Belgian Financial Forum

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“The coronacrisis: policy revolution in macro-economic policy”

November 17th 2020
01.00 – 02.00 p.m. CET (Brussels time zone)

WEBINAR

Elga BARTSCH

PhD, Managing Director, Head of Macro Research of the BlackRock Investment Institute

Elga Bartsch, Head of Macro Research - BII
November, 2020

BlackRock

The Corona crisis: policy revolution in macro-economic policy

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New tools in the box

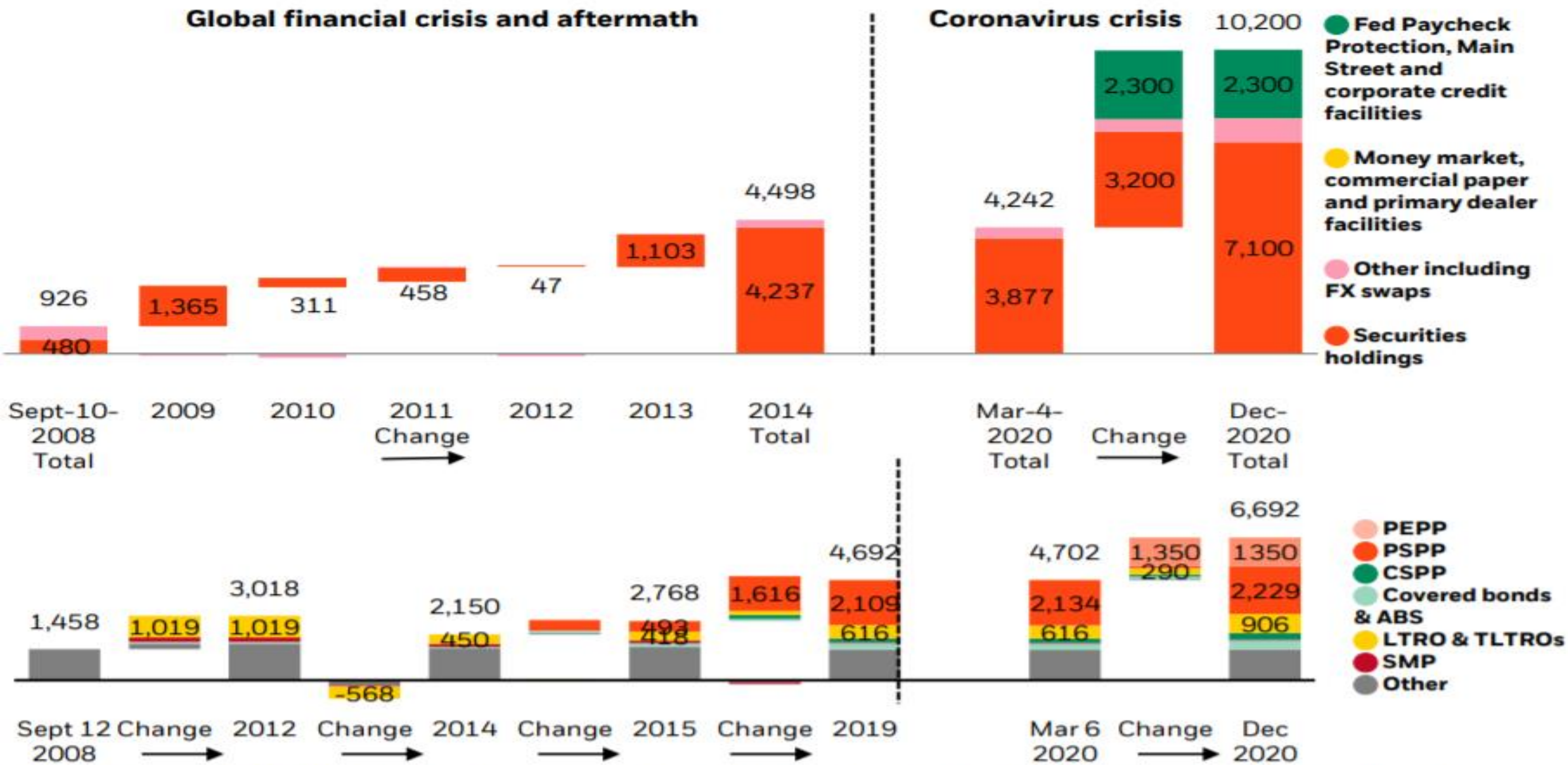
Major central banks policy tools

Central banks and policy tools	US	Euro area	Japan	UK
FX swap lines	✓	✓	✓	✓
Regulatory forbearance	✓	✓	✓	✓
QE – government bonds	✓	✓	✓	✓
QE – credit	✓	✓	?	✓
QE – equity	X	X	✓	X
Negative policy rates	X	✓	✓	?
Direct lending to public authorities	✓	X	X	✓

Source: BlackRock Investment Institute and central banks, June 2020. Notes: The table shows which major central banks have adopted or are considering different "unconventional" policies. FX swap lines are an agreement between two central banks to exchange currencies. Regulatory forbearance is where central banks state that commercial banks may eat into capital and liquidity buffers to boost liquidity. Direct lending to public authorities is direct cash transfers from the central bank to government to finance spending.

A policy revolution not just in terms of speed and size

Contributions to Fed and ECB balance sheets, in USD billions and EUR billions, 2008– June 2020.

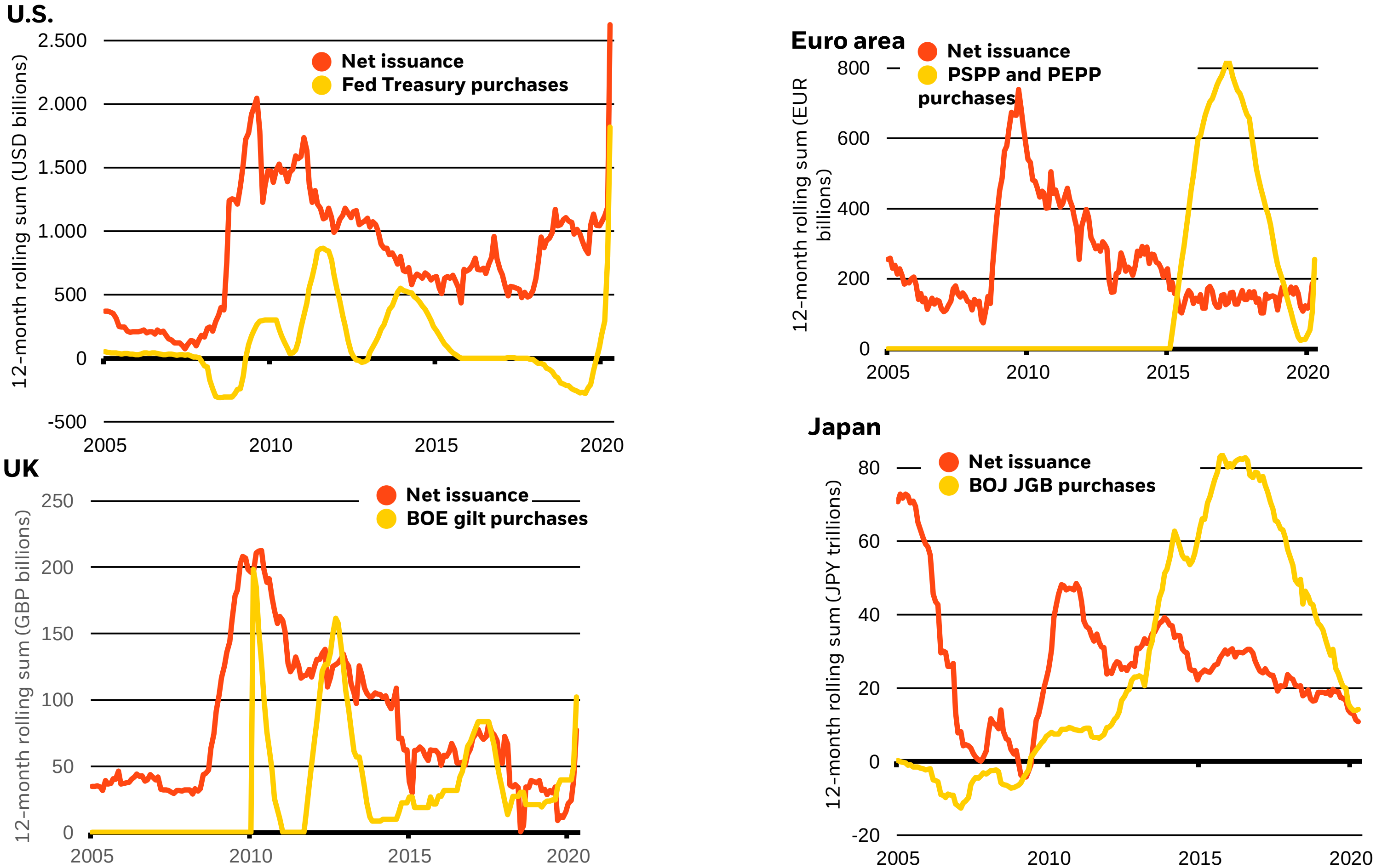


Source: BlackRock Investment Institute, Fed and ECB, with data from Haver Analytics, June 2020. Notes: The top chart shows what the Fed's balance sheet could look like by the end of 2020 with the new facilities launched in the past two months compared with March 6 – just before it began its interventions. The balance sheet at the end of 2020 is based on estimates made by BlackRock's Global Fixed Income economics team. These projections are based on data from the Fed's H.4.1 (balance sheet) release and on the structure of the Fed's facilities found on the Fed website. The purchase pace of securities is listed on the New York Fed website. The estimates also assume that the Fed will increase its planned support for its Paycheck Protection Program loan facility and expand its support for states and municipalities by several hundred billion dollars compared with the initial announcements. By comparison, the Fed pledged as much as $2.3 trillion in loans to support the economy in its April 9 announcement. Estimates of the expected increase and December 2020 totals are rounded. The funding facilities (green bars in top chart) are funded with credit loss protection provided by the U.S. Treasury and lending by the Fed. These programs also include the Term Asset-Backed Securities Loan Program and Municipal Liquidity Facility. The bottom chart shows the ECB's comparable balance sheet expansion. PEPP is the Pandemic Emergency Purchase Programme, PSPP is the Public Securities Purchase Programme, CSPP is the Corporate Securities Purchase Programme, LTROS and TLTROS are (Targeted) Long-Term Refinancing Operations and the SMP is the Securities Market Programme. Forward looking estimates may not come to pass.

A point of no return

Blurring the boundaries

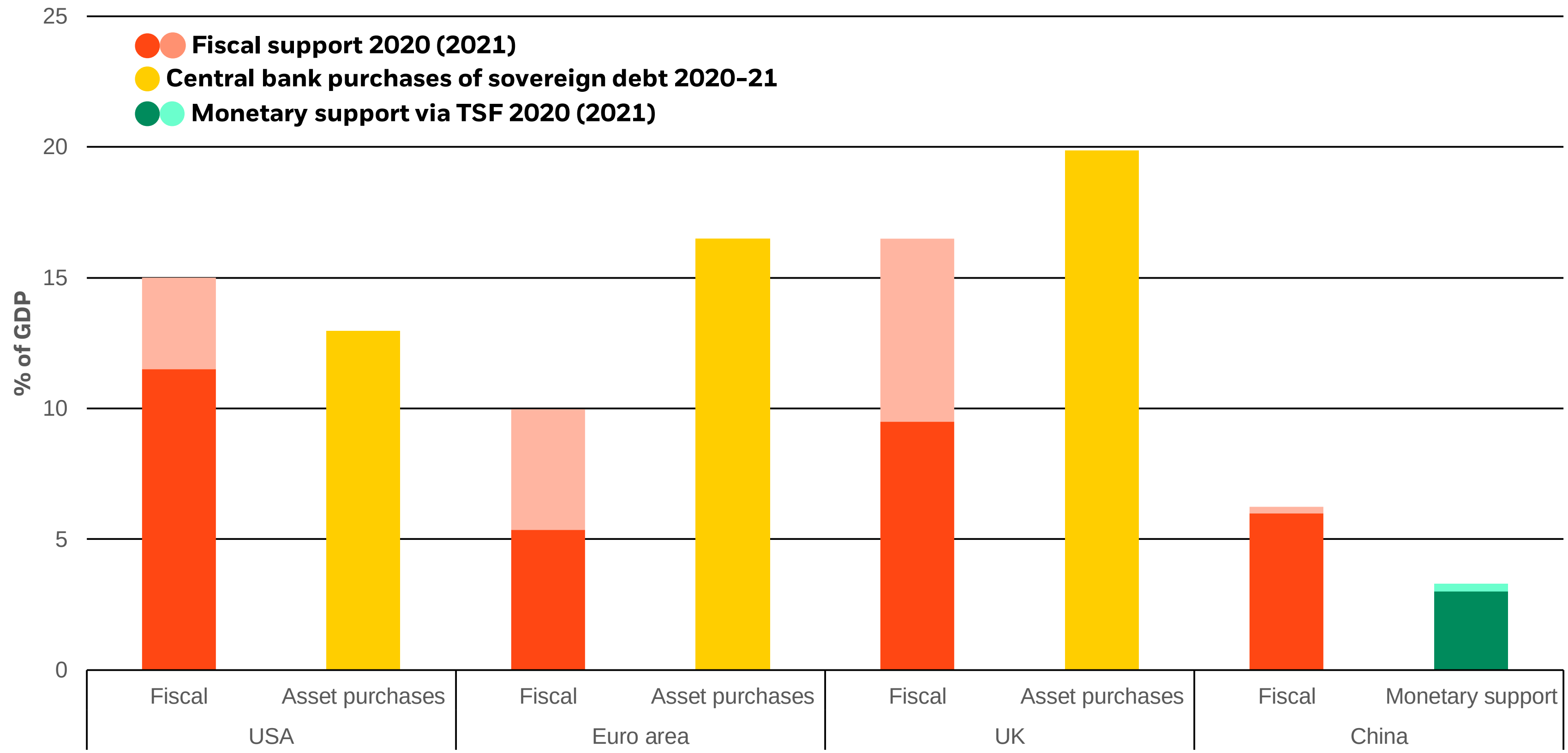
Government bond issuance and central banks bond buying, 2005–2020



Source: BlackRock Investment Institute, ECB, BOE, UK Debt Management Office, Japan Securities Dealers Association, Bank of Japan, US Federal Reserve and the US Bureau of Public Debt., with data from Haver Analytics, June 2020. Notes: These charts show the net issuance of government bonds in the four economies, and the government bond buying programs of the central banks in those economies. In the euro area, the PSPP and PEPP are the ECB's Public Securities Purchase Programme and the Pandemic Emergency Purchase Programme.

Policy support set to continue into 2021

Fiscal and monetary support, 2020–21



Source: BlackRock Investment Institute. BlackRock Investment Institute, with data from Haver Analytics. Note: solid orange bars show estimates of the discretionary fiscal measures in 2020 implemented in response to the Covid-19 pandemic. The light orange bars show the equivalent support for 2021, based on a range of estimates of measures from internal and broker sources. The green bars show the estimated impulse of monetary growth in China, measured via TSF growth stripping out local government debt purchases.

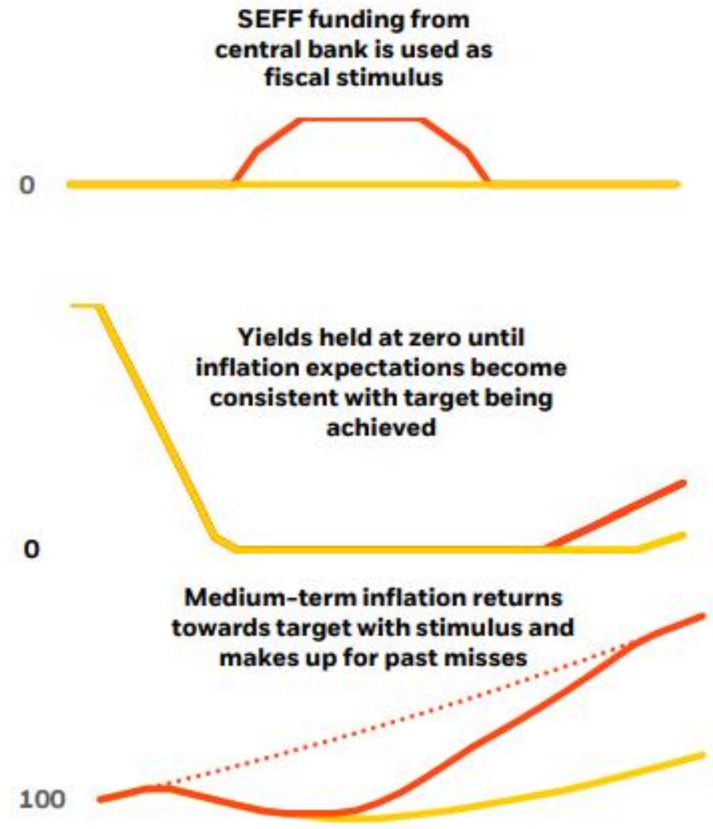
A Proposal: a framework for monetary–fiscal coordination

• An unprecedented response is needed when monetary policy is exhausted and fiscal policy alone is not enough. That response will likely involve "going direct". Going direct, which can be organised in a variety of different ways, works by: 1) bypassing the interest rate channel when this traditional central bank toolkit is exhausted, and; 2) enforcing policy coordination so that the fiscal expansion does not lead to an offsetting increase in interest rates.

• A practical way of "going direct" would need to deliver the following: 1) defining the unusual circumstances that would call for such unusual coordination; 2) in those circumstances, an explicit inflation objective that fiscal and monetary authorities are jointly held accountable for achieving; 3) a mechanism that enables nimble deployment of productive fiscal policy, and; 4) a clear exit strategy. Such a mechanism could take the form of a standing emergency fiscal facility. It would be a permanent set-up but would be only activated when monetary policy is tapped out and inflation is expected to systematically undershoot its target over the policy horizon.

• The size of this facility would be determined by the central bank and calibrated to achieve the inflation objective, which could include making up for past inflation misses. Once medium-term trend inflation is back at target and monetary policy space is regained, the facility would be closed. Importantly, such a set-up helps preserve central bank independence and credibility

Stylised impact of SEFF on yields and prices

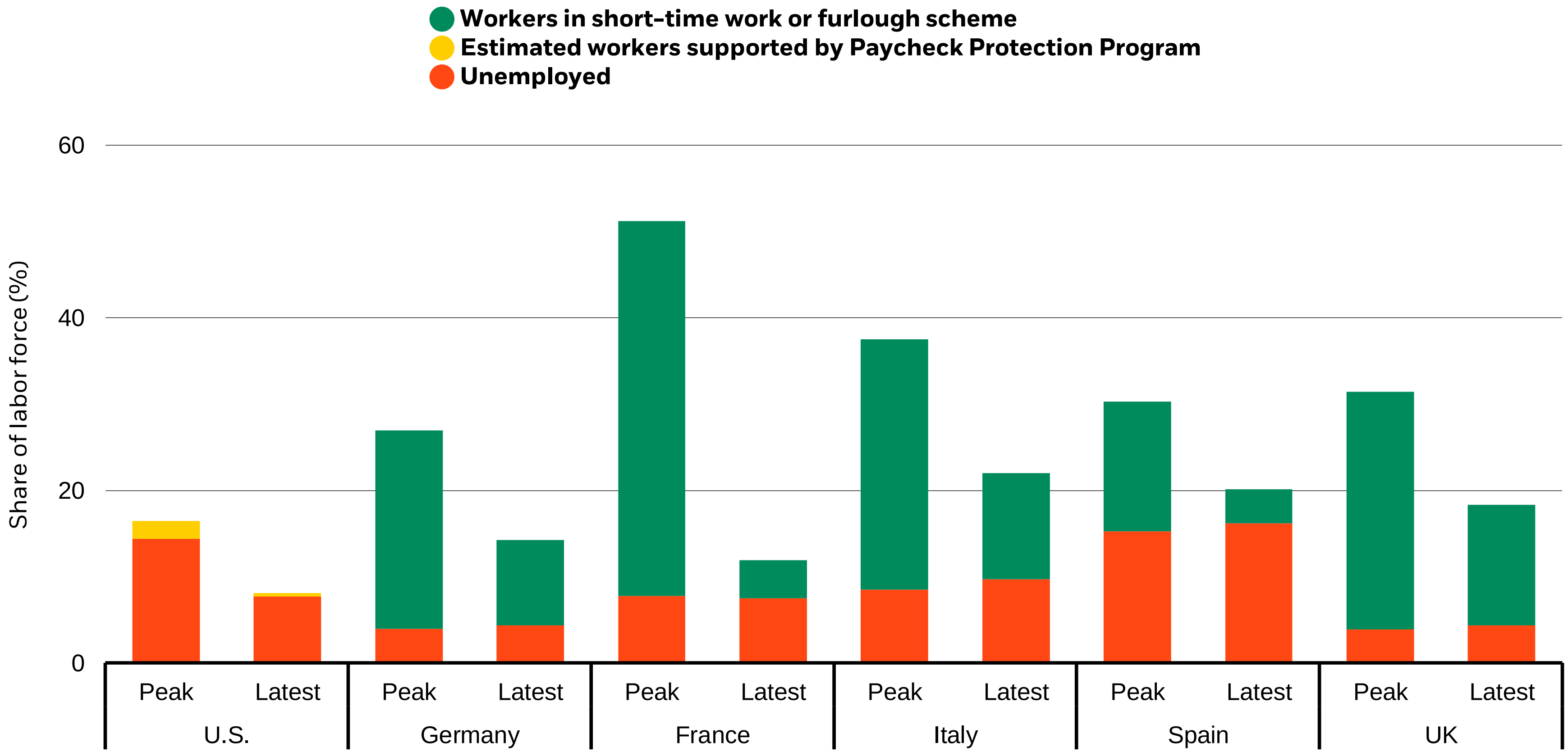


Sources: BlackRock Investment Institute, August 2019. Notes: These stylised charts show the hypothetical impact of a temporary increase in fiscal stimulus financed by the central bank, as reflected in the SEFF funding (red line). The other red lines show the impact on the inflation trend relative to the inflation target (dotted line) and on the long-term sovereign bond yield. The yellow lines show the hypothetical outcome if there is no stimulus in this scenario. For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Fiscal support has been key for the labor market

Furlough schemes have prevented a sharp rise in unemployment in the euro area and the UK. Supplementary U.S. unemployment insurance limited the income shock but has since expired.

Labor market support, June–September 2020

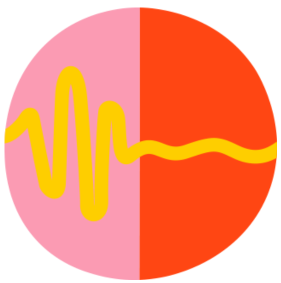


Sources: BlackRock Investment Institute, using data from Haver Analytics, BLS, Eurostat, ONS, DARES, Spanish Labour Ministry, INPS, Autor et al (2020), October 2020. Notes: Data as of 7 September 2020. Latest estimates relate to September in the U.S., August in Germany, France, Italy and Spain and July in the UK. Official estimates of workers still covered by the U.S. PPP scheme are not publicly available, so the yellow bar uses an estimate published by Autor et al for June. Peak bars show the levels at the point where the take-up of furlough schemes was at its highest over the period March 2020-present.

Federal Reserve adopts a new monetary policy framework

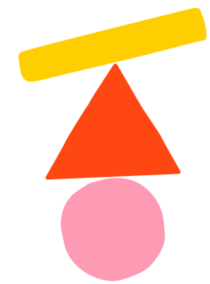
The Fed’s new monetary policy framework is set to have significant implications for inflation outcomes as it allows for inflation overshoots and doesn’t worry about labor markets overheating.

Illustrative schematic of the Federal Reserve’s new policy framework, October 2020



Fed moves toward flexible average-inflation targeting to make up for past misses of its target

Fed plans to worry only about “shortfalls” from full employment

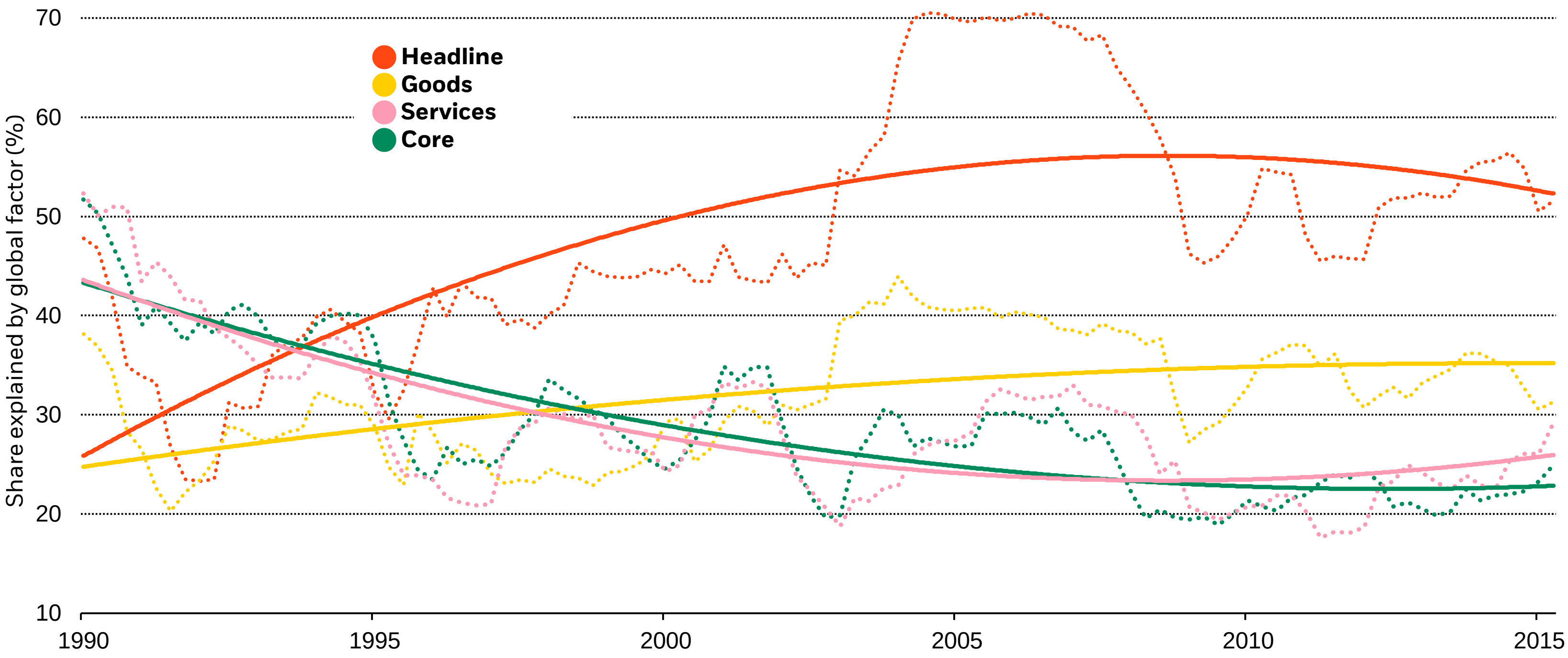


Bottom line: We believe the Fed will tolerate inflation overshoots and find it politically harder to lean against overheating

Sources: BlackRock Investment Institute, November 2020. Notes: For illustrative purposes only. For the Fed’s new framework, see: https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm

Global inflation drivers and deglobalization

Domestic inflation explained by global factors, 1990–2015

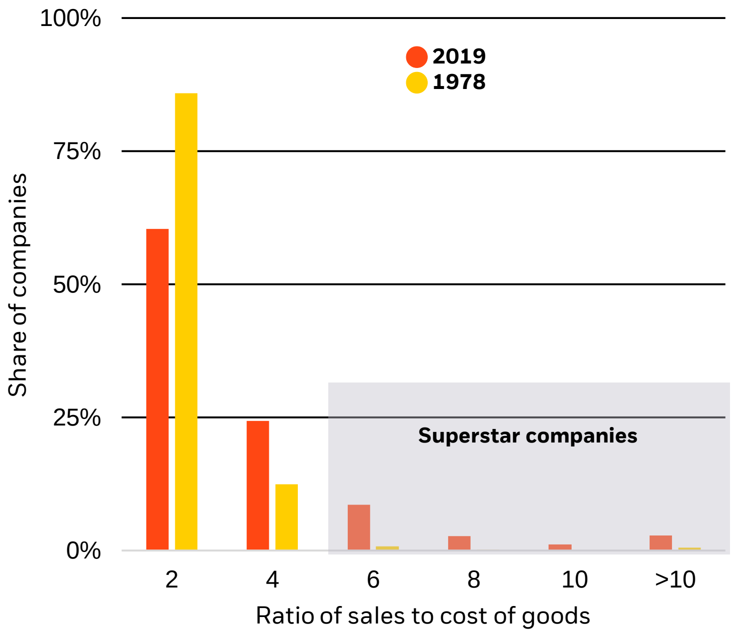


Sources: BlackRock Investment Institute, IMF, OECD, Eurostat, U.S. Bureau of Economic Analysis and Bureau of Labor Statistics, with data from Haver Analytics. Notes: The chart shows how much of the variation of domestic quarterly inflation rates can be explained by global factors for Australia, Canada, Switzerland, Germany, Denmark, Spain, France, UK, Italy, Japan, South Korea, Netherlands, Norway, New Zealand, Portugal, Sweden and the U.S. We determine this by seeing how much of the variation is explained by a common factor (principal component) across these economies. We use a rolling five-year window to estimate the common variation, and the horizontal axis indicates the window starting point. The solid lines are trend lines fitted to the dotted lines.

Reduced competition

Superstar companies

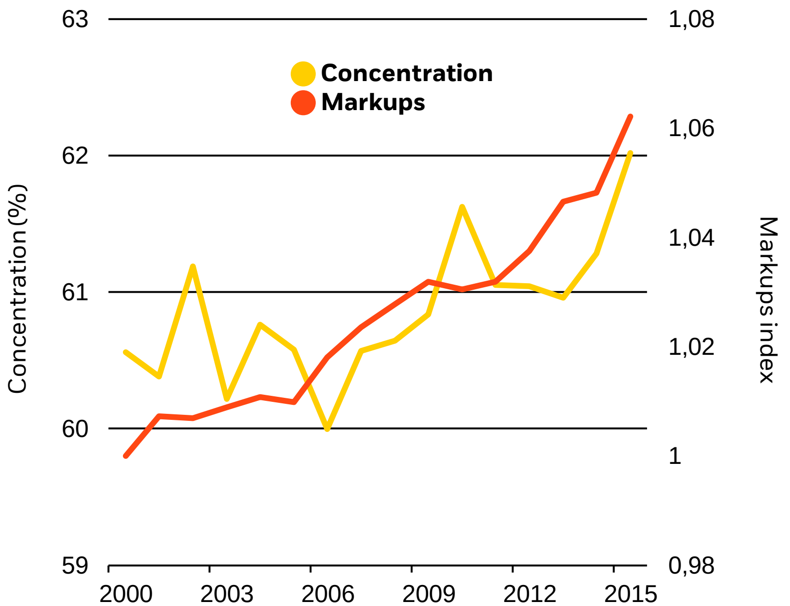
Company markups in Russell 1000 index, 1978-2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream. Notes: The chart shows the companies in the Russell 1000 divided into buckets based on the ratio of their sales versus cost of goods. This helps break out the companies that have the means to pass on markups on their products. For example, nearly 90% of companies in the index had a ratio of two in 1978 but that fell to 60% by 2009. We judge those with a ratio above six to be in the category of superstar companies given how historically rare it has been to pass on such sizable markups.

Increased pricing power

Industry concentration and price markups, 2000-2015

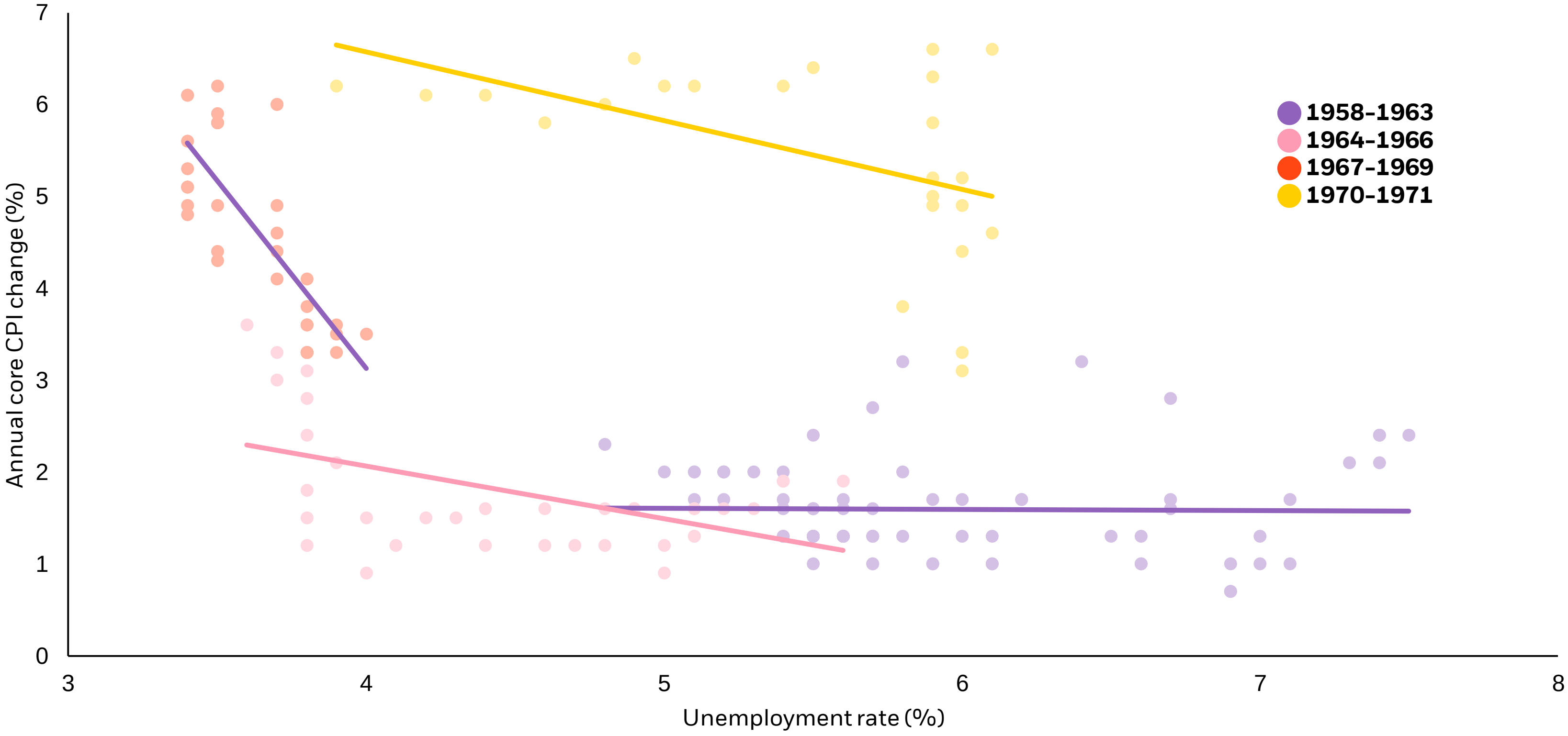


Sources: BlackRock Investment Institute, IMF and Orbis. Notes: The chart shows price markups and industry concentration of more than 1 million firms across 27 major economies based on the IMF 's April 2019 World Economic Outlook chapter two "The Rise of Corporate Market Power and its Macroeconomic Effects." Concentration is computed as the ratio of sales of top four to top 20 companies. Markups are calculated based on the approach of De Loecker and Warzynski (2012). The index is rebased so that the year 2000 = 1.

Risking the nominal anchor

Losing grip on inflation expectations

U.S. Phillips curve, 1958–1971

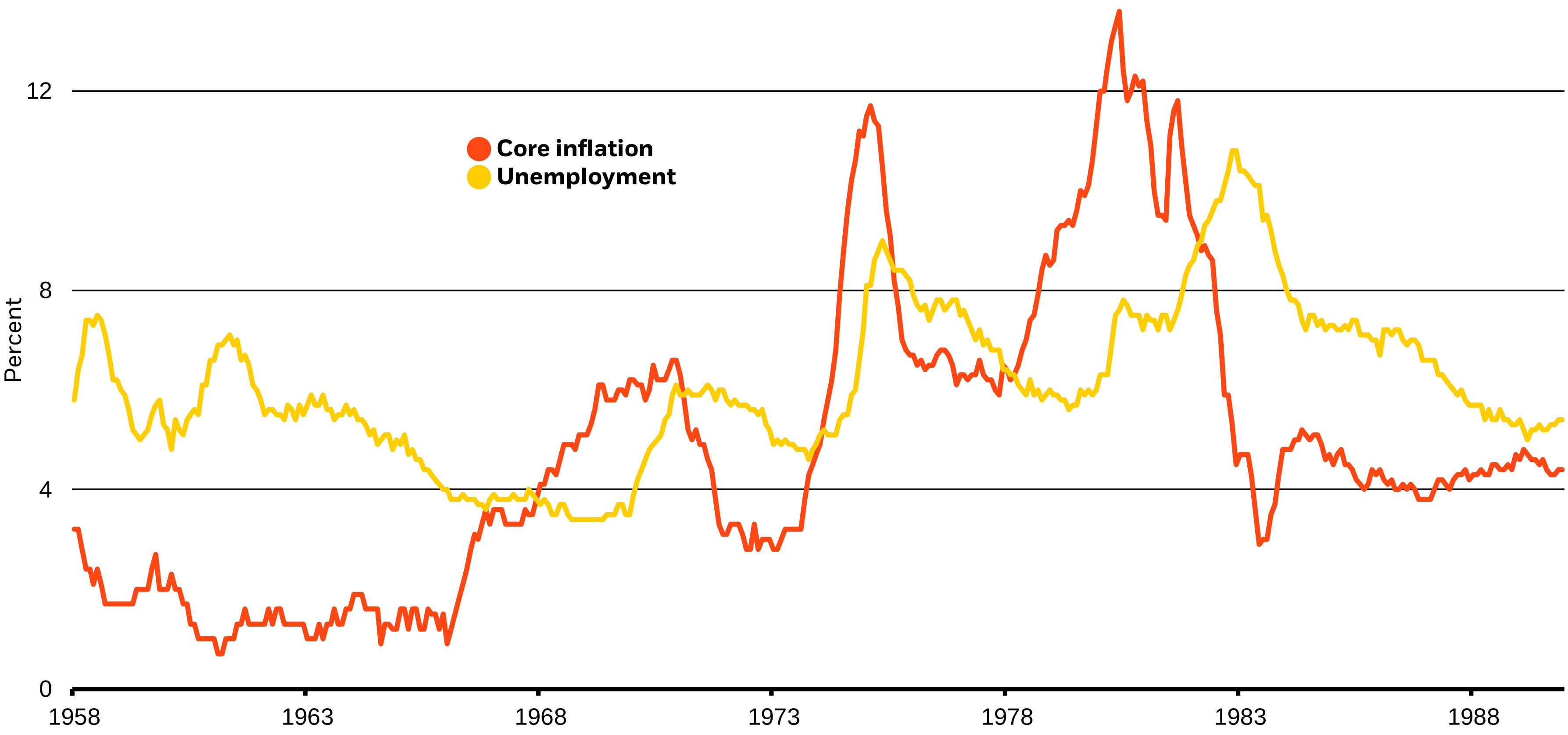


Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Refinitiv Datastream. Notes: The chart plots the cross of the annual change in the core Consumer Price Index (CPI) against the unemployment rate – the Phillips curve.

The Fed could lose its grip on inflation expectations

Inflation expectations could become unanchored and keep shifting higher, as they did in the late 1960s when the Fed prioritized full employment over fighting inflation.

U.S. core inflation annual rate vs. unemployment rate, 1958–1988

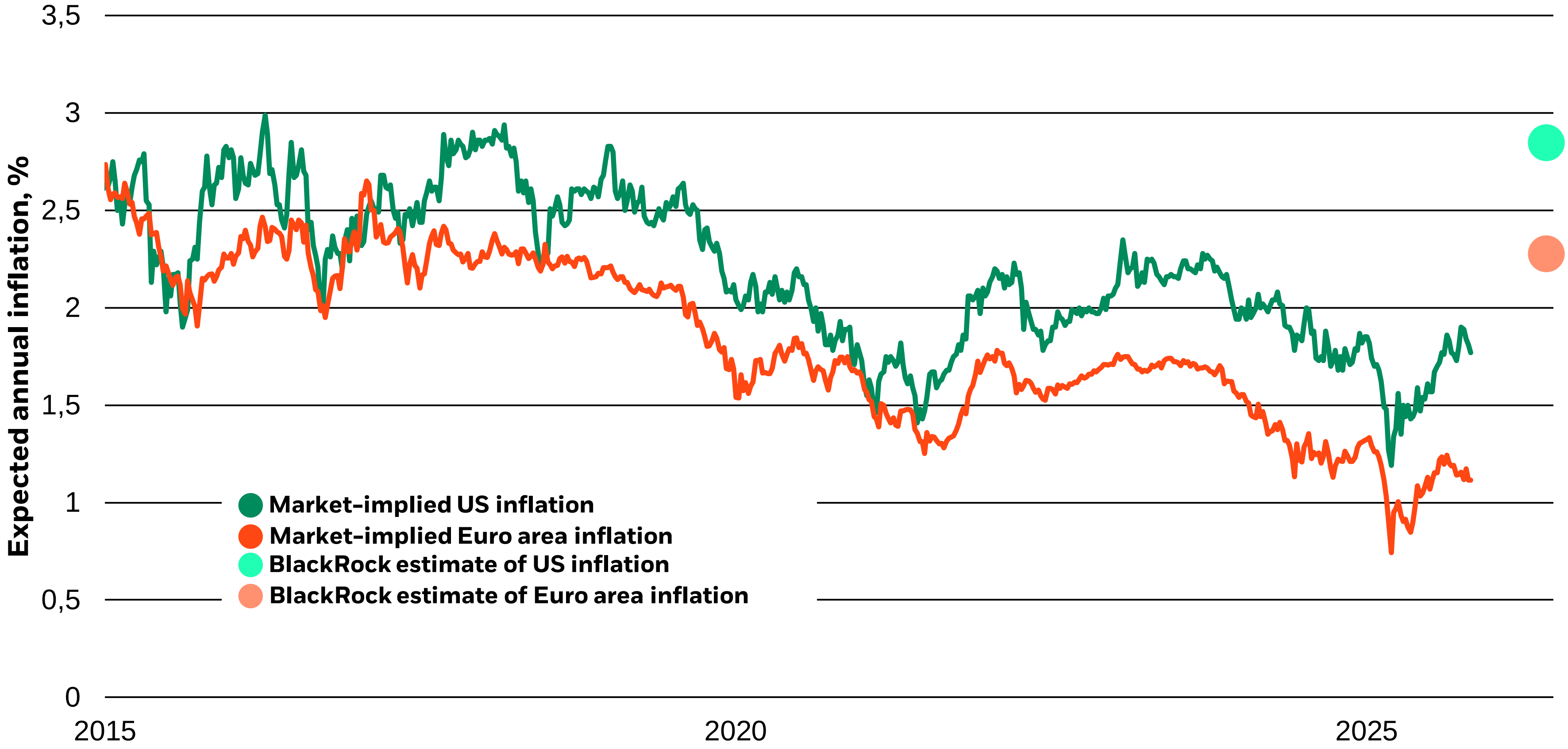


Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Refinitiv Datastream, November 2020. Notes: The chart plots the annual change in the core Consumer Price Index against the unemployment rate.

Rising risks of a shift toward a higher inflation regime

Increasing production costs, changes in the monetary policy framework and greater political pressure on central banks to keep rates low in a high-debt environment risk spurring higher inflation.

Market pricing of forward U.S. and Euro area inflation vs. BlackRock estimate, 2015-2025



Forward-looking estimates may not come to pass.

Sources: BlackRock Investment Institute and the Federal Reserve with data from Refinitiv Datastream, November 2020. Notes: The chart shows market pricing of expected average inflation over the five-year period starting in 2025, for the U.S. in green and Euro area in orange. We show it using the five-year/five-year inflation swap which is a measure of market expectation of inflation over five years, starting in five years' time. In the chart, the lines are shifted forward five years. The green dot shows our current estimate of average U.S. CPI for the same five-year period of 2025-2030, and the orange dot shows the equivalent estimate for Euro area HICP inflation.

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