EDITORIAL

FACED WITH A SUDDEN STOP, POLICY SWITCHES TO A 'WHATEVER IT TAKES' MODE

Recent activity and demand data for China show the huge impact of the coronavirus epidemic. German business expectations have seen an unprecedented monthly drop in March . The drop in the price of oil acts as an additional drag on growth and a source of increased credit risk. The strengthening of the dollar is a source of concern for issuers with foreign currency debt in dollar. Despite swift action of the major central banks and the announcement of increasingly important fiscal policy support in various countries, equity markets have barely reacted: lack of visibility dominates.

Sudden stop. Until recently, the words referred to a sudden halt in private capital flows to emerging economies. Following the epidemic, they now also apply to demand and activity, witness the unprecedented 11-point drop in business expectations in the ifo survey for Germany. The latest data from China provide another illustration: over the January-February period industrial production dropped 13.5% versus last year, real retail sales declined 23.5% and fixed asset investment was down 24.5%. In case this would still be necessary, this is a reminder of the quasi-impossibility of assessing the extent of the hit to growth which results from what is, after all, an exogenous, non-economic shock. This explains why, despite massive, swift action of the major central banks and the announcement of increasingly important fiscal policy support in various countries, equity markets have barely reacted. At most, these actions significantly slowed the speed of decline.

The big additional drop this week in oil prices is making matters worse. Lower oil prices entail a transfer of spending power from producers to consumers, so the former spend less and the latter more. However, today, demand is in no position to react to any significant degree due to lockdowns and bans on international travel. It implies that the negative effect dominates by far: pressure on budgets of oil exporting countries, increasing default risk of certain highly-levered oil companies in the US. Given their weight in the index, this in turn can create a contagion effect within the high yield market as investors decide to reduce their exposure to the asset class.

Finally, the recent, across the board, strengthening of the dollar is complicating matters for the corporate sector in developing economies given their USD debt load. Not only are they faced with a drop in their exports to the advanced economies, but the dollar appreciation puts pressure on their credit quality.

The policy reaction has been swift and impressive. The Federal Reserve has taken the federal funds rate down to zero, restarted QE and embarked on a programme of buying corporate paper. The ECB has introduced a EUR 750 bn Pandemic Emergency Purchase Programme which will run until the end of the year. The US administration and Congress are preparing a USD 1.3 tn (6.5% of GDP) stimulus package. Several European countries have also taken measures to support households and companies. For the eurozone, most important of all is the flexibility which the ECB is now demonstrating. Quoting its President "while the benchmark allocation across jurisdictions will continue to be key to the capital contributions of the national central banks, purchases will be conducted in a flexible manner. This allows for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions"[1] . It couldn't be clearer.

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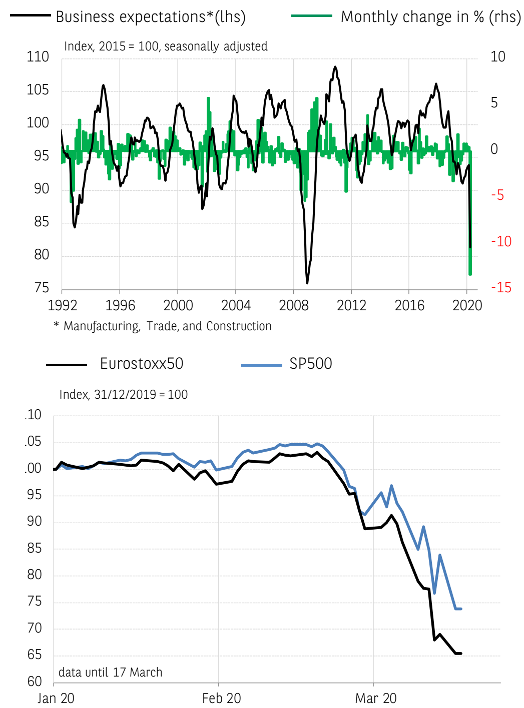
BUSINESS CLIMATE (IFO, GERMANY) AND FINANCIAL MARKETS



SOURCE: IFO, DATASTREAM, BNP PARIBAS

1. Opinion piece of ECB President Lagarde in the Financial Times, 19 March 2020.

The spreading of the coronavirus epidemic triggers a feeling of a 'sudden stop' for the world economy but massive monetary and fiscal policy action should mitigate the impact.