Rosa & Roubini
ASSOCIATES

MAKING SENSE OF *THIS* WORLD 30 March 2020

R&R Weekly Column
By Brunello Rosa

Why COVID Poses An Existential Threat to The EU

In our column of March 16th, titled "The World Is Likely To Be Radically Different After The Coronavirus Crisis" we mentioned that the Coronavirus is posing an existential threat to the survival of the EU. In this column, we want to further elaborate on this issue, following the EU Council meeting on March 26, in which the heads of state and governments failed to reach a deal for a common strategy to fight the crisis.

The underlying principle behind the EU integration process is the *solidarity* that member states should display towards one another on all matters of common interest, after centuries of inter-European conflict. For this reason, the first embryo of the EU was the European Coal and Steel Community, coal and steel representing the key ingredients for the economic recovery in the post-War period. Once solidarity ceases to exist, there is no reason for the Union to exist either. In spite of the initial, delusional hope that COVID-19 was an asymmetric shock to Italy rather than a generalized crisis across the region, and could therefore be addressed by the activation of article 122.2 of the EU Treaty (i.e. grants to the country "seriously threatened with severe difficulties caused by … exceptional circumstances beyond its control"), it is now clear that is a symmetric shock to every country of the EU.

This means that the EU as a whole should react to it, with common instruments, rather than by simply adopting a coordinated approach of national policies by individual member states. Instead, so far national selfishness has prevailed, and countries have reacted by adopting a series of policies based on their individual circumstances. For example, at the fiscal level, Germany has announced a plan of EUR 550bn of fiscal easing (of which EUR 156 will be fresh expenditures), France a EUR 300bn plan, and Italy, given its more stringent budget constraints, only a first EUR 25bn plan followed by another EUR 25bn likely to be announced in April. Virtually all countries have re-instated national borders and suspended the Schengen agreement.

At the EU level, there has thus far been only a partial and temporary suspension of the Growth and Stability Pact (GSP) and an easing of the discipline regarding state aid to private-sector companies. Even the ECB was initially reluctant to engage in its mandatory spread-compression activities, until finally the EUR 750bn PEPP was launched, with the inclusion of Greece and the suspension of the issuer limits. But this is still too little compared to what the EU could and should do to face the existential crisis before it.

With Brexit underway, and the UK initially threatening to deviate from the continental practices of social distancing to follow a chimeric and flawed herd immunity approach; with Schengen and the GSP suspended; with every country following its own approach to COVID, from para-military lockdowns (in Italy, for example) to minimal social distancing rules (e.g. in Sweden), the risk is that re-converging when the crisis is finished will become virtually impossible, as every country will find it more convenient to pursue its national strategies and interests. A country might, for example, bitterly and understandably decline to pursue European reintegration because it felt that it was neglected during the crisis.

Take Italy, for example. In 2011-12 Italy was brought to the verge of default because of the slow and flawed response (by moral hazard considerations) from the EU/EZ to the Greek crisis. Italy, which participated in the rescue packages for Greece, Ireland, Portugal and Spain, came under speculative attack because it was perceived as being part of the PIIGS grouping of economies. Only Draghi's "whatever it takes" pledge and the consequent OMT avoided the disaster. In 2015, during the migrant crisis, Italy was then left alone facing the arrival of ships landing on the southern shores of Europe. In 2020, after the symmetric exogenous shock deriving from COVID, the implicit message from the EU was: "deal with it by yourself, we'll be lenient on your fiscal position, ex-post." It is not clear where solidarity is in all this, and we should not be surprised if, at the end of the crisis, the levels of EU-scepticism will be at historical highs. Other countries are in similar positions, and if the EU fails to rise to the historical task it is now facing, it might end up being the largest, institutional victim of Coronavirus.

So, while Merkel and Von Der Leyen declared their opposition to Eurobonds/Coronabonds being used to finance a pan-European recovery plan, the Eurogroup has been tasked with coming up with technical proposal on the feasibility of risk-sharing instruments. Hopefully, it will come up with some serious proposals in the next couple of weeks, and these approaches will be adopted by the EU Council. But other roads are possible, such as the possibility of activating ESM loans with virtually zero interest rates and null or very limited conditionality. That, in turn, could open up the possibility of using the OMT to fight unwarranted widening of sovereign yield spreads within the EZ.

Our Recent Publications

- Global Outlook Update-PART 3 – Markets – COVID-19 To Depress Valuations Until Pandemic Solution Is In Sight, *By Alessandro Magnoli Bocchi, Brunello Rosa, Nouriel Roubini, 26 March 2020*
- **GEOPOLITICAL CORNER:** Revisiting the Past to Know the Present: The Spanish Flu, the Coronavirus, and the Political Risk Event of a Generation, *by John C. Hulsman, 24 March 2020*

Looking Ahead

The Week Ahead: US, Japan and EZ Macro News to Disappoint

In the US, March's PMI manufacturing will fall sharply into contraction (c: 44.3; p: 50.1) and March labor market data will weaken, as: *i)* nonfarm payrolls will likely drop to -123k (p: 273k); *ii)* the unemployment rate is expected rise to 4.0%, from its historical lows (p: 3.5%); and *iii)* average hourly earnings will likely remain unchanged at 3.0% y-o-y.

In the EZ, retail sales in February are expected to fall to 1.1% y-o-y (p: 1.7%).

In Japan, February's IP data are likely to fall deeper into contraction, to -5.5% y-o-y (p: -2.3%).

The Quarter Ahead: As Business And Consumer Confidence Tumble, World Economy Is Likely To Suffer The Worst Year Since WW2

According to ***WHO's Director-General*** Dr. Tedros: 1) COVID-19 is affecting 199 countries, confirmed cases surpass 660k and deaths approach 31k; 2) "the pandemic is accelerating at an exponential rate. The first 100k cases took 67 days. The second 100k took 11 days, the third just 4, and the fourth 2"; and 3) G20 leaders must "do whatever it takes" to: *i)* overcome the pandemic"; *ii)* protect lives and livelihoods; *iii)* restore confidence; and *iv)* ensure adequate financing.

In the US, President Trump signed a USD 2.2tn stimulus bill, the largest in US history, which includes: *i)* 500bn in loans for distressed companies (o/w 50bn in loans for passenger air carriers); *ii)* 350bn in small business loans; *iii)* 290bn in direct payments to individuals and families; *iv)* 250bn in unemployment insurance; *v)* 150bn for cash-strapped state and local governments; and vi) 130bn for hard-hit hospitals. The Fed: 1) rekindled 14 swap lines with other CBs - aiming to ease the global shortage of USD; as a result, to alleviate funding strains in local markets five CBs borrowed more than USD 200bn w-o-w, up from USD 45mn the previous week (both the ECB and the BoJ drew the most USD since 2009); and 2) announced open-ended asset purchases, with plans to buy: *i*) commercial MBSs; *ii)* bonds, directly when issued and on the secondary market; and, for the first time ever: *iii)* bond ETFs, through its New York arm.

In the EZ, finance ministers are discussing to release emergency funding via the European Stability Mechanism (ESM); countries could borrow up to 2% of GDP. Former ECB President Draghi stated: "(…) you can increase your debt/GDP-ratio by increasing debt or by destroying GDP; choose the former".

Last Week's Review

Real Economy: Lockdown Measures Hit Employment And Growth; CBs Easing Intensifies

In the US, where about 1 in 3 citizens are in lockdown and most non-essential businesses have been forced to close, initial jobless claims spiked to 3.28mn in March (c: 1.0mn; p: 0.282) – the highest level since the series began in 1967, highlighting COVID-19's vast economic impact. A lagging indicator, February's 'durable goods orders' rose above-consensus, by 1.2% m-o-m (c: -0.8%; p: 0.1%), as well as 'durable goods ex. Defense' – a measure of business investment (a: 0.1%; c: -0.9%; p: 3.6%).

In the EZ, measures to contain the COVID-19 outbreak disrupted businesses and demand; March's composite PMI fell to its historical low (a: 31.4; c: 38.8; p: 51.6), as: i) services recorded their steepest contraction on record (a: 28.4; c: 39; p: 52.6); and ii) manufacturing suffered the sharpest fall in over seven years (a: 44.8; c: 39; p: 49.2).

In the UK, CPI inflation fell in February to 1.7% y-o-y (p: 1.8%), while core CPI rose to 1.7% y-o-y (c: 1.5%; p: 1.6%). The BoE kept interest rates at an all-time low of 0.1%, after delivering two emergency cuts in response to virus-induced economic and financial disruption.

In Canada, in an emergency meeting the BoC cut interest rates by 50bps, to 0.25% (p: 0.75) and started asset purchases, and Governing Council will "closely monitor economic and financial conditions, in coordination with other G7 CBs and fiscal authorities", to take further action if needed.

Financial Markets: High Volatility Despite Monetary And Fiscal Stimuli; Oil Down, Gold Up

Market drivers: Unprecedented monetary and fiscal stimuli: 1) eased a USD squeeze that was threatening the global financial system; and 2) encouraged investors and supported a rebound in stock markets, from their three-year lows.

Stocks: w-o-w, global indices fell (MSCI ACWI, -22.3%, to 447), driven by DMs (S&P 500, -23.6% to 2,541; Eurostoxx 50, -27% to 2,729) and EMs (MSCI EMs, -24.1% to 851). Volatility remains high (VIX S&P 500, -0.5 pts to 65.5; 52w avg.: 18.4; 10y avg.: 17.0).

Bonds: w-o-w, returns on indices rose (BAML Global, +1.7% to 288.3), as yields on DM 10y bonds fell for: i) UST (-19bps, to 0.74%); and ii) German bunds (-15bps, to -0.49%).

FX: w-o-w, global demand for USD weakened (DXY, -4.3% to 98.365; EUR/USD, +4.27% to 1.114), and the GBP recovered from multi-decades' lows (GBP/USD, -7.0% to 1.246).

Commodities: Oil prices continued to decline (Brent, -7.6% to 24.9 USD/b), while gold rose (Gold, +8.0% to 1,618 USD/Oz), as it keeps its safe-haven appeal.

@RosaRoubini   Rosa & Roubini   Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

Farah Aladsani *contributed to this Viewsletter.*

The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	*thousand*
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*