The Aerial View

Morning Briefing

October 22, 2020

Fiscal Injections: Right, Left and Center

- **Unprecedented expansion with varying biases**
- **Biases will define micro post vaccine**
- **IMF defines supply side damage as "scarring"**

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IMF Fiscal Monitor highlights core issues

Last week the IMF released its biannual fiscal monitor report (see it here). The main message is that fiscal injection will likely be the only important policy lever to watch going forward.

In the chart below we scale fiscal easing in three groups. First, in terms of additional spending and foregone revenues. Within the advanced economies (AEs), New Zealand, Singapore, Canada, Australia and the US have stood out in terms of speed and size, all above 10% of GDP.

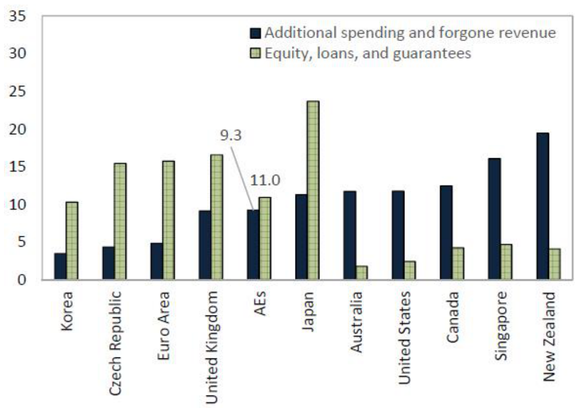
Second, European economies stand out, not only because actual fiscal transfers were moderate against the AE average, but also because they have been more aggressive in terms of equity, loans and guarantees provided. In other words, significant resources aimed at keeping businesses afloat.

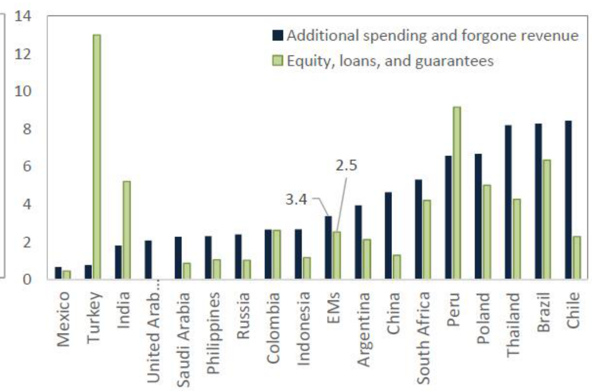
Third, fiscal easing in emerging markets (EM) have so far been 7-8pp of GDP below those observed in AE. Moreover, with the exception of Turkey and India, where government are aiming to support and inject equity to the banking system, governments have been less prone to finance businesses.

An important qualifier between AE and EM is central bank policy bond buying. AE have been more belligerent on fiscal because their central banks have been aggressively buying government bonds.

Central banks' purchases of local debt as a share of central government marketable securities of debt issued since February 2020 was 50% for the BoE, 57% for the Federal Reserve, 71% for the ECB and 75% for the BoJ. Within EM, the most aggressive was BNM at 34%, TCMB at 23%, BI at 20% and SARB at 11%.

Discretionary Fiscal Response in Selected Economies (as of Sep 11, 2020, % of GDP)





Source: IMF Fiscal Monitor, October 2020
Source: each country has its own announcement pace. Most measures announced are short term due to end within months and not later than 2021. AE/EM average is GDP-weighted

> ***European governments stand out because they have been more aggressive in terms of equity, loans and guarantees***

Supply-Side Impact of Measures

Both ends of this equation, Europe and the US, are likely too extreme. The US has been too aggressive with regards to unemployment insurance while Europe has been too aggressive providing equity, loans and guarantees. Supply-side damage in Europe will result in zombie companies and banks, and in the US, a zombie labor force.

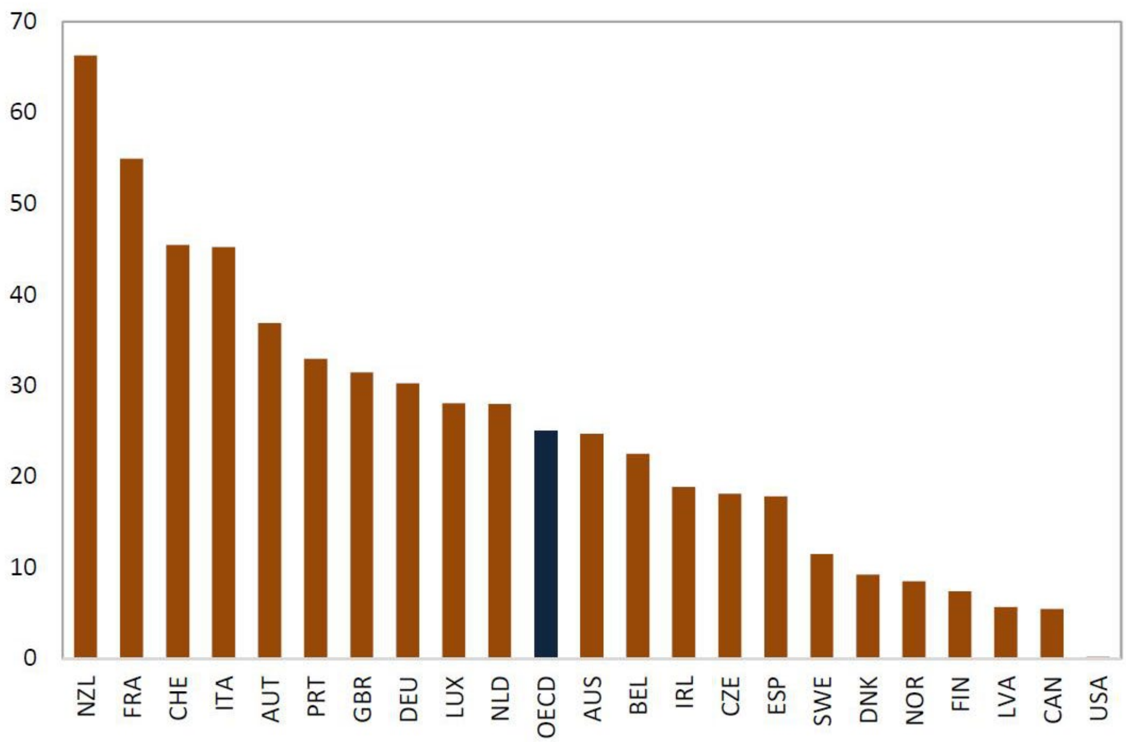
Both zombie outcomes assume two or more years of government-sponsored life support. As noted last week here, the share of debt with an interest cover ratio below 1 (ICR<1) in the euro area was 12.7% before COVID-19 and it is expected to rise to 24.7% in 2020 and 45.7% in 2021.

Firms unable to produce revenues high enough to cover for interest expenses are not only a problem in Europe. Projected ICR<1 in other advanced economies in 2021 is 42%. The issue in the EU is that much of the asset impairment will need to be resolved by governments, potentially raising social discontent.

Across the US, bankruptcies are more likely and swift but the labor market may take more time to heal. According to an NBER study published in July, half of the eligible unemployed back then was entitled to total unemployment benefits that replaced at least 134% of lost wages. Two-thirds of the labor force were eligible for benefits larger than lost earnings, and a fifth were eligible for benefits that at least doubled their lost earnings.

This implies that even a reduction in weekly transfers from $600 to $400 would still keep a substantial share of the labor force better off by collecting unemployment insurance. In the chart we show that most of the European economies have had significant take-up of job retention schemes. Those were schemes set to pay a share of payroll expenses by the public sector.

Take-Up of Job Retention Schemes (as % of employees)



Source: Organization for Economic Cooperation and Development
Note: Data refer to the end of May 2020, except for Luxembourg and Switzerland (end of April 2020). Take-up rates are calculated as a percentage of dependent employees in the fourth quarter of 2019.

> ***In the US, back in July half of the eligible unemployed were entitled to total unemployment benefits that replaced at least 134% of lost wages***

Scars Will Run Deep

By sector, the micro narrative is even more important. In Europe, governments may drive as much as 85-90% of the debt in affected sectors to ICR<1.

In the US, janitors who stayed on the job may have been paid less than unemployed janitors collecting 158% of their prior wage, and laid-off retail workers collected 142% of their prior wage while their colleagues who remained at work received only their prior wage.

Accommodation and Food debt with ICR<1 was 21% before COVID-19, rising to 89% in 2021. Education, arts, entertainment, other services, professional and scientific services will all be running debt with ICR<1 above 65%. All of these sectors will essentially have two-thirds of their debt in firms running pale revenues.

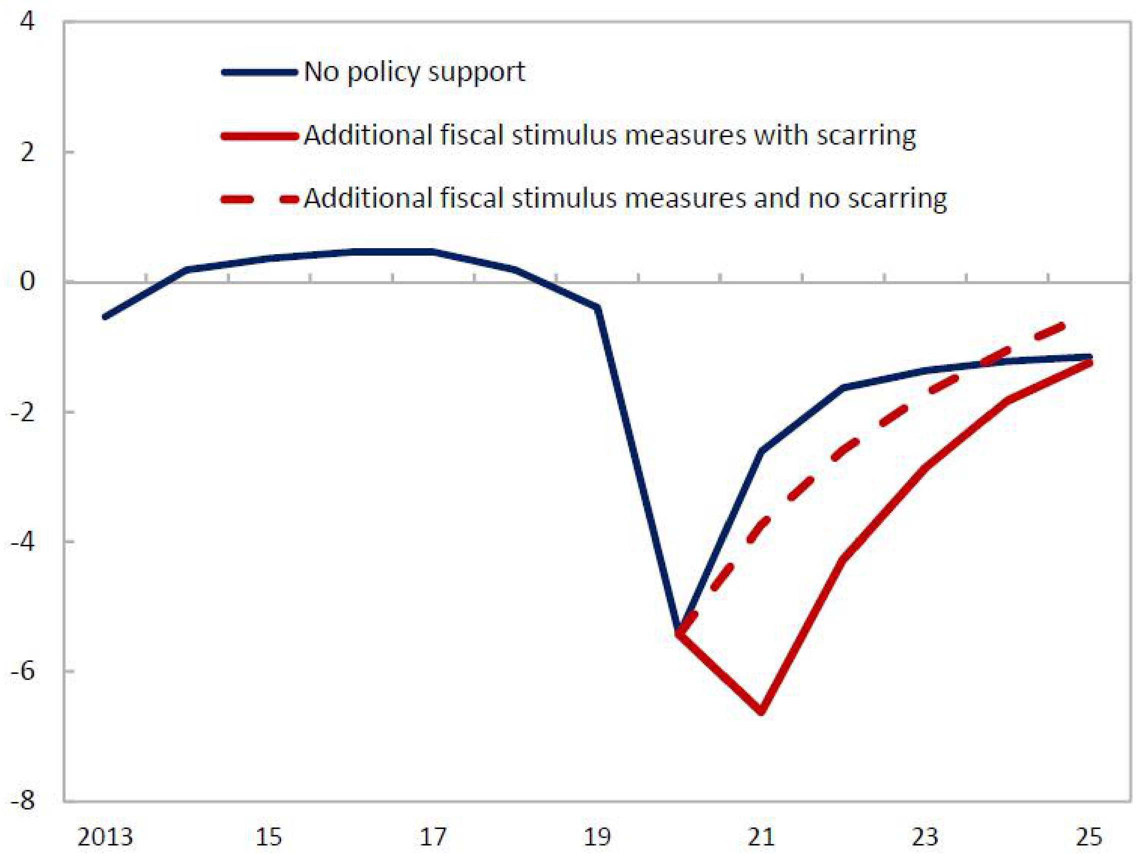
This will cause severe scarring in the recovery. The chart below projects three distinct outcomes. The first would end fiscal support now but would in exchange, result in higher deficits later because activity would take longer to recover with impaired labor and assets.

The second (dotted) scenario, envisions just the right amount of policy support. Labor markets would not be overburdened by generous unemployment insurance support. Zombie companies will be liquidated triggering contingent liabilities granted by governments.

The worst outcome envisions a wrong policy mix. For the US, this means additional income transfers from the public sector to the unemployed even after the lockdown and vaccine.

In Europe, the public sector continues to subsidize borrowing to firms with unrealistic business models. In this scenario an additional 1-1.5pp of GDP in spending would land the fiscal imbalance in the same place where no policy support would result.

Adjustment Projections of Primary Balances (% of GDP)



Sources: IMF Fiscal Monitor staff estimates

Note: Fiscal adjustment path with discretionary stimulus in the first few years for an advanced economy with an average debt level (baseline) at 80 percent of GDP.

Scarring reflects a permanent negative effect of a large negative output gap on the level of potential output. The simulations show desirable policies based on a model where governments pursue both economic stability and debt sustainability

Please direct questions or comments to:

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