Common debt proposal adds further support for periphery bonds

- China’s one-year loan prime rate likely to be lowered by 10bp, to 3.75% (02.30 BST)
- Euro-zone consumer confidence probably remained depressed in May (15.00 BST)
- We think UK headline inflation fell below 1% in April (07.00 BST)

Key Market Themes
While the Franco-German proposal to issue common EU debt to combat the economic fallout from the pandemic is limited in size and some way from gaining final political agreement, it adds support to our view that the yields of euro-zone periphery sovereign bonds are likely to fall back over the rest of the year.

The news that Germany and France have agreed on a proposal for the EU to fund a joint fiscal response to the coronavirus pandemic by issuing common debt backed by the EU budget has pushed the yields of euro-zone periphery sovereign bonds a bit lower over the past couple of days. (See Chart 1.) But the move is relatively small, and the spread between the yields of periphery sovereign bonds and German Bunds remains much higher than before the pandemic hit, which suggests investors remain to be convinced that this is a game changer.

Such scepticism is no doubt warranted. Proposed grand solutions to the euro-zone’s problems are not exactly uncommon. The size of the planned fund, even at €500bn, is relatively small in comparison to the scale of the challenge facing the euro-zone economy. In addition, the money would be disbursed over several years, and it is unclear how much of it would go to the countries that are most in need. And even though the proposal is backed by the four largest EU members (in addition to France and Germany, Italy and Spain have already signalled their support), it will face opposition from some of the smaller northern EU members (Austria’s Chancellor has already come out against) and, probably, from conservatives within Germany itself.

That said, there are at least two reasons to think that this could prove the start of a significant shift in bond markets. One is that the proposal marks the first time that a German leader has backed joint-liability debt issuance to fund major fiscal transfers between member states. In the past, such common debt (issued through the ESM/EFSF and the EIB) has always been used to fund loans to member states. Even if they come at generous interest rates and long repayment horizons, in principle those debts must be repaid. And while the EU budget already includes transfers earmarked for poorer regions (and farmers), they are not funded by common debt. So even if it is a small one, the proposal is a step towards a genuine fiscal union.

Another reason to think that the proposal might become an important milestone is that Ms Merkel has a long history of getting her way. Throughout the many ups and downs over the past decade and a half, she has proven both her ability and willingness to find a compromise that keeps the euro-zone inching forward towards closer integration. Whatever the political obstacles to a deal this time around, it seems likely that she will find a way around them.

This is not to say that the risks around euro-zone sovereign debt will go away any time soon. Euroscepticism appears to be on the rise in both Italy and Germany, which could challenge the political consensus underpinning the currency union. The ECB faces legal difficulties. Divisions between northern and southern members could prove too deep to overcome. Italy’s sovereign debt remains borderline unsustainable, and an increasing share of it looks set to end up on the ECB’s balance sheet in order to keep yields under control. That could become a major problem later on. But for now, we think that the combination of continued central bank support and a sufficient degree of political compromise will push periphery bond yields down further. (Jonas Goltermann)

Selected Data & Events

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* (m/m/y) unless otherwise stated; p = provisional
Key Data & Events

US
The further plunge in housing starts in April provided more evidence of the hit to activity from lockdowns. That said, the weekly mortgage application data suggest that housing demand is now starting to recover. Meanwhile, Fed Chair Jerome Powell was testifying to the Senate alongside Treasury Secretary Steven Mnuchin at the time of writing, with both set to be grilled by lawmakers on the Fed’s new lending facilities. The release of the minutes from the April FOMC meeting on Wednesday should provide further insight into the thinking behind the Fed’s crisis response. (Andrew Hunter)

Europe
France and Germany have proposed a €500bn (4.2% of euro-zone GDP) EU joint fiscal package (see Key Market Themes), which would use the EU’s planned multiannual financing framework for 2021-2027 to back bond issuance. This would be a significant move towards fiscal union. The fiscal benefit to countries hit hardest by the coronavirus crisis would depend on how the funds are allocated, which has not yet been decided, but our best guess is that the transfer to Italy, for example, might be a little more than 2% of GDP spread over more than one year.

Otherwise, data released on Tuesday showed a sharp rise, from 28.2 to 51.0, in Germany’s ZEW Economic Sentiment index in May, as the government’s gradual easing of restrictions has convinced more analysts that the economic situation there will improve over the next six months. Meanwhile, the increase in German construction output in March was not enough to prevent a drop in construction activity in the euro-zone as a whole, which fell by 14% m/m. On Wednesday, we expect to learn that the gradual lifting of lockdowns across the euro-zone boosted consumer sentiment in May, but that it remained extremely depressed. And finally, we forecast that euro-zone headline inflation fell from 0.7% to 0.4% in April.

In the UK, while the headline labour market figures for March didn’t capture the full impact of the coronavirus, the timelier claimant count showed that the proportion of the workforce claiming jobless benefits jumped from 3.5% to 5.8% in April. We suspect that unemployment will rise further in the coming months, particularly from August when the government’s furlough scheme will start to be tapered. Otherwise, inflation figures for April are likely to show that the headline rate fell below 1.0% last month. (Melanie Debono & Thomas Pugh)

Other Developed Markets
In Canada, we think headline consumer price inflation dropped below zero in April, to -0.1% from +0.9%. Core inflation is also likely to have declined, although for methodological reasons it is unlikely to have fallen by as much as in the US.

Elsewhere, the minutes of the Reserve Bank of Australia’s May meeting underlined that the central bank is still reluctant to buy private sector securities even though corporate bond yields remain high. (Stephen Brown & Ben Udy)

China
We think banks will lower the 1-year loan prime rate (LPR), the reference point against which banks price loans, by ten basis points on Wednesday, even though the PBOC has not lowered the rate on its medium-term lending facility (MLF) this month. The LPR was reduced twice last year in the absence of MLF cuts, and we think banks may heed guidance from the PBOC, which in its recently published Q1 monetary policy report argued that borrowing costs should be further reduced. (Sheana Yue)

Other Emerging Markets
In Emerging Asia, Bank Indonesia’s (BI) decision to leave its main policy rate unchanged today at 4.50% was a big surprise given the slump in economic activity and the rebound in the rupiah. That said, we think the central bank will cut interest rates again soon. Elsewhere, with the economy contracting and prices deflating, we think that the Bank of Thailand will cut its policy rate by a further 25bp, to a record low of 0.50%.

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