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Research & Strategy Insights

Policy hurdles, political dilemmas

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Key points

- From a policy angle a new fiscal push in the US is needed but political calculations are narrowing the options.
- We look at the "banking channel" in Europe. There may be some policy space left there.
- The European council meeting on 15 October will be busy, between Brexit and dealing with a last-minute hurdle on the Recovery and Resilience Fund.
- The UK's part-time unemployment scheme focuses on labour re-allocation while raising risks of demand shock.

After some U-turns from the US President and although discussions are continuing, no deal has been found on a new fiscal stimulus package. The Fed has been very explicit on the necessity of a timely and comprehensive additional budgetary push to sustain the recovery. It is unlikely though that another layer of monetary support is imminent to offset the lack of response from the federal government and deal with the softer economy. We may need to wait for the political dust to settle in the US – which may not be come on November 3rd already – to get more visibility on the overall policy mix.

We look at options for central banks though. While we are convinced that quantitative easing, in the current configuration, is the "main game in town", it may not be the only one. For all the ECB's accommodation, lending rates to businesses and households have not fallen in this crisis. In several countries, bank margins have rebounded, as non-financial agents have shifted their cash towards non-interest rate bearing sight deposits. Now, margins may not have improved enough to compensate for banks' higher risk taking in a difficult environment. Making the Targeted Longer-Term Refinancing Operations even more generous, thus reducing banks' average cost of liabilities, would make sense, in our view, reviving the "banking channel".

The European Council meeting on 15 October is important. We do not necessarily think that an absence of deal with the UK this week would signal the end of the negotiations – we think the pressure on London continues to build, as the rising probability of a Biden victory would leave a no-deal UK quite isolated internationally. The council may well be focused on internal affairs. The Recovery and Resilience Fund is faced with a last-minute hurdle, as the EU's multiannual financial framework is conditional on the resolution of a conflict on a new system to enforce rule of law principles in member states. We think a compromise will be found, but a delay is possible.

Finally, we look at part-time unemployment schemes across countries and their likely impact on job retention. The UK system is consistent with a swift reallocation of labour away from "doomed" industries, while raising the risk of an adverse demand shock.

US cavalry encircled?

Upon finishing last week's Macrocast we were still waiting for a signal on the continuation of the US fiscal stimulus. A week later, there has not been any progress on this front, only more volatility. Donald Trump first abruptly put an end to the negotiations with the Democrats' majority in the House. He changed tack however two days later, offering a "minimal package", before going even further last Friday with an offer at USD 1.8tn, only 0.4tn below the Democrats' plan.

There are many moving parts. The Democrats want a stimulus, but they want it on their own terms. A key issue for them is more federal funding for states and municipalities before their own fiscal rules kick in and layoffs of public sector workers – a key constituency for them – take off. This aspect of their plan has been explicitly rejected by the President. They are also probably concerned with offering Donald Trump the chance of another direct cash transfer to US families just before the vote (probably a key ingredient behind Trump's U-turn). **The Democrats have thus to balance the risk of being blamed for blocking another batch of stimulus and – should they win the Senate on top of the Presidency in three weeks – the temptation of merely waiting until January to shape the next package freely**. In the other side of the fence, the President wants a stimulus here and now – it's his clear electoral interest – but there is another stakeholder in the system: the equation is a bit different for Republicans in the Senate. They have repeatedly rejected any deal which would exceed USD 1.0tn, in line with their traditional distrust for massive public spending. **If the Republican Senators calculate than with or without another emergency package in the next few weeks the most likely scenario is that Donald Trump will lose this election, they may want to focus on "ideological purity" and continue rejecting a fiscal push, getting ready to oppose a spendthrift Biden administration next year.**

Another thorny issue is the pending appointment to the US Supreme Court. With the number of session days for such a process dwindling rapidly before adjournment (the committee hearings will start on Monday 12 October), the Republicans may want to focus on this aspect of their legislative activity rather than discussing fiscal plans. Republicans have more seats to defend in this election than Democrats, which means that a lot of them are busy campaigning in their state (votes in the Senate cannot be done *in abstentia*). Of course, the deadline could be pushed by agreeing to a "lame-duck session", i.e. reconvening Congress in November or even December after the election. This would not be unusual (even if this could mean that Senators who have just been defeated in the election would still vote). However, no house can sit without the consent of the other. In clear, the Democrats in the House of Representatives can prevent the Senate from convening a lame-duck session.

In a nutshell, while there is a strong economic rationale for another stimulus – even one smaller than what the Democrats have been pushing for – the path is very, very narrow when taking short term and long-term political interests into account. Nancy Pelosi's response to Donald Trump's latest offer *("one step forward, two steps back"*) was not encouraging, nor was Lamar Alexander's, a Republican Senator *("there is no appetite right now to spend the White House number of the House number"*). Pelosi kept the door open to a deal, but we are losing hope on this front.

Beyond the debate on the current stimulus, we noticed that the equity market seems to be warming to the perspective of a Biden Presidency, with less focus on the tax hikes and more interest in the promised federal spending push. Among sell-side firms, Goldman Sachs in particular has become quite positive on "Bidenomics". The net impact of Joe Biden's platform on markets will probably depend mostly on sequencing, i.e. which one would come first: the tax hikes, or the spending splurge. If the softening of the US economy continues, logic dictates front-loading expenditure. However, as we discussed last week, this would be consistent with the Federal Reserve (Fed) feeling under less pressure to up the ante on its own stimulus, allowing some increase in long term interest rates. The equity market so far this year has been more often driven by the promise of ample central bank liquidity than by the movements in expected demand.

What's left of the banking channel

Last week both the Fed and the European Central Bank (ECB) released the minutes of their September meeting. The members of the Federal Open Market Committee (FOMC) were relatively positive on the state of the US economy, but "*many participants noted that their economic outlook assumed additional fiscal support and that if* *future fiscal support was significantly smaller or arrived significantly later than they expected, the pace of the recovery could be slower than anticipated*". Given the latest developments on this issue, it is fair to infer that the Fed is feeling less comfortable right now. There was little elaboration in the minutes on possible next steps for quantitative easing, but there is obviously a conversation on how to strengthen the Fed's dovish message with "outcome-based guidance", i.e. criteria for lifting policy rates *"in terms of paths for inflation and employment",* an approach supported by "most participants".

The ECB minutes opened the door to more action, without much elaboration on the instruments: *"the case was made for keeping a "free hand" in view of the elevated uncertainty, underpinning the need to carefully assess all incoming information, including the euro exchange rate, and to maintain flexibility in taking appropriate policy action if and when needed"*. Still, beyond the possibility of more monetary stimulus, the ECB is obviously counting on support from fiscal policy. The word "fiscal" appeared 25 times in the text, up from 17 times in July.

We have been arguing for some time in Macrocast that the central banks' focus on fiscal policy can be attributed to a loss of confidence in the capacity of monetary policy's traditional transmission channels to move the dial in the present circumstances, even if this is not explicit – for obvious strategic reasons – in their official communication. **Here, we want to shed some light on the banking channel, normally the most prominent one in the Euro area given the dominance of the bank-intermediated funding model there.**

Interest rates on new loans originated to households and non-financial businesses have not declined since the beginning of the pandemic crisis (see Exhibit 1), despite the ECB's massive accommodation. Of course, the ECB would – rightly in our view – argue that without their action, lending rates to the private sector would have shot up given the rise in the risk premium banks would have demanded, but focusing on counterfactual scenarios have their limits anyway: **the fact is that, judging by the level of interest rates passed to final private borrowers, financial conditions have not loosened**, as they should have to adjust to the deterioration in economic activity and the mounting deflationary pressure. Moreover, it is highly likely that without the government guarantees implemented very early in the crisis risk premia would have increased significantly, which puts in perspective the direct impact of monetary policy on credit conditions.

Exhibit 1 – Lending rates did not fall

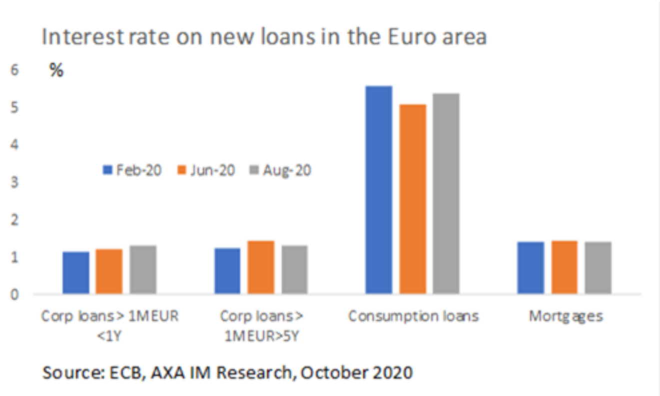
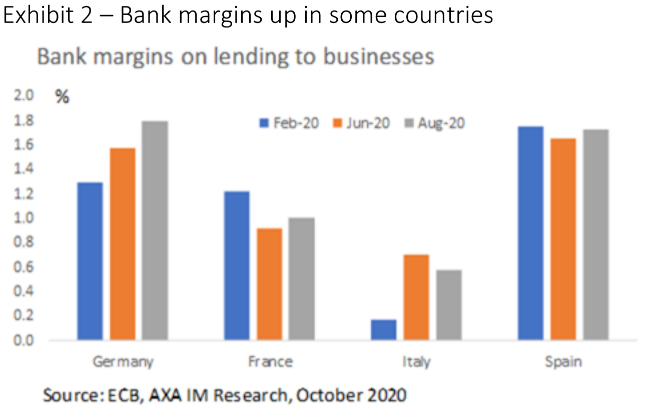


Exhibit 2 – Bank margins up in some countries



True, the volume of new loans to the corporate sector has increased massively at the beginning of the crisis, suggesting that the absence of loosening in financial conditions was not a major hurdle for the corporate sector, but it was hardly a matter of choice for businesses at the time, faced with a steep contraction in cash flows and an urgent need to build liquidity buffers. **A key issue now is to gauge the potential for some further loosening in credit conditions.** The latest Bank Lending Survey (July) was not encouraging from that point of view, suggesting banks were already expecting a net tightening ahead. But we can take a more quantitative look at this issue.
First, the good news: banks' lending margins have improved in Germany and in Italy since the beginning of this crisis (see Exhibit 2). They remained quite high in Spain where they were already more comfortable than in the Euro area average. French banks are the only ones for which margins have declined. The ECB calculates this indicator by subtracting the interest rate paid on deposits from the interest rate levied on loans. Since lending rates have not fallen, the general improvement in margins must come from a fall in funding costs.

Banks have benefited from a “twin movement”: they have responded to the decline in market yields by reducing the interest rate they pay on term deposits, while **businesses and households have re-allocated their cash towards sight deposits, the least expensive source of retail funding for banks**. 90% of the EUR778bn rise in non-financial private deposits observed between February and August in the Euro area went into non-interest-bearing accounts, which normally stand for less than two thirds of total deposits.

However, there is no reason to expect banks will be more inclined to pass the decline in their retail funding costs to final borrowers more than what they have so far. The rise in margins does not necessarily compensate for the increased risk they are taking, now that the window for state guaranteed loans seems to be closing in many member states. In addition, there are limits to the drop in retail funding costs for banks. The decline in the interest rate paid on term deposits can’t go much further (it stood at only 0.2% in Italy for business deposits in August for instance) and the reallocation towards sight deposits was already slowing down this summer: the monthly growth rate of sight deposits peaked at 2.6% in April to decelerate to 0.6% in August.

There is still one weapon in the ECB’s arsenal which could revive the banking channel: making Targeted Long Term Repurchase Operations (TLTROs) even more generous. Indeed, the latest version of TLTROs deals well with the limits of central bank action when policy rates are already negative, since banks – as long as they comply with a not too tough target for maintaining lending volumes to the private sector – can now receive medium-term liquidity at a lower interest rate than the one they now have to pay to park excess reserves on the ECB’s balance sheet. Taking the TLTRO rate further into negative territory would reduce the banks’ average cost of liabilities. Such a move could help push margins up further – if one considers them in a “holistic” manner rather than as the mere gap between the cost of retail deposits versus the yield on loans. Even if this does not trigger any additional decline in lending rates, it would help banks which will need to face growing provisioning costs as defaults rise. If the next batch of the Bank Lending Survey is even more concerning as the last one – as we fear – then we would definitely expect such a move to be implemented by the ECB in December, on top of the extension of the Pandemic Emergency Purchase Programme, even if this means that the central bank’s own financial conditions would be put further on the line (the new TLTRO system is intrinsically a loss-making scheme for the ECB).

Still, **we are convinced that the key to maintain decent access to fresh funds for the business sector lies in the prolongation of the government guarantee schemes. And once again we find ourselves faced with the complementarity between fiscal and monetary policy**. Such system can work only if the market does not question the financial sustainability of the guarantor governments, which entails more support from the central bank in the form of quantitative easing.

October 15th matters, but not necessarily for the obvious reasons

The British press last week took with a pinch of salt Boris Johnson’s “ultimatum” to the EU, threatening to “walk away” if the European Council does not on 15 October agree on the principles of a Free Trade Agreement (FTA) with the UK. We do not think 15 October is necessarily a binary event. Now that it is quite clear the FTA will be narrow in scope, national parliaments do not need to be involved. Endorsement by the European parliament would suffice. This means that the negotiation process could continue into November without hitting a procedural deadline.

Bad news is accumulating for the British government. The latest monthly data for August already suggests Q3 GDP will be softer than expected, and on the covid front the country is following the trend seen in France and Spain with a two-week lag. The situation is bad enough without on top of everything else having to deal with a “no deal” Brexit. Moreover, given the growing probability of a Biden victory, a no-deal UK would find itself very isolated internationally. Boris Johnson had bet a lot on his proximity to Donald Trump. Conversely, the Democrats have been clear that any post-Brexit arrangement detrimental to the Good Friday agreement in Northern Ireland would make a trade deal between the US and the UK impossible. We don’t think the British government holds much leverage now. Some cosmetic concessions are probably needed from the EU – for instance on fishing rights – to allow Boris Johnson to save face, but we are cautiously optimistic that discussions can continue after 15 October with only "generically good words" from the European council and that a deal can be reached in time.

But it's not all about the UK. **The Recovery and Resilience Fund will probably also rank quite high in the conversation topics at the European Council.** In principle it should be plain sailing, following the final agreement reached on the regulation proposal at the ECOFIN level last week. The process remains cumbersome, but we welcome the fact that member states will be allowed to draw 10% of their entitlement as "pre-financing" within two months of the legal entry into force of the scheme, which would mean by the end of February normally. Some governments were worried that the Commission's surveillance of their "Recovery and Resilience Programmes" containing the details of the projects to be refinanced would imply too stringent macroeconomic conditionality. Reading the draft carefully we think a balance has been found. Yes, the member states' fiscal trajectory will be part of the EC surveillance, but every time these aspects are mentioned in the text it is always in reference to the "Macroeconomic Imbalance" process, which is much less stringent than the quantitative Stability and Growth Pact. We read this provision as a "safeguard clause": future disbursements would be withheld only if a member state were to behave completely irresponsibly on fiscal matters.

Yet, the completion of the legislative process on the Recovery and Resilience Fund (RRF) is suspended to some resolution on the "rule of law" dispute. The Council is under pressure from the European parliament to toughen up the financial sanctions against countries – Hungary and Poland are the current targets – which stray too far from the EU's constitutional values. The issue is terribly complex, but one of the main bones of contention is that in the option favoured by parliament (following the initial offer from the Commission), a qualified majority of the Council would be required to oppose a sanction proposed by the Commission (reverse qualified majority), while in the milder compromise pushed by the German presidency it would take a qualified majority to approve a sanction, thus lowering the bar. Another problem lies in the principle of proportionality embedded in the German compromise: the financial sanction should be commensurate with the impact of the breaches to the rule of law on the EU's budgetary interests. It may be often difficult to prove a breach of the rule of law in a given member states – for instance affecting the principle of power separation – has a direct effect on the EU's "budgetary interests".

The European parliament is threatening to vote down the Multiannual Financial Framework (MMF) – the budget plan for the EU over the coming seven years – without which the RRF cannot exist in its negotiated form (note that the EP can approve or reject the MMF as a whole but cannot amend it). At the same time, Hungary is threatening to veto the MMF (unanimity is necessary on these matters in the Council) if the rule of law provisions is toughened up.

A breakthrough is needed, preferably on the occasion of this European Council meeting on 15 October. Ultimately, the EP would probably hesitate to stop the EU's main instrument to deal with the economic consequences of the pandemic, while Hungary itself has much to lose if the paralysis of the EU's fiscal process ultimately means that it would miss out on structural funds. But the whole process could be delayed, at a moment when speed of execution is crucial to stop a relapse in recession in its tracks.

Part-time unemployment and job retention

The debate on how to shape the fiscal support is only starting. We noticed last week a note by Agnes Benassy-Quere, the French Treasury chief economist, focusing on how to spur private consumption. In our understanding, her conclusion is that, beyond the income-boosting budgetary measures already in the pipeline, the best way to sustain decent consumer spending is by providing as much visibility as possible on employment prospects. We concur. We have made the point repeatedly that deflating the "saving bubble" which has emerged since the beginning of the crisis is key to sustain the recovery, but that is likely to be jeopardized by individuals anticipating a deteriorating labour market. **This suggests that the quality and durability of the employment support schemes are crucial ingredients in the policy toolbox. On this, as often, the devil is in the details.**

The UK is the latest European country coming up with a part-time unemployment scheme, deployed at the moment the generic – and generous – "furlough" scheme expires outside the UK areas hit by new lockdown measures. The principle is quite simple. If the employer can still provide enough work for 1/3 of normal working time, the cost of the unworked hours is split 1/3 each between the government, the employer and the employee. Total pay would fall by 22% in this case. Job retention – i.e. the quantum of jobs which will not be lost altogether thanks to the scheme – should be the key measure of success. Simple calculations suggest the British scheme may well fail from this point of view.

We start with the very simple case of a business with two employees reducing their hours to 50% of their initial working time. After 6 months – the announced duration of the scheme at this juncture – this will add up to a cost of 8 months of the initial individual wage. Statutory redundancy payments in the UK stand at one week's wage per year in the company for workers between the age of 22 and 41 (1.5 week afterwards). The cost of keeping one of the two employees at 100% of initial working time and firing another one with a 10-year tenure would stand at 8.5 initial individual wages after six months. **The incentive to retain workers is thus quite slim, especially when compared with the French and German systems (see Exhibit 3**). Note that in the French case we used the minimum statutory redundancy payment (1 week per year of tenure) while many sectors are covered by more generous collective agreements**. In the British case the incentive to keep the two workers on the payroll with reduced hours disappears altogether if the departing worker has less than 8 years tenure.**

Exhibit 3 – Part-time unemployment schemes provide different incentives across countries

Cost of part-time unemployment vs. dismissal

Assuming 10y of service

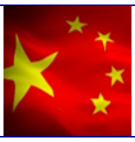
In months of salary, cost for 6 months	UK	Germany	France
Firm's cost of 2 persons working 50% and under ST working scheme	8.0	6.0	6.6
Firm's cost of 1 person working full time and 1 person fired	8.5	11.0	8.5

Source : AXA IM Macro Research calculations, Sept. 2020

Of course, the calculation for employers is more complex than that. Laying off staff entails "hidden costs" above the direct impact of the redundancy payments. Businesses have invested in training, and they cannot be certain they will be able to find employees with the same skills-set easily when the economy starts again**. The "premium" that employers are ready to pay in bad times to keep workers on their payroll is probably dependent on the level of qualifications of their staff and medium-term demand prospects.**

The choice of a "low-generosity" approach in the UK probably reflects a focus on future supply-side conditions there. While the part-unemployment scheme is offered to all sectors, it will probably encourage job retention mostly in highly skilled industries with decent chances of thriving post-Covid. Businesses where low-skilled workers dominate and with lower chances of survival have little incentive to use the scheme intensively. The scheme is thus consistent with a swift reallocation of labour away from "doomed" sectors.

The UK Chancellor of the Exchequer is closer to the conservative tradition of small government, allowing market adjustment to run their course even at some significant – albeit hopefully transitory - social cost, than to the new "interventionist" brand of Toryism which PM Boris Johnson has been pushing in office (probably against his own instincts). There is an economic logic in Sunak's strategy – which is clearly endearing him to a growing number of Tory parliamentarians – but it is a risky one though. **Low job retention in a country where the ordinary income protection safety nets are weak can trigger a prolonged depression in demand. In France and Germany, automatic stabilisers in the form of generous unemployment benefits schemes can cushion the impact of rising unemployment on aggregate demand**. Large accumulated households' savings also provide some protection. These ingredients are missing in the UK.

Country/Region	What we focused on last week	What we will focus on this week
	• President Trump left hospital, plans to hold rallies over weekend. • Stimulus discussions halted by President mid-week, but seemingly resumed end-week • Vice President TV debate Pence and Harris • September FOMC minutes gave little outlook on QE, focused on calling for fiscal support • Latest consumer conf and credit falling • Jobless claims in latest week	• The latest in on/off stimulus talks, we do not now expect stimulus before elections • US September retail sales, to shape Q3 forecast, currently expect 5.1% q/q • US CPI inflation for Sept, headline and core expected to edge higher to 1.4% and 1.8% • Empire and Philadelphia Fed surveys (Oct) • 2nd Presidential TV debate appears off
	• ECB minutes were more dovish than the press conference, highlighting risks on inflation and growth. We expect action in December • German IP disappointed at -0.2%mom, dragged down by car production • French INSEE sees growth at 0%qoq in Q4 • Services PMIs show diverging trend: Spain	• EA industrial production to rise 1%mom • EA countries to submit their 2021 Draft Budget plans by October 15 • 15-16 October EU Council on Brexit will review the state of the negotiations on the future UK-EU partnership - seen as the last deadline for reaching an agreement
	• UK new cases growth surges, test positivity highest since May • UK monthly GDP rose by just 2.1% in August, far below ours and consensus expectations. • Chancellor Sunak announced further package of support ahead of restriction	• UK has threatened to walk away from FTA negotiations if no deal in sight by EU Summit - expect negotiations to continue. • Labour market report (Aug), expected to show rise in jobless as furlough fades • BoE Credit Conditions Survey • Moody's sovereign rating review
	• Despite some improvements, September Services PMI remained in contraction territory at 46.9. • September Economy watcher polls highlights	• Bank lending is likely to remain dynamic • August Industrial production revision should be unchanged. Despite improvements in auto sector for instance, production has difficulties to recover.
	• Services sector continues to expand briskly, as reflected by a further rise in the PMI and improved Golden Week holiday sales	• Export growth should maintain its recent momentum, while price pressure is expected to ease due to falling pork prices
	• Last week, BCRP decided to maintain policy rate unchanged at 0.25%, considered the current stance appropriate and gave guidance that policy should not change in the coming months. • Taiwan exports (Sep.) rose 9.4%yoy, mainly driven by electronic components	• Central bank meetings: Indonesia, Korea, Chile • Industrial production in India, Mexico (Aug) and Russia (Sep) • GDP%yoy in Peru (Aug)

Upcoming events		
	US :	Tue: NFIB small business optimism, CPI; Wed: PPI; Thu: Empire State mfg sur, Phila Fed index, second Presi debate; Fri: Retail sales, IP, Busi inventories, Michigan cons senti (prel.), LT invst flows
	Euro Area:	Ge: CPI, HICP (final); Wed: ECB Lagarde speaks, IP, Sp HICP (final); Thu: ECB Lagarde CNBC debate, EU Council Meeting (Brexit), Fr HICP (final); Fri: EZ, It HICP (final)
	UK:	Mon: BoE Haskel&Bailey speak; Tue: Unemployment (ILO), average earnings; Thu: BoE Credit Condition Survey; Fri: Moody's review of UK credit rating
	China:	Mon: Private 'core' machinery orders; Wed: IP (final)
	Japan:	Tue: TB, export, import; Thu: CPI, PPI

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