

The Aerial View

Morning Briefing

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The Second Wave in G10

- Euro area is yet to deliver fiscal easing
- Canada has monetary policy room
- Currency appreciation may boost purchasing power and sentiment



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Tackling COVID-19 Version 2.0

With the onset of the fall, the attention of markets is again turning to policy response in the event of a second wave. [Earlier this week we showed](#) that China, Russia and Mexico are the countries with most capacity to ease within EM. In this note, we apply the same yardstick to G10 economies.

We first look at economies with the highest potential to inflict additional closures. As of writing, Europe and North America are on an equal footing.

For EM, we took deaths per million as the main yardstick to watch in relation to desired fiscal expansion. LatAm appears to be the region with the most need for government spending, followed by EMEA, with Asia being a distant third, within which India, Indonesia and Philippines standing out as being particularly hard hit in deaths per million terms.

For G10, we opted to use the spike in new cases in relation to the first wave. Starting from the Americas, Canada cases are about the same as in the first wave, while in the US, cases are about 30-40% higher than in the first wave in April but 30% below the peak observed during the summer in July. It seems that in the Americas the second wave is, for now, about the same as in Europe with a couple of exceptions.

Across the Atlantic, France seems to stand out with a three-fold increase in cases compared to the spring peak. New cases in the UK may have peaked at about 50% higher than the previous peak. In Spain new cases are also running about 15% higher than previous peaks. Otherwise new cases are either the same or well below the first wave, at least for now, in Germany, Sweden and Switzerland.

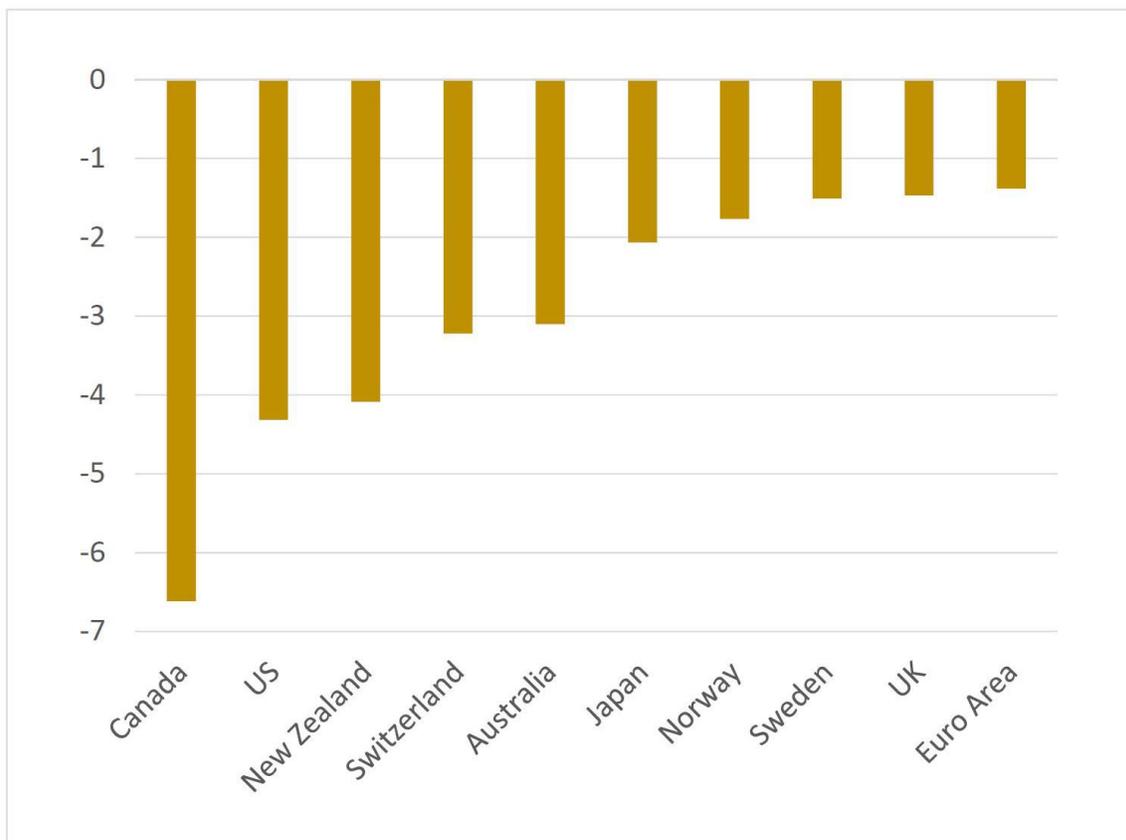
In APAC, between Japan, New Zealand and Australia a second wave seems most significant in Japan compared to Australia, while cases in New Zealand were almost insignificant on a global scale.

In the chart below, we show the z-score of the most recent 12-month cumulative fiscal balance for each G10 economy. We deduct the last fiscal imbalance reading by the historical average and normalize this with the historical standard deviation. The time frame used to estimate the average and the standard deviation is the period since the global financial crisis.

Our calculations are, in our opinion, a better gauge than the fiscal balance to GDP ratio. While fiscal expansion has been significant in most economies around the world, normalizing by a denominator that is also collapsing by 8-15% produces an overblown estimate of fiscal expansion.

Actual local currency in relation to its own history would work as a better approximation. We therefore find that the UK and the euro area are both yet to deliver additional significant fiscal expansion. The countries in the most advanced stages of fiscal easing are Canada and the US.

Z-score 12-month Fiscal Balance



Source: BNY Mellon calculations and Haver Analytics

Notes: For New Zealand we use changes in tradable public debt. Averages and standard deviations are calculated using data since the global financial crisis.

We therefore find that the UK and the euro area are both yet to deliver more significant fiscal expansion

Monetary Policy Hopes

The main hope for monetary policy is higher inflation. Assuming this cyclical turn is mostly damaging to the supply side may mean a disproportionate increase in inflation as the global economy recovers.

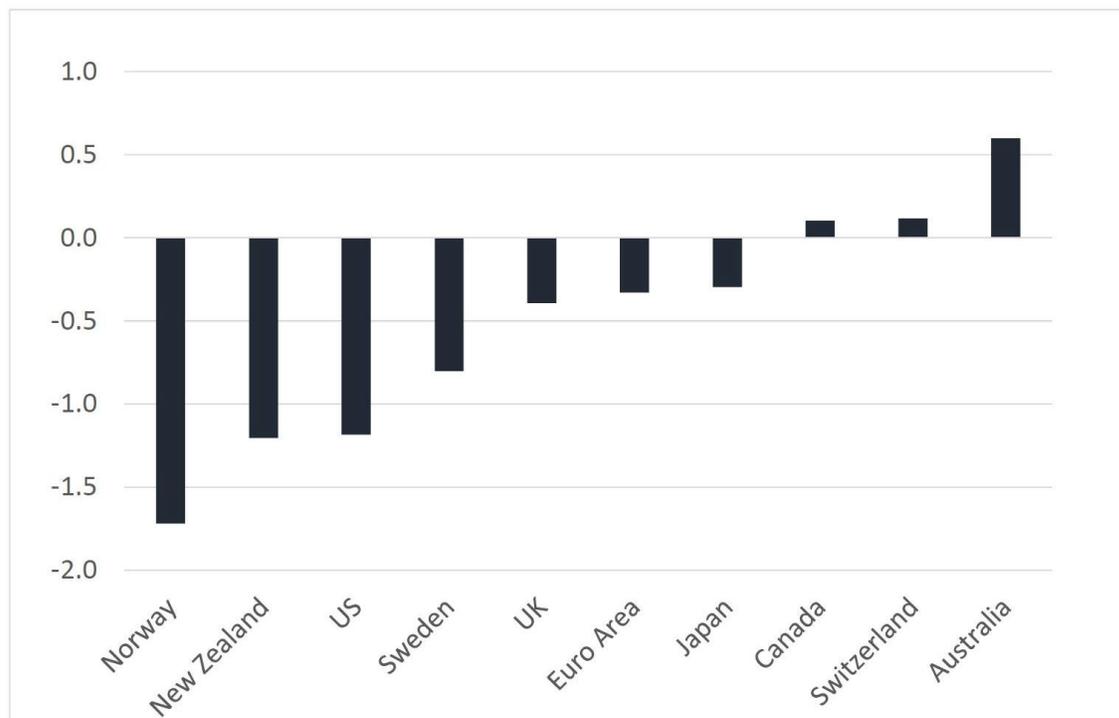
Impairments will likely be permanent in many industries such as travel and entertainment as a result of long-term curbs in business travel as well as measures applied to avoid future pandemic outbreaks. In addition, memories past will likely feed additional protectionism which was already impairing the supply side heading into the Great Lockdown.

In the chart below we draw a simple ex-post real interest rate with the main reference rate deducted by the most recent inflation reading. Again, the US appears prominently to the left hand side of the chart while Canada seems to have room to ease more.

Australia and Switzerland may also be a candidates for more meaningful easing,

perhaps through bond buying.

Ex-post Real Interest Rates



Source: BNY Mellon Calculations and Haver Analytics

Yen appreciation would push much of Asian currencies stronger

Currency Appreciation to Boost Sentiment

Yesterday we discussed this topic in regards to the euro area. Currency appreciation may support demand through sentiment as households feel an improvement in purchasing power.

In the table below we show our main currency valuation results for G10 currencies. We estimate three models: PPP, DEER and BEER. PPP represents the fair value taking into account price differentials between the base currency against its main trading partners' using BIS trade-weighted real effective exchange rates.

DEER is a dynamic equilibrium using simple regressions of the real effective exchange rate on terms of trade, foreign direct investment and productivity. BEER is a partial equilibrium using the current account and a sustainable estimate of the external imbalance as a function of demographics, money, credit and terms of trade.

The USD is the most overvalued currency in G10 with a 6.5% overvaluation. The Swiss franc is next at 4.7% overvaluation. Otherwise, all other G10 currencies have room to allow their own currencies to appreciate by as much as 5-7% on a trade-weighted basis and still be within reasonable valuation territory.

This currency appreciation would be an obvious corollary assuming we observe meaningful fiscal easing in the euro area and the UK as suggested in the first part of this note.

Japan will likely remain an important question mark in this equation. Yen appreciation would push many Asian currencies stronger as well. The Chinese yuan would benefit in particular. It is significantly overvalued against the rest of the region as we suggested in our note earlier this week.

Currency Valuation

	PX_LAST	PPP	DEER	BEER	Average	Misalignment
USD	1177	1078	1181	1057	1106	6.5%
EUR	1.173	1.20	1.18	1.19	1.19	-1.5%
JPY	105.4	84.0	102.8	104.6	97.1	-7.9%
AUD	0.72	0.73	0.79	0.86	0.79	-9.6%
CAD	1.33	1.24	1.27	1.19	1.24	-7.2%
NZD	0.66	0.65	0.72	0.62	0.66	0.1%
GBP	1.29	1.45	1.38	1.40	1.41	-8.3%
EURCHF	1.08	1.17	1.11	1.11	1.13	4.7%
EURSEK	10.50	8.92	10.42	10.62	9.99	-4.9%
EURNOK	10.94	9.06	9.70	10.23	9.67	-11.7%

Source: BNY Mellon estimates

Note: PPP represents the fair value taking into account price differentials between the base currency and its main trading partners using a moving average back to 1994 using BIS trade-weighted real effective exchange rates.

DEER is a dynamic equilibrium using simple regressions of the real effective exchange rate on terms of trade, foreign direct investment and productivity.

BEER is a partial equilibrium using the current account and a sustainable estimate of the external imbalance as a function of demographics, money, credit and terms of trade.

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