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Harr's View

Now the hard part – crisis to extend but not escalate

Thomas Harr, PhD, Global Head of FI&C Research, +45 45 13 67 31, thhar@danskebank.com

Good evening all

Today, I argue why restrictions are likely to remain in place for many months, the bar for broad lockdowns is high, and why fiscal and monetary policy are set to remain stimulative for a long time. I will also touch on financial markets. In this regard, I am inspired by the enormous amount of discussions I am currently having with Nordic institutional investors. This week, there has been a worrying pick-up in the infection rates in the large Eurozone countries (see *here* for our update). However, the number of hospitalisations, ICUs and fatalities are still lower than in spring. But hospitalisations are rising sharply in France and Italy, which suggests that fatalities should start increasing, although less than in spring as the mortality rate for hospitalised people has dropped substantially. Many European countries are expanding and extending restrictions by requesting people stay at home, limit social interaction and wear face-masks in public, and by closing restaurants and bars and even non-essential retail shops in a few countries.

There is a rationale for governments to restrict people's actions, as individuals do not fully take into account that their consumption and work habits raise the risk of infecting others, i.e. they exert an externality on society. There is a trade-off between preventing disease spread and decreasing economic output. Hence, in designing restrictive policies, governments may take into account the infection potential of industries' activity and the importance for the economy. Research shows that restaurants, bars and leisure industries have high infections relative to economic output, in contrast to universities, banks and other financial institutions. This explains some of the recent restrictions by governments. There is a stronger argument for tightening restrictions when the number of infected people rises, if the mortality rate increases and if there are capacity constraints at hospitals. There is an argument for loosening restrictions if it becomes easier to isolate vulnerable people and if there are risks of large losses of human capital in case of a lockdown. Research shows that extensive testing and quarantine can substitute for and is preferred to broad lockdowns.

In my view, the fact that infections are rising, winter is coming where the virus has better conditions to spread, and the increasing strain on hospitals in some countries suggest that restrictions will broaden and remain in place in Europe for many months. Restrictions are likely to remain in place even when the vaccine arrives if individuals are hesitant to be vaccinated, it is not effective and you need to take it several times. **However, the fact that the mortality rate is lower, extensive testing is more widespread and there is a greater understanding of how to 'dance' with the virus without hurting the economy too much, suggest that the bar for broad lockdowns remains high.** There are also political considerations. For example, governments may have an interest in 'talking tough' by appealing to worried voters, while at the same time ensuring that the restrictions have limited economic impact. Voters will reward politicians for sounding hawkish, but they will also penalise them if the economy collapses. The introduction of face masks in many countries could be interpreted as a hawkish signal by governments with limited economic impact.

The crisis would imply destructions of supply and jobs, particularly in industries such as travel, restaurants, hotels and leisure. However, jobs could be created elsewhere if demand is sustained, which necessitates loose fiscal and monetary policy for a long time. I believe fiscal dominance of monetary policy has become more entrenched due to the crisis, while there is a greater acceptance that high public debt is less of a concern when interest rates are at the lower bound. I expect the ECB will extend its PEPP programme to cap the yield on Italian and other periphery debt, although we don't expect it will pre-commit next week (see our preview *here*). There is also an inequality element. The individuals who work in the above-mentioned industries tend to be less educated and wealthy and at bigger risk of unemployment. The Fed now focuses on inclusion, which is another reason for it to keep ultra-loose policy for a prolonged period to support low income and minority households. The risk is moral hazard, i.e. the creation of zombie companies which are kept alive through state support, and which may eventually trigger a political back-lash as some clients have argued. But this effect goes both ways. **If policymakers believe that the crisis will be over in a year's time, they need to keep vulnerable industries such as restaurants and bars afloat. Meanwhile, if we believe that the crisis is temporary, demand may be flowing to the 'wrong' areas, e.g. to property markets.** This would create imbalances, which policymakers would have to pay attention to.

Over the last week, equity and credit markets have moved sideways despite the mild lockdowns, which can be explained by the fact that 2021 consensus growth expectations have not dipped. **However, I expect European equity and credit to weaken this week due to the rising downside growth risks.** US inflation expectations and yields rose and curves steepened this week. In my view, this is due to the market pricing in a Biden sweep, which I discussed *here*. The question is now how much is already priced in. I will turn to that question next Sunday. That's it for today's comment and I wish you a great Sunday evening. Best regards Thomas

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