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Harr's View

The political disruption of the COVID-19 crisis

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Good evening all

Today, I discuss the political consequences of the crisis. In this regard, I will reflect on our webinar on Wednesday with former Prime Minister of Sweden Carl Bildt, where we discussed US-China tensions and the cohesion of the EU in response to the crisis (see *here*). I will also reflect on a series of investor calls we had this week on the back of my note last Sunday on monetary financing and the next euro crisis. **Carl Bildt argued the crisis will be more disruptive economically and politically than most people anticipate. I agree with him.** On a global scale, US-China tensions have intensified as both countries are blaming each other for the spread of the virus. Carl Bildt argued that tensions between US and China are likely to intensify irrespective of the outcome of the US presidential election. *A recent survey* suggests that 66% of Americans now view China unfavourably, which is the highest level since the survey started in 2005. A record high share of both Republicans and Democrats now have a negative view on China. A deterioration in the US-China relationship is a significant risk for the global economy as it could trigger new trade and tech tensions. Trump may hold back on new tariffs ahead of the election, due to fear of repercussions for the economy and stock markets. However, he could impose new tariffs on China (and Europe) if he wins the election. A Joe Biden victory is likely to be more positive for the transatlantic relationship and global cooperation. **For some time, I have argued that there is a 40% risk of a crisis that lasts substantially longer than just H1-20. An escalation of geopolitical conflicts, such as US-China tensions, may be a trigger for a more prolonged crisis.**

Carl Bildt was more constructive on Europe. He believed that the EU will agree on a substantially increased budget, which will involve grants to e.g. Italy. Several investors we spoke with this week also believed we are moving in that direction. I agree that an expanded EU budget will involve grants to heavily affected countries, but this will not prevent debt-to-GDP ratios in Southern Europe from exploding in coming years which requires monetary financing by the ECB. Therefore, we expect the ECB to expand and extend its purchases of government bonds at its meeting in June, in addition to its newly announced liquidity facilities that provide incentives for banks to buy domestic bonds. (See our ECB strategist Piet Christiansen's Chart of the Week for details as well as our ECB review *here*, EUR government bond analysis *here* and EUR covered bonds comment *here*). **Investors agree with our view that the Eurozone is caught in an unstable equilibrium, where there is a political risk that the ECB suddenly hesitates due to, for example, disagreement in the Governing Council, a constitutional court ruling in one of its member states against its current policy or higher inflation.** Notably the German constitutional court will give its verdict on the legality of the PSPP on Tuesday. Another risk is a rise in anti-euro sentiment in some of the member states. Two-thirds of Italians do not trust the EU, and the population is now split between staying and leaving the euro (see *here*). Interestingly, Carl Bildt expects that even a populist, euro-sceptic government in Italy would end up staying in the euro when the alternative grave consequences of leaving become clear (like Greece in 2015).

This week, we discussed debt forgiveness both with Carl Bildt and in discussions with clients. Carl Bildt argued that debt write-offs would be part of the longer-term solution to the crisis, but investors rightly argue that this is not really possible in the case of the ECB. In principle, a central bank can write off a certain amount of government bonds it owns as long as it remains solvent. Moreover, in theory a central bank is able to ensure its solvency though money printing if it is profitable. However, the scale of the money printing required to safeguard a central bank's solvency may undermine price stability. Therefore, in practice if a central bank takes a large loss on its balance sheet and its solvency is threatened, it will have to be recapitalized by the state. In the case of the ECB, it would have to be bailed out by its member states which would be complicated, and they would prefer providing grants through the EU budget.

Within countries, there was in the early stage of the crisis a 'wartime peace' between governments and oppositions in dealing with the acute health and economic disaster. It clearly appears that the wartime peace is now over in many countries, where governments and oppositions in several countries are clashing over the healthcare response and the opening up of countries. Longer-term, the focus will shift to the explosion in the number of unemployed people. This is particularly a concern in countries with less developed welfare systems, such as the US, where a substantial number of relatively low-paid service workers have lost their jobs. **I am worried about countries in Southern Europe which have been hit hard by the healthcare crisis, and where travel and tourism constitute a significant part of their economies. This could drive new waves of populism and anti-globalisation trends.** Finally, I want to flag our third COVID-19 focused webinar. On Tuesday, Professor Richard Baldwin will talk about global supply chains and the future of work in the aftermath of COVID-19. How will the crisis accelerate the digitalisation of our economies and what are the implications for inequality and populism? That is all for today's comment. I wish you a great Sunday night and coming week. Best regards, Thomas.

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