulus package in Germany and additional stimulus from the European Central Bank. It looks as if Europe has finally got its act together. To me, the most remarkable breakthrough is the change of heart on fiscal policy within the German government. Who, at the start of the year, would have imagined that the austerity champion of Europe would morph into such a big spender? This new German approach to fiscal policy, both at the national and European level, should not be underestimated.

Admittedly, there is also a lot that we still don't know. We don't know how strong the rebound in economic activity will actually be in May and June. And, even more important, we don't know how long this rebound will last or how severe the permanent damage caused by the crisis will be. We also don't know whether our winter lockdown scenario, which sees the virus return later in the year, will materialise. The latest super-spreader events illustrate how difficult it will be to sustain a longer period of social distancing.

Most of the things that we still don't know could easily shatter our current tentative optimism but the things that we do know give us hope that, at least, the worse may be behind us.

**Carsten Brzeski, Frankfurt +49 69 27 222 64455**

## ING's three scenarios for the global economy and markets



### Alternative scenarios

#### Scenario 2: Winter lockdowns return

- Lockdowns end by summer but come back over winter
- Winter outbreak not manageable
- Social distancing remains a feature for 12 months

2020 GDP	United States	Eurozone	China	Markets (End 2020)	10Y yield	EUR/USD
	-6.5%	-10.1%	-2.7%		0.50%	1.10

#### Scenario 3: 'Worst case'

- Social distancing rules tightened for prolonged period of time
- Vaccine unavailable to the masses for 12-18 months
- Stricter social distancing remains a feature for 12-18 months

2020 GDP	United States	Eurozone	China	Markets (End 2020)	10Y yield	EUR/USD
	-13.7%	-16.3%	-4.5%		0.25%	1.05

Note: Quarterly GDP forecasts have been rounded to nearest whole or half number  
Source: ING

## Taking stock of ING's scenarios

### Base case assumptions

Full lockdowns end by summer (varies by country)



Update: **Still valid**

Mobility data shows that activity is gradually returning, albeit less rapidly in areas that saw stricter lockdowns

Social distancing remains a feature for 6-12 months



Update: **Still valid**

Clear that social distancing rules here to stay until a vaccine is available. Risk is that these measures last longer

Winter outbreak seen as more manageable



Update: **Too early to say**

Early data shows reproduction 'R' rate has been kept under control as lockdowns end. But too early to say if test & trace strategies will succeed in limiting second spike

Some lost/ furloughed jobs are permanently lost

**NEW**



Update: **New assumption**

With some industries (notably aviation & hospitality) unlikely to recover until a vaccine is found, firms forced to make permanent job cuts if/when government support ends

Global travel remains restrictive



Update: **Still valid**

While tourism-heavy industries are pushing to revive the summer season, a number of countries are enforcing new quarantine rules. Appetite for business travel likely to stay reduced

Progress on vaccine by year-end but not widely available until 2021



Update: **Valid but uncertain**

There are over a hundred vaccine programmes according to the WHO, but with most still in pre-trial stage, a wide rollout this year is unlikely. The risk is that it takes much longer.

Better contact tracing helps manage another outbreak



Update: **Mixed progress so far**

Covid-19 testing has been ramped up, but progress on contact tracing apps/services remains mixed so far in parts of Europe & the US

### Alternative scenarios

#### Winter lockdowns return

Lockdowns end by summer but come back over winter, as second outbreak unmanageable and vaccine will only be available in 2021. Social distancing in place for 12 months

Update: **Still possible**

While lockdown exits have so far been fairly smooth, it's too early to conclude that test/trace systems will prevent a second outbreak. There are concerns that social distancing fatigue could prompt a return the virus – and there are early signs of outbreaks in Southern US states. However any renewed lockdowns may become more local rather than global in nature, and some governments may be less inclined to lockdown at all given the social/economic hit already accrued. The risk is that some countries possess less firepower to support their economies through a second wave, and the permanent damage is greater than from initial lockdowns

#### Worst case scenario

Return of lockdowns as people start ignoring social distancing and virus spread accelerates. New lockdowns remain largely in place throughout 2021. Vaccine unavailable to the masses for 12-18 months.

Update: **Evolved**

Our initial assumption here that lockdowns remain in place for the foreseeable future has become outdated. But decreasing compliance with social distancing could force governments to reinstate lockdowns and stricter social distancing rules for longer. This could also occur if the virus starts to mutate and becomes more infectious, and if it takes until the end of 2021 before a vaccine is found. Social distancing would become the norm, with severe knock-on effects and permanent damage to economies. This scenario could initially resemble the 'winter lockdown' case, but then assumes a much slower recovery given the greater degree of permanent damage to sectors where it's harder to adapt to social distancing

Source: ING

# US: Hints of a V, but don't get carried away

## James Knightley

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There has undoubtedly been some very encouraging data in some key parts of the economy, but social distancing, consumer caution, domestic tensions and the threat of a return of the virus mean nothing can be taken for granted



Source: Shutterstock

## Re-opening triggers a recovery

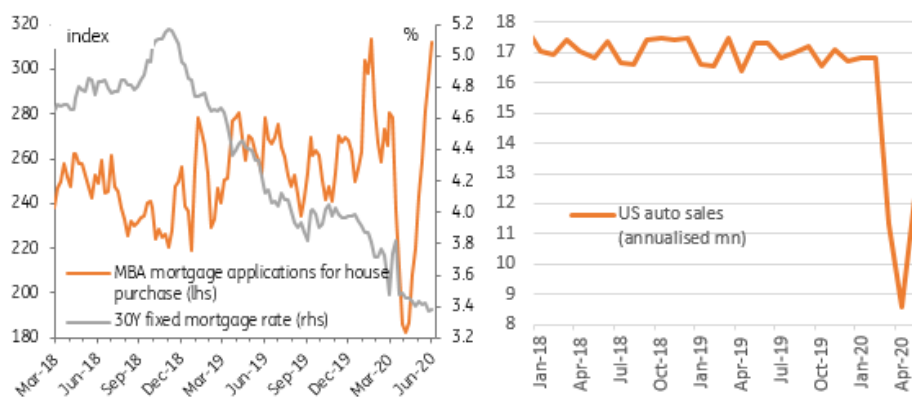
While it is true that the US economy is re-opening, it is very uneven. Google mobility data suggests that states such as Montana and Idaho have virtually returned to “normal” in terms of visits to retail, restaurants and museums. However, in Michigan and Illinois visits to those locations are still down 25-30% while in the most populous coastal states, such as New York, New Jersey and California, visits are still down 40-50%.

Nonetheless some of the recent data has offered very positive signals. Mortgage applications for home purchases have risen for eight consecutive weeks and are well above anything seen through 2018 and 2019. Falling mortgage rates have boosted affordability, while we have to remember the average age of a home buyer in the United States is 47 years old. This means interested parties are more affluent, have better credit history and less likely to work in retail and hospitality than the young who are typically renting.

Most of these purchases are likely to be investment properties or second homes, which is still good news for the broader economy as encourages construction, which promotes jobs and is typically correlated with higher spending on garden equipment, furniture, home furnishings and building supplies.

Car sales too are rebounding, which is again tied to demographics. The typical car buyer is around 50 according to JD Power. So again they are older, more affluent with better credit history so better able to take advantage of some of the great deals available relative to a younger person working in hospitality or retail and who has recently lost their job.

**Fig 1 As V-shaped as you can get... mortgage approvals and car sales**



Source: Macrobond, ING

### Jobs market springs back into life

Even in the jobs market there are signs of encouragement. All economists were caught out by the surprise rise in employment in May. The weekly claims data has suggested firings continued in their millions while historically credible demand indicators such as the ISM employment indices and the ADP payrolls suggested no real pick-up in demand for new workers. Instead the jobs appear to have originated in the small business sector, which flew under the radar.

The Paycheck Protection Program has been credited as a key driver of this. This \$669bn business loan program provides retrospective incentives for rehiring. A small business that fired workers early on in the crisis has until the end of this month to rehire for those positions in order to benefit from the ability to convert the loans to grants. The NFIB small business survey showed a modest pickup in hiring in May and according to the NFIB 75% of small businesses applied for the loans and 93% have received the money.

This has helped to generate an air of optimism about the prospects for recovery and looking at US equity markets you could be forgiven for thinking, “what crisis?” The S&P 500 is now up 11%YoY and is within touching distance of its all-time highs. Yet you look at the bond market and interest rate futures and the sense here is that there is still a lot that could go wrong.

### But the headwinds are strong

Firstly, we simply do not know what path the virus will take. States that have started to re-open early have seen some evidence of a pick-up in cases versus those that have stayed under lockdown. Should the number of cases increase this could see calls for containment measures to be reinstated. Moreover, we remain concerned about a potential for the virus to regain a foothold as we head into winter and conditions are more conducive to transmission. With little to indicate a vaccine is imminent it is far too soon to relax about the potential health and economic costs.

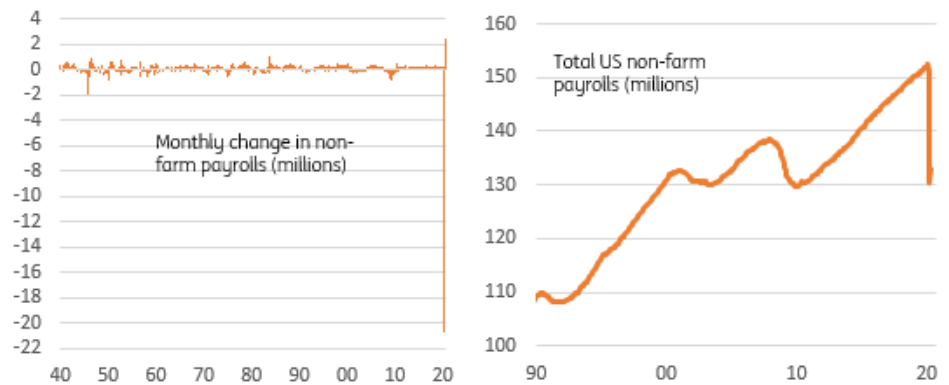
Then there is the general social distancing, consumer caution and travel restrictions that will prevent a return to pre-Covid 19 “normality”. If restaurants, bars, gyms and retailers can only have a limited number of customers many may find they are simply not economically viable and close with jobs losses resulting. Indeed, retailers and hospitality venues in major cities will struggle given office workers are set to continue primarily working from home for some time to come. With global demand remaining weak, hiring in manufacturing and service sector could remain depressed.

At the same time, many businesses that are trying to re-open can't afford to hire given the boost to unemployment benefit payments. Benefits are average nearly \$1000 per



week with the University of Chicago estimating that 68% of claimants have more income than when they were working.

**Fig 2 Employment has a long climb ahead of it**



Source: Macrobond, ING

### A long list of challenges ahead

Then there is the fraught political backdrop in the US right now. The death of George Floyd has set off a wave of protests, some that have ended in violence. Heightened political tensions have created a sense of entrenched division that will make reconciliation challenging. This too could have negative feedback on economic sentiment and economic activity at a time when employment is still 19.5 million lower than in February.

Corporate debt defaults, an equity market correction, and heightened trade tensions also are all threats we have to be cognizant of. So, while we have revised up our near-term economic assessment, the medium-term risks suggest a full V-shape recovery is unlikely with a return to pre-Covid-19 activity levels many quarters away.

# Eurozone: Bottoming out

## Peter Vanden Houte

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With the easing of the lockdown measures, growth is picking up in the eurozone albeit very gradually. Additional fiscal stimulus is being put in place but inflation is still going nowhere. The ECB has increased the size of its bond-buying programme, but we think it'll still be insufficient and a further increase in the second half of this year looks likely.



Source: Shutterstock

## Subdued recovery

The good news is that most recent data now indicates that the eurozone recession probably troughed in April.

The gradual opening of shops and factories pushed sentiment indicators slightly higher in May. That said, the upturn remains very cautious, which is not really a mystery in an economy where social distancing remains the norm. The latter also explains why services, where human interaction is key, has hardly seen any improvement; they'd already taken a big hit in the first quarter, falling 6.8%, while GDP shrank 3.6%.

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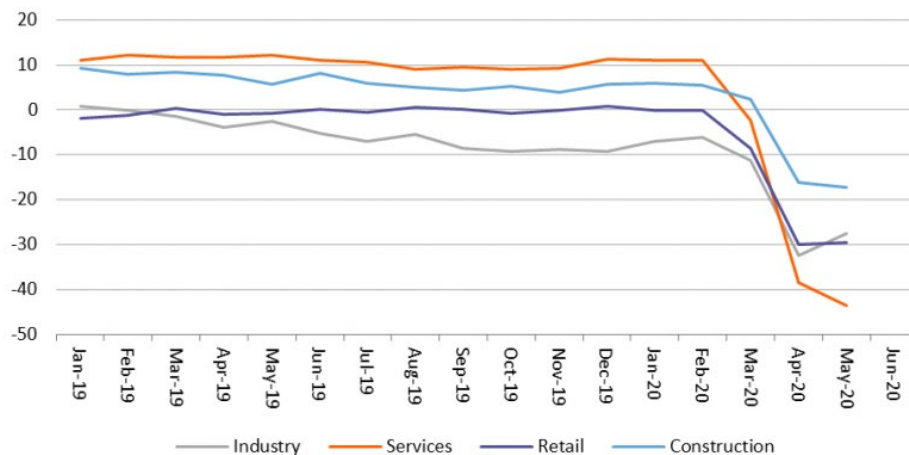
*“Our GDP growth forecast remains at -8.0% for this year and +4.5% for next year”*

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These are labour-intensive sectors of the economy, with often low paid workers with a high propensity to consume. On top of that, the Covid-19 crisis has accelerated some structural trends, necessitating some painful short-term adjustments. As an example, the boost e-commerce received from the lockdown is likely to accelerate the loss of employment in high street shops. Such trends could weigh on the strength of the recovery. We have slightly downgraded our second-quarter GDP, now expecting a contraction of close to 13%.

Our GDP growth forecast remains at -8.0% for this year and +4.5% for next year. As a reference, in its base case, the ECB is looking at an 8.7% GDP contraction this year, followed by a 5.2% expansion in 2021.

**Fig 3 Improvement in manufacturing economic sentiment; services lagging**



Source: Refinitiv Datastream

**Fiscal boost**

France recently announced a 'cash for clunkers' scheme and a lengthening of temporary unemployment measures. There was also an increased subsidy to buy electric cars in Germany, as part of a bigger stimulus plan worth almost 4% of GDP.

The flipside of the strong fiscal stimulus is that budget deficits in most eurozone countries are expected to hit close to 10% of GDP this year and are not going to decline very rapidly

According to the Bundesbank, this package should add one percentage point to German GDP this year and 0.5% in 2021. The flipside of the strong fiscal stimulus is that budget deficits in most eurozone countries are expected to hit close to 10% of GDP this year and are not going to decline very rapidly. That would again bring a very delicate exercise that turned awry after the financial crisis: how to get budget deficits down without killing the recovery?

**The common bond dream**

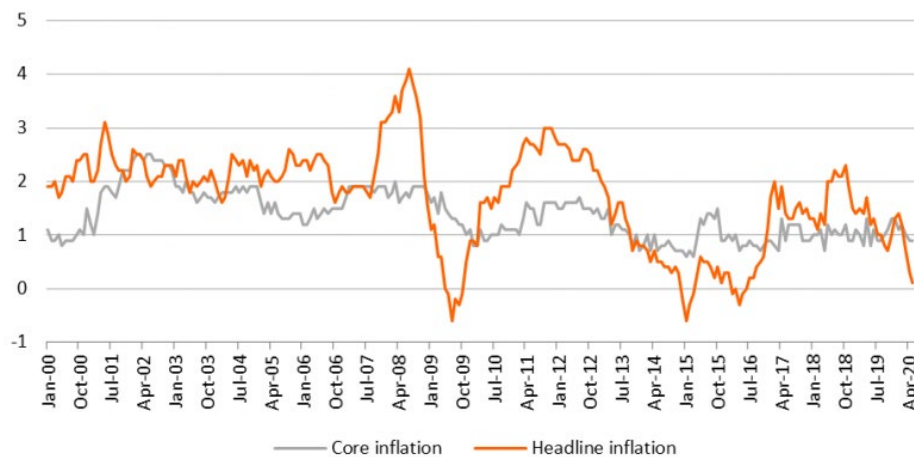
The proposal from the European Commission to put in place a €750 billion recovery fund to help the countries that are most negatively impacted by the Covid-19 crisis is an interesting development, should it be approved by the European Council although we think it will be watered down.

*“The fact that the EU will actually issue bonds to finance the programme comes pretty close to issuing a common bond”*

While it might not be a game-changer in terms of a short-term stimulus (the grants in the programme would be worth about 0.7% of GDP per year for the coming four years), it would clearly be an important symbolic step towards more integration.

The fact that the European Union will actually issue bonds to finance the programme and request additional sources of income to service the debt, comes pretty close to the issuance of common bond.

**Fig 4 Inflation still going nowhere**



Source: Refinitiv Datastream

### More QE

A temporary VAT cut in Germany will probably push eurozone inflation into negative territory in the second half of the year. The ECB itself has more or less given up hope that it will reach its objective in the medium-term because the staff forecast for 2022 is now only 1.3% for headline inflation. That explains why the ECB felt comfortable in further increasing its Pandemic Emergency Purchase Programme (PEPP) by €600 bn with an extension of purchases until at least June 2021.

We think that this will probably still be insufficient and a further increase in the second half of this year looks likely. The only potential party pooper is the German constitutional court. While its verdict didn't concern the PEPP, the Bundesbank's position in the other bond-buying programmes could be compromised.

Even though ECB President Christine Lagarde stated that the ECB is confident that a good solution will be found, the matter could create some uncertainty in the short run.

# China: PBoC's mixed message

The People's Bank of China has sent mixed messages about its monetary stance. Here's what we expect for June

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Source: Shutterstock

## Is the PBoC reluctant to ease?

Before the Two Sessions- China's most important political event of the year - the PBoC removed from its monetary policy report language which described its stance as prudent. The market (myself included) assumed that this meant the central bank would take a more aggressive easing stance to address the economic damage from Covid-19.

However, the PBoC has shown by its actions that this assumption was quite wrong.

- 1) The central bank did not cut the Loan Prime Rate in May.
- 2) The size of the innovative re-lending programme announced after the Two Sessions is too small, at a maximum creating CNY 1 trillion loans for SMEs between March and December 2020. By way of comparison, April's one-month new yuan loans came to more than CNY1.6 trillion. That's why we think this programme is too small. Moreover, if exporters and manufacturers do not see an end to the fall in export orders, this re-lending programme will not prevent them from shutting down, and certainly won't encourage them to think about hiring more factory workers.
- 3) Although the maturing MLF could be rolled over on 15 June, there has been a net absorption of CNY270 billion liquidity in open market operations between 1-9 June. This is particularly eye-catching because June marks the end of the half year when liquidity has traditionally been very tight. The PBoC seems to be confident that liquidity will be ample at the end of the half year period. As such, we no longer call for a targeted RRR cut or RRR cut of 0.5-1.0 percentage point in June.

In short, the central bank has been reluctant to pump extra liquidity into the financial system, with more focus on SME loan availability.

### **Still expect one rate cut but the chances are falling**

Despite the seemingly tight stance shown by the PBoC, we still expect a rate cut in June of over 50%. We expect one rate cut on the 7D reverse repo, the 1Y Medium Lending Facility and 1Y Loan Prime Rate by 10-20 basis points.

That is because the economy is in poor shape amid weak global demand and the manufacturing sector is trying to turn to the domestic market as external demand falls. A lower interest rate will help corporates to lower their interest costs, as prices of products are more likely to fall than rise in a weak economy.

Though we still expect a rate cut in June, we have to admit that the chance is falling as the PBoC may want to save ammunition for the future if tensions between China and the US increase. The PBoC does not want the policy interest rate to reach a level which is too low and could potentially lead to a liquidity trap in China.

# Asia: Still slowing

## Rob Carnell

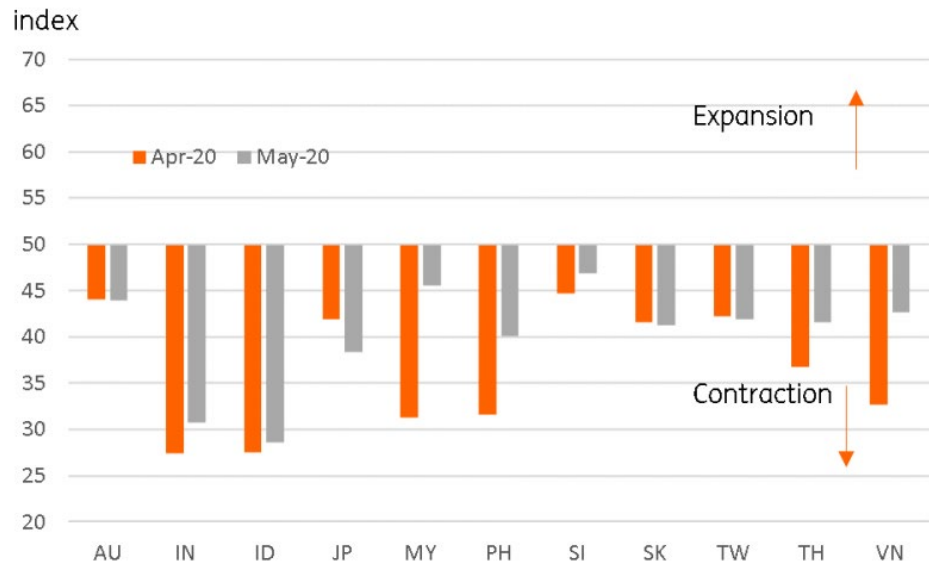
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The release of May Purchasing managers indices provides a helpful snapshot of where Asian economies stand following the sharp declines in April, which marked the first full month for many of these economies under movement controls, and in some cases, picked up on the early stages of re-opening.



Source: Shutterstock

Fig 5 Asia Ex-China Purchasing Manager Indices



Source: Bloomberg, ING Mfg PMIs

## The fiscal packages keep on coming

There is still a tendency for governments across the region to allow fiscal policy to take the strain off the economy. Scope to do this rests on a number of factors – how fiscally secure an economy is, how much of a ratings buffer exists to burn in letting the deficit widen, and whether this is accompanied by a current account deficit too, in which case, the currency may come under pressure.

Japan can hardly be described as a paragon of fiscal virtue, with a debt-to-GDP ratio that will exceed 220% this year. But as a case in point, they recently announced a second supplementary budget to help lift the economy totalling a quite incredible 40% of GDP.

Like some other economies in the region (Malaysia for example, with its claimed 20% boost to the economy), Japan's headlines haven't attracted a great deal of market attention from cynical investors used to government smoke and mirror tactics (double-counting, soft loans, accrued spending etc). Indeed, it is unclear who the intended audience is for these announcements, as the general public must also be totally aware of the game being played. But there is also some genuine stimulus underlying all the fluff. Not enough, in our opinion, to make us want to revise any of our growth forecasts higher. But enough to improve the prospects for recovery post-Covid19 lockdowns.

Still, as first-mover China is showing clearly, while the end of lockdowns is a necessary condition for recovery, it doesn't guarantee much strength, especially for the more export focussed economies.



# CEE: The worst seems to be behind us

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CEE economies are bracing themselves for a slow recovery. But as unemployment is set to rise and high inflation isn't an issue any longer, more monetary easing is on the way. In FX, RUB prospects remain bright while CZK remains our favourite CEE low yielder. Poland central bank's aggressive steps should translate into a further steepening of PLN swap curve



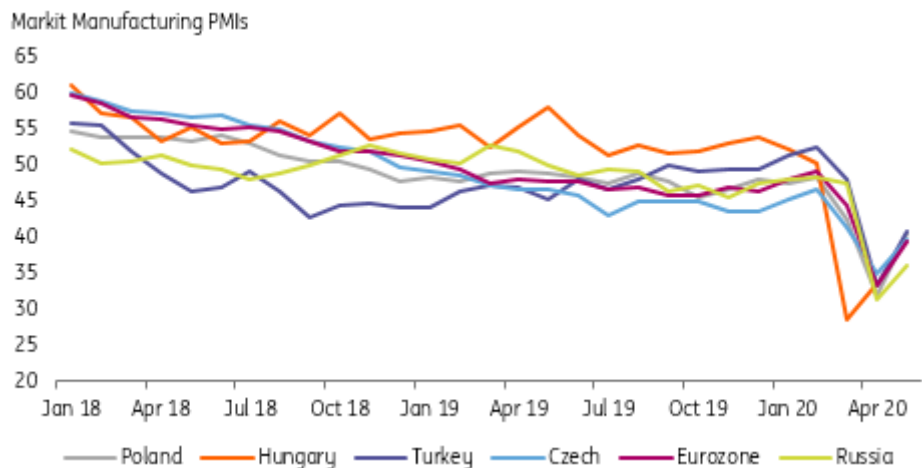
Source: Shutterstock

## CEE economies: The worst seems to be behind

With the CEE region being one of the first movers in Europe to start easing lockdown measures, the economic data should continue improving, with 2H20 growth posting a rebound. But despite the recent rally in markets, we continue to look for a U-shaped rather than V-shaped recovery, as was evident in the rather limited rebound in May CEE PMIs (Figure 6).

As is the case for wider Europe, the CEE recovery will be gradual and will take time to make up for the Covid-19 related output loss.

**Fig 6 Rebound in PMIs consistent with U-shaped recovery**



Source: ING, Bloomberg

### **More easing on the way**

Although the CEE economics should be on the gradual road to the recovery, the expected increase in unemployment (governments' supportive measures will continue to be rolled back as the economies get out of the worst) and the further decline in inflation across the region towards or in some case below the target both suggest that any meaningful reversal of the recent monetary easing measures seems unlikely. The bias of local central banks is still skewed towards more easing.

We expect the Czech central bank to deliver one last rate cut to bring rates to technical zero, Hungary's central bank to reverse some of its previous FX stabilising hikes and Poland's central bank to fully complete its large scale aggressive QE programme. In Russia, the central bank is poised to cut rates again too.

### **Poland's central bank cranking up its relative dovishness**

While the CEE region does not necessarily stand out trend-wise (vs other emerging market regions or wider Europe) on the growth and inflation fronts, it offers interesting intra-regional stories.

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*“Poland's central bank seems to be challenging National Bank of Hungary's position of the most dovishly perceived central bank in the region”*

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Perhaps most importantly and reflecting the price action in the CEE rates market, Poland's central bank seems to be challenging National Bank of Hungary's position of the most dovishly perceived central bank in the region. The very large quantitative easing and aggressive rate cuts by Poland (all in the context of a large domestic fiscal stimulus) translated into a meaningful steepening of the PLN IRS curve. 5s10s PLN IRS - the part of the curve that is the bell-weather measure of the perceived behind the curve dynamics, have been steepening meaningfully so far this month.

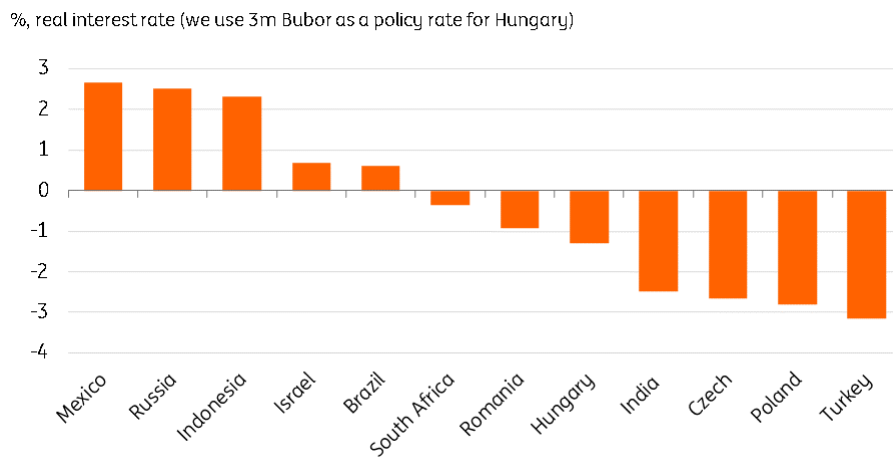
In contrast, the very cautious NBH stance (FX stabilising hikes, limited QE with the NBH cancelling the QE auctions for the second week running) improved the outlook of Hungarian assets vs Poland (both FX and rates).

### **Steeper CEE curves, driven by core rates**

Steeper CEE curve looks to us to be the direction ahead as the local long-end rates will continue being dragged higher by rising core yields (mainly UST yields) while the front-end will remain anchored by either unchanged or lower policy rates (with rate cuts in Czech and Hungary in large part priced in).

But given these dynamics, the PLN IRS curve appears the most prone to steepening within the region.

**Fig 7 CEE low yielders having fairly negative real rate within the EM spectrum**



Source: ING, Bloomberg

**CEE FX feeling the love of weaker USD environment**

CEE currencies benefited greatly from the global reflation trade dynamics which unlocked further broad-based USD weakness. While all EM currencies gained, one additional idiosyncratic benefit the CEE FX enjoyed stemmed from the rise in EUR/USD (CEE currencies are the only EM FX segment that directly benefits from the rise in EUR/USD). Hence, and despite the nature of rally which would normally favour higher beta high yielders, the low beta low yielding CEE currencies did fairly well and in many instances competed with EM high yielders in terms of spot gains.

**High yielding RUB preferred to low yielding CEE FX**

We now think the bulk of the CEE FX rally is behind us and further gains should be more modest. Not only some of CEE currencies still screen expensive vs EUR on short term basis (though less so than last week), but given the scale of the spot gains and the limited carry potential and the fairly negative real rate (Figure 2), if risk sentiment remains benign, EM FX high yielders should do better. Here RUB ticks the box - the still respective carry, one of the highest real rates in the EM space and supported oil prices make the currency well positioned in the EM FX space.

Among low yielding CEE FX, CZK remains our top pick. The relative strong fiscal position, inflation minded CNB and, in our view fairly, low odds of FX interventions to lean against possible currency strength (as CPI is to remain close to the target and the deflation risks are not present) all makes the koruna attractive.

# Dollar Hoarding: It's hard to let go

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As the dollar bear trend starts to gain momentum, questions will be asked about all those dollars hoarded in March - an exercise associated with an 8% dollar rally that month. Delving into some new data on the amounts and the participants involved, we look for clues as to when these dollar hoarders might be prepared to let go



Source: Shutterstock

## Dollar hoarding: What is it?

When I think of dollar hoarding, one episode really stands out for me. It was during the Russian crisis in late 2014 when Russian corporates were reluctant to sell their USD export earnings back into the local FX market. This USD hoarding was sending USD/RUB through the roof until some local moral suasion was used to encourage Russian exporters to offload their dollars for roubles.

But a quick Google search for 'dollar hoarding' now typically delivers references to events in March this year when a funding squeeze drove the dollar higher. At the time corporates were being blamed for the move as they sought access to precautionary stockpiles of dollars ahead of expected supply chain disruptions. The Financial Times lent some support to the story with reports that corporates had drawn down US\$124bn from their bank credit facilities in the last three weeks of March - a time when a traditional supply of USD funding - the Commercial Paper market - had seized up.

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*“Trying to pin down this hoarding activity in terms of data is a challenging task”*

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ING's [Markets team wrote a lot](#) on this subject at the time and in addition, [this BIS paper](#) delivers some useful analysis of this issue - especially on some of the key protagonists on both the supply and demand side of the dollar funding story. On the demand side of the dollar funding equation, there is a myriad of dollar users as a result of the currency's dominance in trade and financial flows. In addition to corporates, there is large buy-side demand for dollar funding to hedge USD-exposed diversified portfolios. And, of course, banks play a major role here - European banks' dependence on the wholesale markets to fund USD loan books had been a major source of distress in 2008.

Trying to pin down this hoarding activity in terms of data – and what it means for the dollar in general – remains a challenging task. But we think we’ve found a few clues.

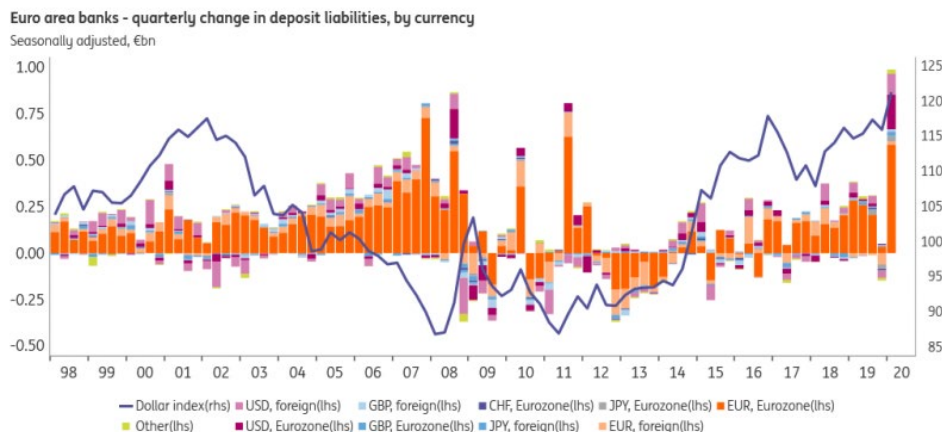
### Insights from Europe

If the narrative of dollar hoarding plays out, USD deposits should show up somewhere. Where better to look for those USD deposits than from the banks, which report changes in deposit liabilities to their local supervisors. For the eurozone banking sector, ING’s Teunis Brosens routinely analyses the monthly ‘Monetary Developments in the Euro Area’ release from the ECB. Here it seems that some of this dollar hoarding activity may have emerged in the March publication.

Teunis’s chart below shows how euro area banks have seen their deposit liabilities surge by close to EUR1trn in 1Q20. This is the largest quarterly increase on record. Well over half of that is in euros and reflects local liquidity hoarding by banks, corporates, and financials. The stand out for us in this chart is the increase in USD deposit liabilities reported by Euro area banks – at almost EUR300bn. This well exceeds the prior record increase of EUR240bn also seen at the time of a major dollar funding squeeze in 2008.

Looking at where those USD deposits derived from, the ECB data shows a roughly 60:40 split in favour of eurozone over non-eurozone residents. Also, look at the dollar performance during this period – stress and the large build-up of deposits have typically been associated with a stronger dollar. This supports claims for the dollar to be the world’s only true funding currency.

**Fig 8 Euro area banks: Quarterly change in deposit liabilities, by currency**



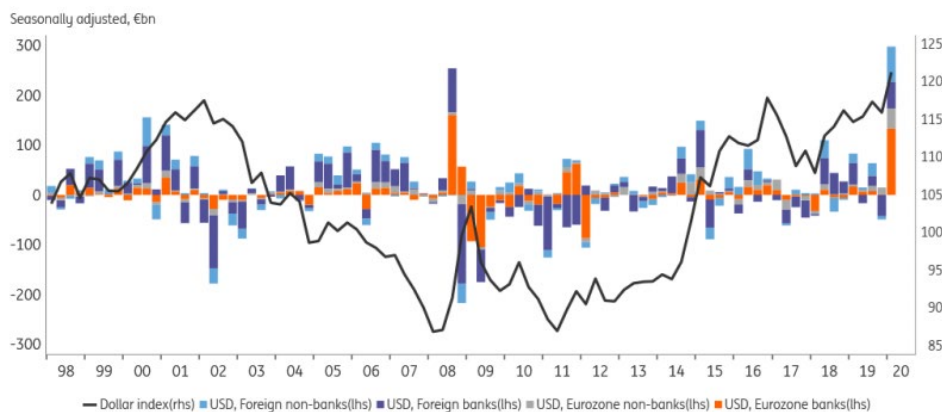
Source: ING, ECB

### Hoarding: A banking or corporate phenomenon?

In addition, the ECB data disaggregates these USD deposits into bank versus non-bank lenders. Was it all corporates preparing for supply chain challenges or more the banking community driving the rise in USD deposits? The data suggest that banks accounted for two-thirds of the rise in USD deposits (about EUR185bn). That still means that non-banks, including corporates, grew their USD deposits at Euro area banks by over EUR100bn in 1Q20. But we suspect that the narrative of corporates drawing USD via bank credit lines – and paying anywhere up to 1.00% p.a. for the privilege – may not be the key driver here.

Instead, we suspect that the euro area banks’ use of the Fed’s USD swap lines is driving the show. Eligible counter-parties can secure USD funding via seven and 84-day swap facilities, auctioned by the ECB. By the end of March, the ECB had lent out around US\$100bn to euro area banks through these Fed swap lines. And it may be the use of these Fed USD swap lines that provides the most timely signals for the precautionary dollar funding story.

**Fig 9 Euro area banks - quarterly change in USD deposit liabilities, (by region and by participant)**



Source: ING, ECB

**Reading the tea leaves and dollar implications**

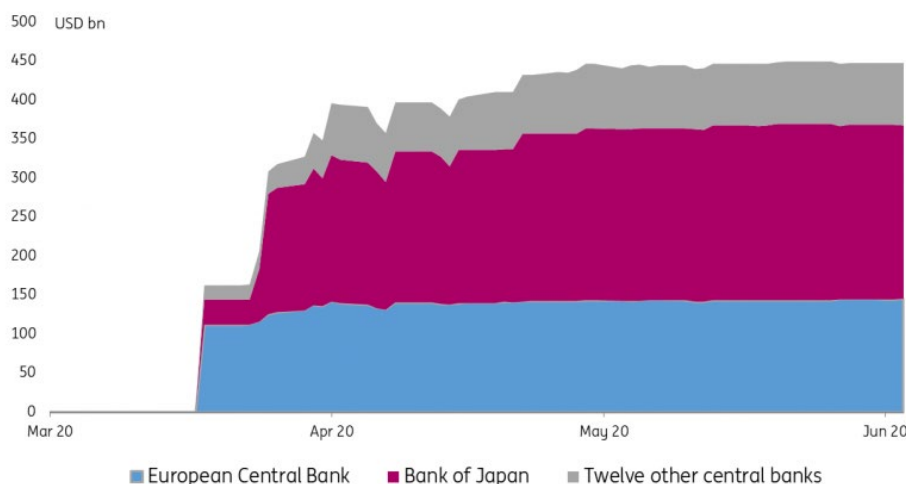
If the use of the Fed USD swap facilities could be the key driver of the USD deposit swing, then the good news is that data on its use is made available [in a timely manner by the Fed](#). Currently, 14 central banks have access to the Fed’s USD swap facility, borrowing a current total of US\$44.7bn.

There is a view that these precautionary dollars stay held into 2021 as banks wait to see the level of bankruptcies (our credit team sees 10-12% default rates in the European High Yield arena versus 6% priced by spread indices) or wait for a second wave of Covid-19. That caution makes sense and certainly, there are no signs as yet from the Fed data that banks are prepared to let their USD borrowing roll-off.

However, the total amount now borrowed from the Fed is not far off the peak use of Fed dollar swap lines in December 2008 – then at US\$580bn. Somewhat surprisingly those dollar swap lines were wound down to zero by the end of 2009 – by which time the Broad Dollar Index had fallen 15% from its highs. Currently, the Broad Dollar Index has only fallen about 5% from its March 2020 peak.

We will now certainly be adding the use of the Fed’s USD swap lines to our toolkit. Any signs that banks are prepared to let their precautionary USD borrowing roll-off would add weight to our preferred view of more normalised conditions, [a return of portfolio flows to emerging markets](#), and a benign dollar decline leading EUR/USD to 1.20 by year-end.

**Fig 10 Central banks use of Fed's USD swap lines, amounts outstanding (USD bn)**



Source: ING, US Federal Reserve

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## Rates: Why the yield curve should do its own thing

The best-case scenario would be no yield curve control. The Fed sets the funds rate and engages in quantitative easing rather than moving rates into negative territory. That's artificial enough, let the yield curve do its own thing beyond that. That said, if pushed, yield curve control would likely start on the front end and move out the curve



Source: Shutterstock

### What exactly is yield curve control - just glorified quantitative easing?

Yield curve control: three simple words. And a simple concept, at least it should be. But it's very nuanced.

The precise wording suggests that the entire curve is controlled. Control here implicitly means a cap on yields, and so is a means to preventing yields from rocketing higher. It is executed through the central bank standing ready to buy bonds should the market yield drift above the desired yield. Straightforward enough, but why do it? And on what tenors? And what are the potential unintended consequences?

A starting point is to note that yield curve control is all about the price.

The supply versus demand for bonds typically determines their price. Should a central bank wish to control that price (and by implication it's yield), it will stand ready to buy those bonds. So in the case of yield curve control, we know the price, but not the quantity. Contrast that with quantitative easing where the central bank knows the quantity it will spend, but has no target price for the bonds it buys. The object here is to add reserves to the system, that can be deployed in the wider economy.

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*“In the case of YCC, we know the price, but not the quantity. Contrast that with QE, where the central bank knows the quantity it will spend, but has no target price for the bonds it buys”*

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Yield curve control feels similar to quantitative ease, as it too adds reserves. But the object of the exercise is quite different. It is far more about containing and controlling market rates. The Federal Reserve deployed this policy during the post-war years. The Reserve Bank of Australia currently employs a policy with a concentration on the 3-year tenor, and the Bank of Japan has had a policy concentration on the 10-year since 2016.

In all cases, one key objective is to provide some certainty for funding costs for the government and the wider economy. The Fed is now considering something similar.

### **In which tenors should yield curve control be concentrated on? And what are the risks?**

The dominant view centres on controlling the front end, starting with the 2/3yr area. These are both auction maturities for the US Treasury, mapping out the first couple of points on the curve that extends to the 5yr, 7yr, 10yr, 20yr and 30yr benchmark maturities. The advantage of a front end focus is that it is more controllable.

The Fed sets the funds rate with certainty, and in that sense has far more control of the 2yr rate than the 30yr rate. The latter has a much longer nose into the future and is thus more heavily influenced by longer-term interest rate and inflation expectations.

Therein lies a risk for a pure front end focused policy - the risk that the curve steepens from the back end; there is nothing to stop 10yr to 30yr yields from shooting higher. This may not be a bad thing as it reflects a solid reflection of optimism on the future for the economy. But it could be damaging if the expectation was misplaced, as it means higher than ideal funding costs for government, corporates and the personal sector. Another driver could be supply, as the US Treasury has had to increase issuance for Covid-19 impacted financing requirements. Countering that impact has benefits.

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*“Therein lies a risk for a pure front end focused policy - the risk that the curve steepens from the back end; there's nothing to stop 10-yr yields from shooting higher. This may not be a bad thing. But it could be damaging if the expectation was mis-placed.”*

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The argument against yield curve control for longer tenors are twofold.

First, it is deemed to be more difficult to control longer yields as they are more slavish to longer-term expectations. Second, artificially fixing such long tenor yields robs both the market place and the Fed of an important discounting function that the shape of the yield curve and the level of long rates provides. A counter-argument is only by controlling long tenor rates can economy-wide rates be truly contained, ranging from corporate refunding in the 5-10yr maturities and the likes of 30-year mortgage rates.

### **What types of yield levels make sense to cap at? And what about forward guidance?**

There is one important technical argument in favor of longer tenor yield control to do with the required quantities required to achieve such control. The thinking here is most of the market capitalization is in shorter tenors, so to control this, bigger volumes would need to be bought by the Federal Reserve. On top of that, there is bigger bang for the buck in longer tenors by virtue of the fact that these are longer duration product, so a small effect on price would have a bigger effect on yield. In other words, the Federal Reserve may be able to spend less to control yields in longer tenors.

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*“If the Federal Reserve set 1% as a target for the 10yr, that is entirely defensible with the funds rate at zero, and a curve effectively mapped out as 100bp. Something similar could be said for a 2% target for the 30yr.”*

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But that in part depends on the level of yields chosen. If the Federal Reserve set 1% as a target for the 10yr, that is entirely defensible with the funds rate at zero, and a curve effectively mapped out as 100bp. Something similar could be said for a 2% target for the



30yr. For levels like these to be challenged there would need to be a material breakout in inflation expectations to the upside. The front end is more straightforward in the sense that the Federal Reserve has complete control over the funds rate, and in that sense could set 25bp as a viable target for the 2yr yield (versus the funds rate of zero-25bp).

There is another strategy that the Fed could pursue. It could announce a set target rate for the 2yr (or 3yr) and vow to cap that yield. And then for longer tenors it could assert that there will be non-specific yield curve control employed. In other words, the Fed could map out a level for yields for longer tenors that they would object to, setting implicit caps to yields right out the curve, but without announcing what these cap levels are.

This more fluid policy would be easier to deploy, as the targets can be moving ones. The downside is it leaves the market guessing as to when it hits those caps, and in that sense subject to excessive conjecture.

### **Does the Fed really need to engage in yield curve control? If it does, what effect?**

So what does this all tell us?

First, there is no certainty that the Fed will deploy yield curve control. Right now there is no specific need to. The 2yr is practically anchored near the ceiling of the zero-25bp funds rate range, and the 10yr is still below 1% (and the 30yr below 2%). Moreover, we observe that the 5yr is rich to the curve on the 2/5/10yr fly, which is a signal that this is not a bear market for bonds at this point.

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*“There is another strategy that the Federal Reserve could pursue. It could announce a set target rate for the 2yr (or 3yr) and vow to cap that yield. And then for longer tenors it could assert that there will be non-specific yield curve control employed.”*

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Second, if the Fed does venture into yield curve control they would have to make the call that yields were threatening to obstruct funding circumstances, that could, in turn, threaten the recovery. It seems likely that they would start off by setting a cap on the 2yr. That would limit the money market curve. But steepening pressure could build from the back end in consequence. Forward guidance would be of minimal use here, as the Federal Reserve simply can't provide this with certainty for 10yrs, and investors know that.

Third, the only way to contain the curve would be to deploy a bond-buying out the curve with the objective to shepherd the curve along a tolerable range. The main trigger points here would be soft caps, where soft buying would happen as a tolerance range was entered, morphing to stronger buying as the ultimate cap rate was approached. The range and the cap rate would ideally be known by the market place but could remain unannounced.

That would give the Fed the flexibility to change both the range and cap, depending on wider circumstances.

The best-case scenario would be no yield curve control.

The Fed sets the funds rate and engages in quantitative easing rather than moving rates into negative territory.

That's artificial enough, let the yield curve do its own thing beyond that.

# Brexit: Four scenarios for trade talks and UK markets

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We still narrowly expect the UK and EU to sign a free-trade agreement this year, albeit a basic one. But the chances of an extension to the transition period beyond 2020, which could have given businesses more time to prepare, looks unlikely. Expect some initial disruption to supply chains at the start of 2021 as Britain formally leaves the single market



Source: Shutterstock

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## Base case: Transition period not extended, but free-trade agreement signed this year

Time was already looking tight for a UK-EU free-trade agreement to be signed this year, and the coronavirus health pandemic has only added further strain. But while an extension to the post-Brexit transition period could offer negotiators and businesses more breathing space, it's looking unlikely. Both sides have until the end of June to agree with such a delay, but the UK is adamant it won't ask for extra time.

One way or another, that means the way the UK trades with Europe will change dramatically at the start of 2021. A trade deal could still feasibly be struck, albeit one that is pretty basic. And with scope for compromise in some areas - notably fishing - we're still narrowly inclined to say an agreement will be signed. The conclusion of the withdrawal agreement agreed last October showed how movement can come late in the day.

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*“The prospect of initial disruption to supply chains, owing to possible delays at ports, suggests the UK is at a higher risk of slipping into a so-called ‘W shape’ recovery, whereby growth is hit for a second time at the start of 2021”*

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Perhaps that will prove to be optimistic, but ultimately for the economy, it matters fairly little. With or without a deal, the UK is leaving the single market, adding an array of new barriers for services. Meanwhile, even with zero tariffs, goods producers will still have to contend with plenty of new paperwork to prove where the product was made - rules of origin.

The prospect of initial disruption to supply chains, owing to possible delays at ports, suggests the UK is at a higher risk of slipping into a so-called 'W shape' recovery, whereby growth is hit for a second time at the start of 2021. With businesses unlikely to have the capacity to fully prepare for the changes amidst the current disruption, all of this potentially could further slow the recovery in investment and hiring from the Covid-19 shock.

**2 No transition extension and no trade deal agreed this year**

If negotiations break down, it's likely to be over state aid.

Brussels wants the UK to maintain some alignment on EU state aid rules in exchange for tariff-free access to the European market. Britain wants full-scope to support industries in the post-virus recovery. There's also reportedly a view in Westminster that the costs of 'no deal' have already been registered over recent weeks, and that the economic damage would be hidden by the wider Covid-19 shock.

Economically, 'no trade deal' doesn't look substantially different from the scenario above, given that both would see a substantial decrease in market access. Tariffs will raise additional costs in some specific industries but for the bulk of goods, the real costs come from customs clearance and the potential delays, which also exist under a free-trade agreement.

Politically though, there are some differences. A broad free-trade deal could be coupled with unilateral measures to cushion the blow at the start of 2021. That's unlikely to happen if talks break down and an agreement isn't reached. In the longer term, trading on WTO terms is unlikely to prove sustainable, but starting from a point of political tension makes it tricky for both sides to return to the table, either for trade or wider cooperation.

**3 Both sides agree this month to extend transition by 6-9 months**

It's looking less and less likely by the day, but there's still time for both sides to agree to an extension of the transition period.

That would give businesses more time to prepare for the forthcoming changes, and if an extension were to be agreed, that might be how Boris Johnson frames the decision. To be clear though, this is only postponing the inevitable economic hit. But crucially it would reduce the risk of disruption coinciding with another outbreak of Covid-19 over the winter.

**4 Transition not extended this month, but with a deal in sight, both sides agree to a delay later on**

This is undoubtedly a wildcard scenario - one that currently looks fairly unlikely. Most EU lawyers are adamant that once June deadline has passed, the opportunity to end the transition period is gone.

But with the UK set to opt against an extension this month, there's an emerging debate on whether the situation could be fudged later in the autumn if a deal appears to be in sight. The Institute for Government has recently looked into this, and their conclusion is that the decision to extend the transition period would require a whole new agreement, that would be both time-consuming and legally complex to agree. That's unlikely to be practical given the time available, even if the political will exists.

So as we said above, probably the best outcome we can expect is a collection of unilateral actions designed to help firms adjust initially. Financial services equivalence is a good example, but clearly none of these measures will replicate the current level of access.

**Fig 11 Four scenarios for UK-EU talks**

	Transition period extension?	Free-trade agreement? (Zero tariffs)	Economic impact	Market impact			
Most likely	① ING base case <b>No</b> Transition period will finish at end-2020	<b>Yes</b> Despite lack of progress so far, compromise reached on key issues by Oct	Even with an FTA in place, UK is leaving the single market and that presents wealth of new costs/frictions	EUR/GBP	2Q 0.91	3Q 0.92	4Q 0.90
Order of likelihood	② <b>No</b> Transition period will finish at end-2020	<b>No</b> UK rejects deal to retain greater control over state aid. Starts trading on WTO terms with EU in 2021	Similar to FTA, but with added tariff costs. Also less likely to see unilateral actions to cushion initial disruption	EUR/GBP	2Q 0.91	3Q 0.92	4Q 1.00
	③ <b>Yes</b> Both sides agree in June to extend transition for 6-9 months	<b>Yes</b> An extension buys more time to strike a deal and implement it	Reduces the risk of supply chain damage coinciding with winter virus outbreak. Gives businesses more time to prepare	EUR/GBP	2Q 0.86	3Q 0.85	4Q 0.85
	④ <b>Yes</b> But not in June. Both sides strike separate agreement to extend transition in the Autumn	<b>Yes</b> Reason for extension in this scenario likely to be because a deal is in sight	As above in ③	EUR/GBP	2Q 0.91	3Q 0.86	4Q 0.85
	④ <b>Yes</b> But not in June. Both sides strike separate agreement to extend transition in the Autumn	<b>Yes</b> Reason for extension in this scenario likely to be because a deal is in sight	As above in ③	10Y Gilt	2Q 0.30	3Q 0.50	4Q 0.60
Least likely							

Market impact produced by ING's FX and Rates teams  
 Source: ING

# Why we don't expect negative rates in the US or UK... yet

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**While President Trump likes the idea of negative interest rates, it's clear the bar is set relatively high for the Federal Reserve to adopt them. We are perhaps more likely to see sub-zero rates in Britain, but even here we think policymakers will be much more inclined to use quantitative easing for the time being**



Source: Shutterstock

## The bar is set relatively high for negative rates in the US and UK

While US equity markets have surged back to within touching distance of their all-time highs, interest rate markets are pricing a far less rosy outlook. Even after May's surprisingly strong jobs report, implied yields suggest little prospect of a US rate hike any time soon, with a slight bias towards the Fed cutting rates within the next 12 months.

It's a similar story in the UK. The message from the Bank of England is that negative rates can't be ruled out, and that's helped push overnight index swaps (OIS) to price in negative rates.

But while we shouldn't rule anything out, we still think that the bar is set relatively high for policymakers to take interest rates below zero – particularly in the US.

US President Trump clearly likes the idea – and the 'gift' of being paid to borrow may look attractive for a government expected to borrow more than USD 4 trillion this year – but Fed Chair Jerome Powell is clearly more cautious.

## Powell is reluctant to head into negative territory

Powell recently noted that “for now it's not something we are considering” and “we think we have a good toolkit and that's the one we will be using”. Here are some of the reasons why:

- **There's no pressing need.** After all, the combination of sharp interest rate cuts, “unlimited” QE and the re-ignition of various schemes from the financial crisis, has seen lending spreads narrow significantly and credit flow freely. Why would Jerome Powell and the Federal Reserve decide to cut rates into negative territory if they truly believe, as Powell stated on 10 May, that “when you have negative rates, you wind up creating downward pressure on bank profitability, which limits credit expansion”?

- **Experience in the eurozone and Japan shows the policy hasn't generated inflation.** Richmond Fed President Thomas Barkin stated that "I haven't seen anything personally that makes me think they're worth a try here"; a view widely shared within the FOMC. The criticisms you usually hear are that consumers don't always spend more, it hasn't generated inflation elsewhere, and central banks will have a hard time raising rates again, leaving less room for action if there is another downturn.
- **They could cause "significant complexity or distortions to the financial system",** according to the October FOMC minutes. Policymakers also noted negative rates "could have more significant adverse effects on market functioning and financial stability here than abroad." It would certainly put pressure on the \$4.8 trillion money market fund sector, with numerous funds already waiving management fees to ensure net asset values don't break below \$1. The fear is that negative short-term rates result in an avalanche of redemptions that could lead to severe, but short-term, financial market strains.
- **Negative interest rates also create a disincentive for businesses to maintain cash buffers to deal with any financial stress** – such as, for example, the current pandemic, which is causing a massive blow to revenues and corporate profitability.

### **Negative rates could still come - but they're more likely in the UK than US**

Given this backdrop and the fact recent US macro data has provided positive surprises, it is safe to say negative rates are not on the agenda, at least for now.

But the Fed has been very careful not to completely rule out negative interest rates and the Fed funds futures market thinks that the FOMC, like the Bank of England, could eventually soften its stance. The catalyst could be a second wave of Covid-19 and renewed lockdowns with associated economic and financial market distress.

One concern is that the hit to investment from Covid-19, and the resulting slowdown in productivity growth, could see the so-called neutral interest rate decline further. That means that 'in theory' an interest rate fixed at zero will become decreasingly stimulative as time goes on, which perhaps could see negative rates more heavily considered by policymakers in the future. It would also, theoretically, incentivise people to take more risk in their investments in the hunt for yield, take on more borrowing and spend more. All of which should boost economic activity.

But would this be any more effective than expanding the tools central banks are currently using? We don't think so.

While in the UK the potential for negative policy rates is perhaps greater because mortgage rates more closely follow Bank rate, it is working at the wrong end of the yield curve in the US. Longer-term Treasury yields are the benchmarks used to price mortgage borrowing and corporate credit meaning that formal yield curve targeting would likely be far more effective – discussed by our colleague Padhraic Garvey.

Moreover, Powell himself has eloquently made the point that "the Fed has lending powers, not spending powers". A renewed collapse in demand with a further rise in unemployment and state and local governments running out of cash requires the Federal government to step in. This means fiscal policy should carry the burden, supported by the Federal Reserve's QE strategy which should cap government borrowing costs as debt issuance surges.

It is doubtful a negative Fed funds rate would add meaningfully to this when considering the costs involved.

# Eurozone: Debt monetisation by stealth

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While the European Central Bank is not allowed to monetise debt formally in the wake of the Covid-19 crisis, there seems to be some scope to do so, without fear of galloping inflation. It might even be needed to hit the inflation target



Source: Shutterstock

## Monetary financing of government debt.

I never thought one day I would actually be discussing something a “serious economist” (an oxymoron?) would turn away from in horror.

Mention Weimar and Zimbabwe in the same sentence and you know what I am talking about: monetary financing of government debt.

For people not familiar with the concept this is when a central bank prints new money and basically hands it over to the government to spend, without the obligation to have to pay it back one day. Plenty of proposals have been floating around over the past few years and not all of them are actually feasible or permitted by the European Treaties.

Nevertheless, it is still worth looking at some of the alternatives and discussing the pros and cons in the wake of the Covid-19 health crisis that has hit the eurozone. With debt levels already very high in most member states lack the fiscal capacity to tackle this new deflationary shock. So why not create the means through the printing press?

## Perpetuating debt holdings

The easiest proposals focus on the part of sovereign bonds currently held by the European Central Bank (for simplicity we will use the terms ECB and Eurosystem as substitutes). Why not just eliminate this debt by replacing these bonds with a zero-coupon perpetual? This would give member states some breathing space and the capacity to spend more. But not so fast. The central bank is actually owned by the government (though there are a few cases where the ownership is mixed). And within the Monetary Union, governments receive dividends from their national banks (who in turn receive their share of the ECB's profits). A central bank's profit derives from the difference in interest income on the assets it holds and the interest it pays on its

liabilities. Bank notes by nature don't carry an interest rate. The profit the central bank makes on this is called seigniorage. In normal times, a positive interest rate is paid on commercial bank reserves, which are a large part of the central bank's liabilities. But now the ECB actually charges a negative interest rate on a big chunk of bank reserves. Therefore, they also contribute to net interest income. If the ECB exchanges interest-bearing debt on the asset side of its balance sheet with a zero-coupon perpetual, then, of course, bank profits will decline, which will result in lower dividends for the governments in the future. For most central banks in the Eurosystem, the dividends and taxes paid to the state are now around 0.1% to 0.3% of GDP.

What most people don't realise is that there is already some mild form of debt monetisation. As a matter of fact, in the current public sector Purchase Programme, bonds on the ECB's balance sheet that come to maturity are replaced with new bonds. As in practice, the ECB will buy the new bonds that the governments are raising to reimburse the central bank, it is pretty much as if the central bank is holding the debt permanently on its balance sheet. What's more, the interest they pay to the central bank are, at the end of the day, partially given back as a dividend. This is, of course, the case as long as the interest paid on central bank liabilities is zero or lower. So, in a nutshell, as long as the central bank rolls over its stock of sovereign bonds, there is nearly no difference with the situation where it replaces these bonds with a zero-coupon perpetual: this part of the debt is not reimbursed and comes at close to no interest cost. Admittedly, for the time being, there is no commitment to keep them indefinitely on its balance sheet.

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*“It is important that debt financing by the ECB is believed to be genuine in practice, but non-existent in theory.”*

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### **Further expand the balance sheet**

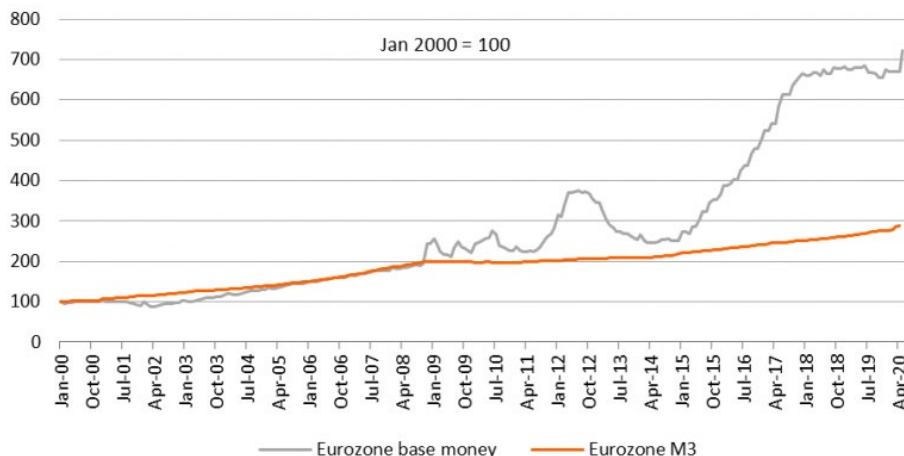
Of course, the ECB could continue to expand its balance sheet by further buying sovereign bonds and refinancing these bond holdings forever. Actually, that is pretty much what happened during and after the Second World War. Major central banks strongly increased their balance sheets by purchasing government debt and while the balance sheets were mostly reduced afterwards in terms of GDP, they hardly ever did in nominal terms (see here).

In that way, it is believed that the Federal Reserve's printing press financed about 15% of the war expenditures. As the French President Emmanuel Macron compared the current Covid-19 crisis to a war-like situation, a case could be made for a permanent increase in the ECB's balance sheet. The trouble is that monetary financing isn't actually allowed under the EU treaties. Therefore, the ECB can use its balance sheet for monetary purposes, but can never commit to keeping government debt on its books indefinitely. The recent ruling of the German Constitutional Court is likely to draw even more scrutiny to the central bank's policy in this regard. Of course, the ECB could do this by stealth. It doesn't have to say overtly that it will continue to refinance government debt, but in practice, it could do so.

The only trouble here, a problem signalled by Adair Turner, is that the central bank might be too credible in its denial of monetary financing. In other words, the general public could believe that the debt in the hands of the ECB will have to be repaid someday, implying higher taxes in the future. That could lead to higher savings, and consequently less growth now (a phenomenon called Ricardian equivalence, if you want to impress your friends). So it is important that debt financing by the ECB is believed to be genuine in practice but non-existent in theory.



**Fig 12 The money multiplier collapsed**

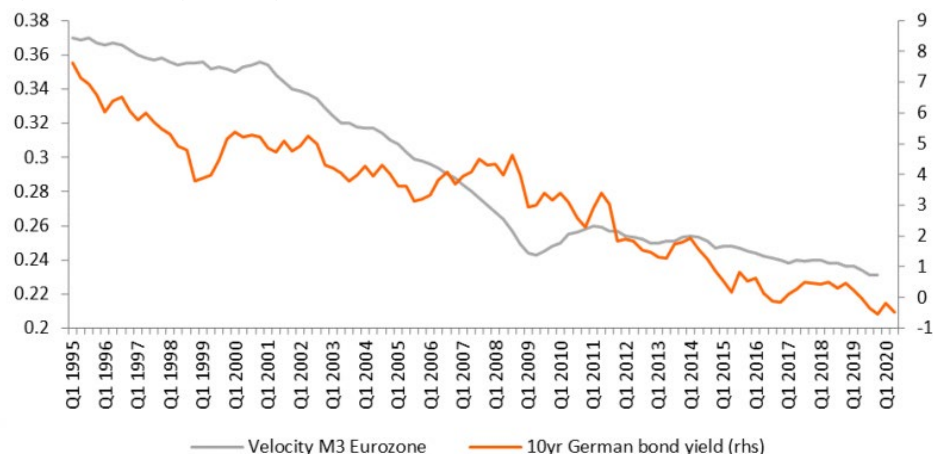


Source: Refinitiv Datastream

### The hyperinflation sirens

But wouldn't this further increase in the size of the balance sheet lead to more inflation? We already had a strong increase in the size of the balance sheet in previous years, not only in Europe, but also in the US and Japan. The argument goes that more of this would push inflation through the roof. The reasoning behind this is to be found in the quantitative theory of money: the more money in circulation, the more inflation ([see here for a recent warning](#)). What is lost in this reasoning, is that there is a difference between the money created by the central bank (base money, which equals notes in circulation and bank reserves) and broad money in the hands of the general public. The money multiplier, which is the ratio of broad money to base money has actually collapsed. This is because quantitative easing directly creates broad money and bank reserves in similar amounts, but there is no extra money creation involved through bank credits in the process ([see here for a detailed explanation](#)). On top of that, the velocity of money, which measures the number of times the stock of money is used to do purchases during a certain time period, has also strongly declined. The latter is logical. As interest rates on alternative assets are very low, people hold a larger chunk of their wealth in the form of money, without actually using it to do transactions. To illustrate these points you only have to look at what happened in Japan over the last few decades. Since 1997, base money has increased by a whopping 970%, while consumer prices over the same period have basically remained unchanged. In other words, the increase in the ECB's balance sheet through the purchase of additional government bonds doesn't need to lead to significantly higher inflation, though of course the amount of government bond purchases without causing higher inflation, is not limitless either.

**Fig 13 Declining velocity**



Source: Refinitiv Datastream

### **Too low an inflation rate**

You could even wonder if, at the end of the day, a little bit more inflation is not what the eurozone needs. Over the last 10 years, average inflation has been 1.3%, while average core inflation and the average GDP deflator came out at 1.1%. Nominal GDP growth, therefore, averaged a mere 2.5%. That is a worrying phenomenon since the real burden of large debt levels remains high, further depressing growth. With the current downturn creating a huge negative GDP output gap, some extra stimulus seems warranted, without immediately having to fear galloping inflation. And with short term interest rates already negative, the only tool the central bank has left to boost the economy further is balance sheet expansion. Since it is not obvious how to determine the exact amount of permanent balance sheet expansion, the central bank could announce a price level target in the future (see e.g. Bernanke), ideally one that allows for some correction of the inflation undershoot that we experienced over the last decade. The establishment and extension of the Pandemic Emergency Purchase Programme is already an important step in this regard, though at this moment the programme is still labelled as temporary.

### **Monetary dominance**

The final question is whether the ECB, by monetising part of the fiscal expansion, would become hostage to the fiscal authorities. Fiscal authorities might want to prevent an interest rate increase because this would implicitly increase the cost on the debt held by the central bank (it would reduce the central bank's interest income and thereby the dividends paid out to the governments), while at the same time, new debt would also have to be issued at a higher interest rate. And if the fiscal expansion to fight Covid-19 is now accommodated by the central bank, why couldn't the same thing be done to finance the green agenda? In that way, fiscal policy would become dominant, a thesis advanced by the proponents of Modern Monetary Theory: governments can spend newly created money as long as there is no full employment. Only when the situation of full employment is reached do governments have to hit the (tax) brakes to avoid inflation. However, past experiences of the central bank's monetary policy being subordinated to fiscal policy did not end well. A politician who needs to get re-elected is generally not the one who will "take away the punch bowl just as the party gets going". That is basically the reason why most industrial countries have opted for an independent central bank that has to maintain the purchasing power of money in the longer run. But even when maintaining the dominance of monetary policy over fiscal policy, we believe that today, there is some scope to accommodate fiscal expansion by a further increase in the ECB's balance sheet, without having to fear inflation going through the roof. At the end of the day, it might even be needed to bring inflation back to close to, but below 2%.

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## Stagflation - not coming to an economy near you

Some analysts suggest that the pandemic and lockdowns will lead to a return to stagflation, last seen in the 1970s and very early 1980s. We don't agree, which in some ways is a pity, as it might not be all that bad an outcome if it did happen.



Source: Shutterstock

### Relative price increase possible, probable even...

High inflation is generally not regarded as a good thing, as it reduces the value of savings. Combine that with high unemployment and a stagnant economy, and you have all the ingredients for a nasty cocktail and also the making of a high “misery index”.

With many economies coming out of Covid-19 lockdown and demand likely to increase, but supply disruptions likely to linger, some pundits have been pointing to the likelihood of stagflation and wagging a warning finger.

It is, in our view, entirely possible, even probable that such conditions lead to short-term relative price increases in some areas, for example, supermarket staples, and healthcare items such as masks and sanitizers. But even with broader price increases, one of the unique features about earlier episodes of stagflation, was how supply shocks (oil in the 1970s and 1980s) became embedded. And for this to occur requires mechanisms that will be extremely hard to replicate today.

### Things are very different to the 1970s

Accommodative central banks were partly blamed for earlier bouts of stagflation, and today, it is hard to argue that with QE becoming widespread, and more central banks knocking on negative rates, that monetary policy is not at least as accommodative as it was in the 1970s.

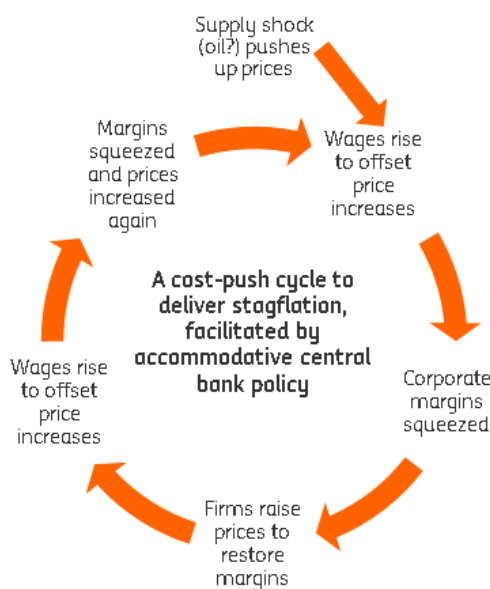
But for this to develop into stagflation requires a wage-price spiral that is hard to imagine occurring today, at least not in any developed market economy.

In the 1970s, with large manufacturing sectors and high domestic content to production, mass unionisation, collective bargaining, and employees with high degrees of firm-specific skills a price shock could lead to wages being bid higher, squeezing corporate margins, and requiring an offsetting price increase from the firm to keep margins positive. That, in turn, would spark another round of wage increases, and then margins squeeze and price increases and so on (see stylistic diagram).

Another way of putting this is, easy money isn't particularly inflationary without a high velocity of money – and this has collapsed across the developed world. It isn't enough to just cut rates or print money – the real economy actually has to respond, not just financial assets, and that doesn't happen much anymore.

Even with a little less help from globalisation in the coming years than we may have become used to, the situation today and likely in future years too is far less prone to inflation than it once was. Labour has next to no say any more on its remuneration, irrespective of how low the unemployment rate falls. And manufacturing is a fraction of the importance for economies it once was, is largely automated, and uses workforces that have been de-skilled and become easily replaceable.

**Fig 14 Stylistic diagram of how stagflation takes root**



Stagflation cycle  
Source: ING

**A bit of inflation, even stagflation might not be all that bad...**

Central banks, even using today's policies, which would have been considered absurd in the 1970s, can't often even get inflation high enough to hit the middle of their inflation targets when times are good. What hopes then of stagflation in a post-Covid19 world? The answer seems to us is, practically none.

And in some ways, this is a pity, because aside from the withering effect of inflation on household savings, inflation has exactly the same effect on debt. This enables governments to deflate away debt piles accumulated in bad times and enables households to borrow and spend, safe in the knowledge that rising wages will make debt service more manageable as time progresses, even if today it is a struggle.

Consequently, some have even suggested running inflation "high" deliberately after the pandemic has eased, just to reduce the debt pile, which otherwise, may weigh heavily on future growth prospects. Right now, however, such suggestions fall foul of the

practical difficulties of making that happen, and in the end, some other approach is likely to be needed to reduce the inevitable debt burden stemming from the Copvid-19 pandemic. The “stag” bit of stagflation looks eminently achievable. The “flation” bit is another matter.

([This note is summarised from an earlier piece](#), and you may also like to [see the linked video](#))

## Eurozone: Periphery in peril

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The initial shock to the eurozone economy from the Covid-19 pandemic was very symmetric as all countries went into lockdown at roughly the same time. But the pace of recovery will be far more asymmetric, with many peripheral economies at risk of a longer lasting slump.



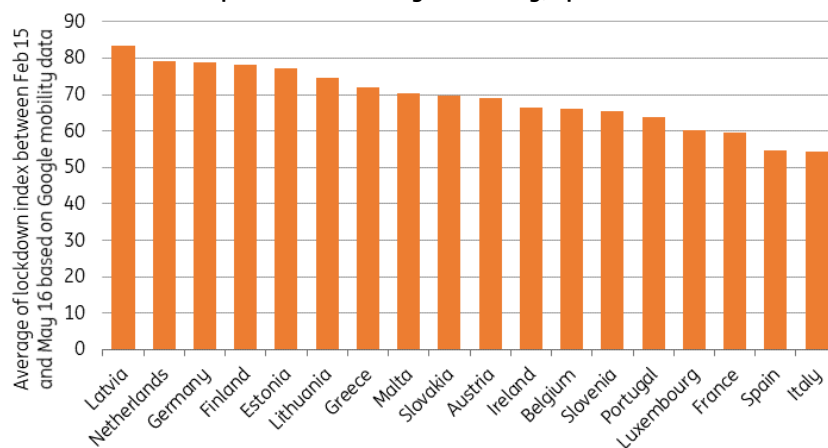
Source: Shutterstock

### Most drivers of the speed of recovery favour the old “core” countries

Going over a variety of factors that play a role in the speed of recovery from the crisis, a rather consistent picture emerges. There are very little scenarios imaginable in which southern Eurozone economies manage to recover as quickly as their northern counterparts. Below we'll list the drivers we deem important and show the differences between northern and southern counterparts.

Looking at a variety of factors that we deem important for the speed of the recovery of this corona crisis, we find a much weaker base for a swift recovery in the southern eurozone economies than in the north. Take the depth of the lockdown for example, which as can be seen in chart 1 has been much more severe in Italy and Spain than in Germany and Netherlands. The more severe the downturn, the more likely it is that lasting damage to the economy has occurred, increasing the chances of a slower recovery. That is especially the case when safety nets and emergency fiscal spending are weak, which is also the case in Spain and to a somewhat smaller degree in Italy, Portugal and Greece for example. Northern economies therefore seem much better prepared for a deep downturn.

**Fig 15 The lockdown impact has been largest in Italy, Spain and France**



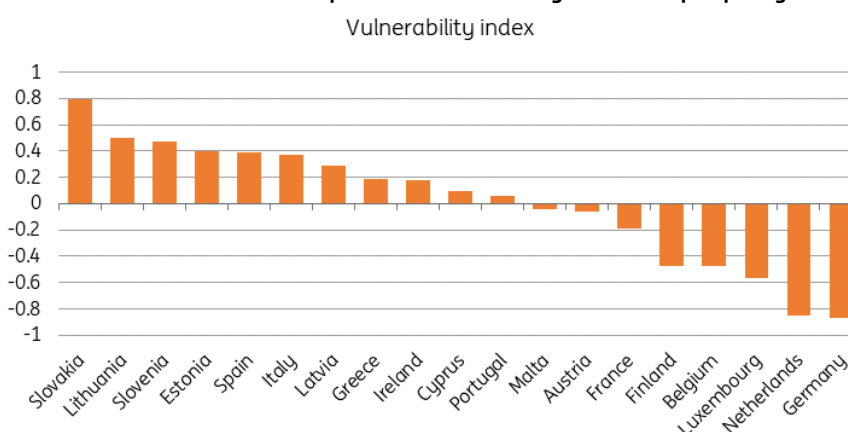
Source: ING Research, Google Covid-19 Community Mobility Reports

Specific to this crisis, we see that the sectoral composition of periphery countries does not favour a fast recovery. Countries more reliant on tourism for example are likely to experience a weaker recovery as that sector will likely experience a slow bounce back from the lockdown. The same holds good for countries with more small businesses and businesses with weaker financial buffers as they are more likely to go bankrupt in times of no income or reduced income. Financial buffers are also important for households in the recovery, because countries with lower household buffers tend to see weaker spending in the recovery. Out of the factors above, countries like Spain, Italy, Portugal and Greece tend to perform weaker than their northern counterparts. Only in terms of household buffers do Germany and Netherlands come out lower on the list. A final factor taken into account that would put northern economies at a disadvantage is openness of the economy as a slow recovery of world trade would hamper economic recovery as well.

**The old eurozone periphery is most vulnerable to a prolonged slump**

Taking all of these factors together, we can create an index measuring vulnerability to a prolonged corona slump. Without applying any weights, the index is essentially agnostic about which factors will weigh the most. The countries that are most vulnerable according to the index are the CEE countries, followed by Spain and Italy, while Portugal, Greece, Slovenia and Cyprus also rank as more vulnerable than average. The countries that are more likely to bounce back quickly are all the northern eurozone economies. This sounds a lot like the old familiar lines drawn around the “core” and “periphery” of the euro crisis.

**Fig 16 The “core” is better set up for a swift recovery than the “periphery”**



Note: index comprises an average of normalised indicators: automatic stabilisers, emergency fiscal spending as a percentage of GDP, percentage employment of small enterprises (under 10 employees), average of the three financial conditions factors mentioned in the text, liquid household assets as a percentage of GDP, sectoral composition and the average for our lockdown index.

Source: ING Research, Google Covid-19 Community Mobility Reports

### **A longer recovery in southern eurozone economies could have worrying implications**

If indeed southern eurozone economies are in for a much longer economic slump on the back of the Covid-19 crisis, this could have worrying implications from a debt perspective. While some countries have committed to smaller than average support packages, debt as a percentage of GDP will still be significantly higher if GDP does not recover for a longer period of time. It is not unthinkable that debt-to-GDP ratios rises faster by mid-2021 in countries that have spent a smaller share of GDP on the crisis, simply due to the diverging trends in economic growth.

These concerns about debt levels already seem to have played a role in the size of the support packages by individual governments. The size of announced fiscal spending by country so far links best with market yields for government bonds and the level of government debt prior to the crisis, rather than the depth of the lockdown or automatic stabilisers, for example. This indicates that despite the historic steps taken within the EU, such as activating the “general escape clause” in the stability and growth pact by the European Commission and the ECB's PEPP bond buying programme, governments have still been wary about longer term debt worries while fighting this crisis.

The recent discussion and latest proposals on a European Recovery Fund indicate that there is a growing awareness of the longer-term problem an asymmetric recovery could create. A pan-European fiscal response on top of the already agreed package of European Investment Bank support, loans for short-time unemployment schemes and a possible European Stability Mechanism credit line, could alleviate this problem to a certain degree. This is particularly true if the fund uses grants rather than loans, though there could still be a potential problem with moral hazard. The message to financial markets concerned about debt sustainability and euro break-up risk would be loud and clear: the EU leaves no country behind.



Fig 17 ING global forecasts

	2020F					2021F					2022F
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	
<b>United States</b>											
GDP (QoQ%, ann)	-5.0	-38.0	30.0	9.5	-5.3	5.0	3.5	3.5	3.0	4.6	3.1
CPI headline (YoY%)	2.1	0.3	0.0	0.0	0.6	0.6	2.2	2.6	2.5	2.0	2.0
Federal funds (% eop)	0.25	0.25	0.25	0.25		0.25	0.25	0.25	0.25		0.50
3-month interest rate (% eop)	0.5	0.30	0.30	0.30		0.30	0.30	0.30	0.30		0.70
10-year interest rate (% eop)	0.75	0.75	1.00	1.00		1.00	1.00	1.25	1.25		1.75
Fiscal balance (% of GDP)					-20.6						-10.1
Gross public debt / GDP					104						108.1
<b>Eurozone</b>											
GDP (QoQ%, ann)	-14.0	-42.0	47.0	9.0	-8.0	3.0	2.0	2.5	2.0	4.5	2.2
CPI headline (YoY%)	1.1	0.3	-0.2	0.1	0.3	1.1	1.1	1.5	1.5	1.3	1.6
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00		0.00
3-month interest rate (% eop)	-0.40	-0.35	-0.35	-0.35		-0.35	-0.35	-0.35	-0.35		-0.2
10-year interest rate (% eop)	-0.47	-0.30	-0.30	-0.30		-0.25	-0.20	-0.20	-0.15		0.10
Fiscal balance (% of GDP)					-8.8						-3.9
Gross public debt / GDP					102.9						100
<b>Japan</b>											
GDP (QoQ%, ann)	-2.0	-25.0	18.0	2.0	-4.9	0.5	1.0	1.0	1.0	1.0	1.1
CPI headline (YoY%)	0.5	-0.1	0.5	0.3	0.3	0.7	1.2	0.9	0.7	0.9	0.7
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1		-0.1
3-month interest rate (% eop)	0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00		0.00
10-year interest rate (% eop)	0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00		0.00
Fiscal balance (% of GDP)					-16.9						-9.8
Gross public debt/GDP					222						228
<b>China</b>											
GDP (YoY%)	-7.0	-3.0	-0.5	4.5	-1.5	6.0	5.0	4.0	2.0	4.3	4.0
CPI headline (YoY%)	5.0	3.0	2.2	1.5	2.9	2.0	2.5	2.5	2.9	2.5	2.5
PBOC 7-day reverse repo rate (% eop)	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
10-year T-bond yield (% eop)	1.9	1.5	1.6	1.7	1.7	1.8	2.0	2.4	2.6	2.6	3.0
Fiscal balance (% of GDP)	2.6	2.8	2.9	3.0	3.0	3.05	3.1	3.15	3.2	3.2	3.5
Public debt (% of GDP), incl. local govt.	7.08	7.15	7.1	7.05	7.05	7.03	7.00	6.95	6.90	6.90	6.75
<b>UK</b>											
GDP (QoQ%, ann)	-7.5	-54.0	62.0	13.0	-8.7	3.5	3.5	2.5	1.5	5.4	1.8
CPI headline (YoY%)	1.7	0.5	0.3	0.7	0.8	0.9	1.7	1.8	1.8	1.5	1.7
BoE official bank rate (% eop)	0.1	0.1	0.1	0.1		0.1	0.1	0.1	0.1		0.5
3-month interest rate (% eop)	0.6	0.2	0.2	0.2		0.2	0.2	0.25	0.3		0.6
10-year interest rate (% eop)	0.3	0.3	0.4	0.4		0.5	0.6	0.7	0.8		1.2
Fiscal balance (% of GDP)					-13						-6.9
Gross public debt/GDP					107						107.4
EUR/USD (eop)	1.10	1.15	1.18	1.20		1.18	1.15	1.12	1.10		1.10
USD/JPY (eop)	107	110	110	105		102	105	108	110		110
USD/CNY (eop)	7.08	7.15	7.10	7.05		7.03	7.00	6.95	6.90		6.75
EUR/GBP (eop)	0.89	0.91	0.92	0.90		0.90	0.88	0.88	0.88		0.85
Brent Crude (US\$/bbl, avg)	51	33	40	50	44	50	60	60	63	58	65

GDP forecasts are rounded to the nearest whole/half number, given the large magnitude and uncertainty surrounding our estimates

Source: ING forecasts

**Real GDP growth (QoQ% annualised unless otherwise state) and market forecasts**

Scenario 1 – Base case											
	1Q	2Q	2020			2021					2022
			3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	FY
United States	-5.0	-38.0	30.0	9.5	-5.3	5.0	3.5	3.5	3.0	4.6	3.1
Eurozone	-14.0	-42.0	47.0	9.0	-8.0	3.0	2.0	2.5	2.0	4.5	2.0
China (YoY%)	-7.0	-3.0	-0.5	4.5	-1.5	6.0	5.0	4.0	2.0	4.3	4.0
Japan	-2.2	-25.0	18.0	2.0	-4.9	0.5	0.9	0.9	0.9	1.0	1.1
United Kingdom	-7.5	-54.0	62.0	13.0	-8.7	3.5	3.5	2.5	1.5	5.4	2.0
EUR/USD	1.10	1.15	1.18	1.20		1.18	1.15	1.12	1.10		1.10
USD/JPY	107.00	110.00	110.00	105.00		102.00	105.00	108.00	110.00		110.00
US 10-year yield (%)	0.75	0.75	1.00	1.00		1.00	1.00	1.25	1.25		1.75
Scenario 2 – Winter lockdowns return											
	1Q	2Q	2020			2021					2022
			3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	FY
United States	-5.0	-38.0	30.0	-10.0	-6.5	1.0	9.5	9.5	7.5	1.8	5.4
Eurozone	-14.0	-42.0	47.0	-25.0	-10.1	20.0	10.0	2.5	2.0	2.7	2.6
China (YoY%)	-6.5	-3.0	-2.0	1.0	-2.7	4.0	3.0	2.0	2.0	2.8	3.3
Japan	-2.0	-25.5	19.0	-11.0	-5.6	-1.0	0.0	0.0	0.0	-2.0	0.0
United Kingdom	-7.5	-54.0	62.0	-22.0	-10.8	2.0	22.0	7.5	5.0	1.1	4.1
EUR/USD	1.10	1.15	1.12	1.10		1.15	1.20	1.15	1.10		1.10
USD/JPY	107.00	110.00	100.00	100.00		100.00	103.00	105.00	105.00		105.00
US 10-year yield (%)	0.75	0.75	0.50	0.50		0.75	0.75	0.75	1.00		1.50
Scenario 3 – 'Worst case'											
	1Q	2Q	2020			2021					2022
			3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	FY
United States	-5.0	-50.0	-10.0	0.0	-13.7	5.0	5.0	6.0	20.0	-2.0	10.0
Eurozone	-14.0	-48.0	-15.0	-5.0	-16.3	6.0	4.0	3.0	20.0	-3.7	5.5
China (YoY%)	-7.0	-5.0	-4.0	-2.0	-4.5	0.0	3.0	3.5	4.0	2.6	3.0
Japan	-2.0	-25.0	19.0	-9.5	-5.5	-4.0	-4.5	-4.5	-4.0	-4.1	-2.0
United Kingdom	-7.5	-62.0	-6.0	3.0	-18.0	2.0	5.5	10.0	20.0	-2.7	12.5
EUR/USD	1.10	1.15	1.10	1.05		1.15	1.30	1.20	1.20		1.20
USD/JPY	107.00	110.00	100.00	90.00		95.00	100.00	100.00	100.00		100.00
US 10-year yield (%)	0.75	0.75	0.50	0.25		0.25	0.25	0.25	0.50		1.00

Source: ING (Note most growth forecasts rounded to nearest whole or half number)

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