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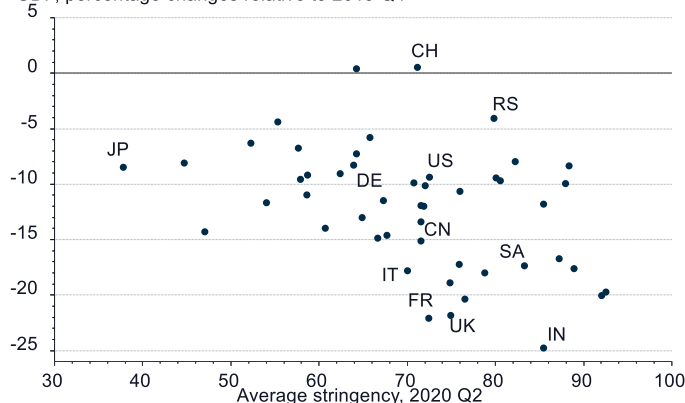
Headlines

- 2020 Q2 GDP data are now available for more than 80 countries and suggest the global economy contracted by 6.6%
- Q3 GDP figures have been encouraging; China (2.7%), South Korea (1.9%), Vietnam (3.1%) and Singapore (7.9%) all report rebounds in growth
- Cases continue to rise in Europe; new infections in Belgium pass 0.1% of the population per day
- Scientists report that South Africa may have passed threshold for herd immunity, but UK researchers suggest that antibodies may fade with time

According to standard economic theory, there exists a short-run trade-off between unemployment and inflation (such that scarcity of resources can lead to higher prices) but no such relationship exists in the long run (i.e. persistently higher inflation does not result in permanently lower unemployment). In a recent blog post, Oxford professor Simon Wren-Lewis argued that the relationship between the epidemiological and economic impacts of the COVID-19 virus can be thought of in a similar way; in his view, the reproduction/R rate of the virus can only be lowered in the short run through lockdowns (which entail a substantial economic cost).

GDP and lockdown stringency, 2020 Q2

GDP, percentage changes relative to 2019 Q4



Source: Refinitiv Datastream / Fathom Consulting

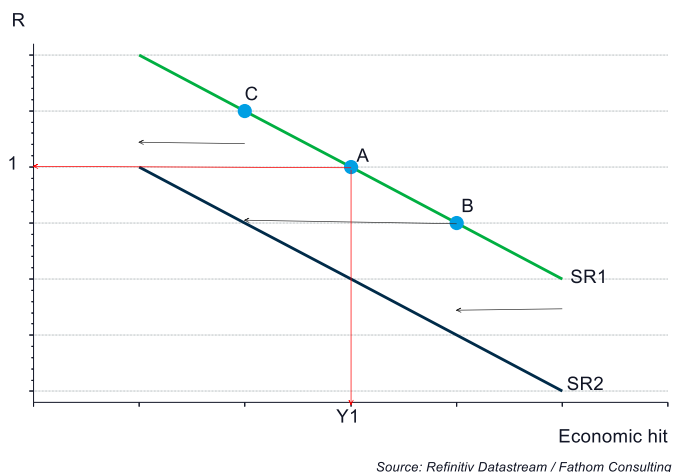
This conceptual relationship might be summarised in a chart such as the one below. In the short run, the range of outcomes available to a government might be summarised in curve SR₁ below. If a government targeted an R number of close to but below 1 (as many did during the first wave), the economic hit is given by Y₁. Alternatively, policymakers could target better health outcomes (and worse economic outcomes) by opting for policy B or target a herd-immunity approach and end up closer to point C.

The introduction of an effective track and trace process, social distancing and face coverings are all likely to improve outcomes by shifting the short-run relationship to the left (i.e. facilitating a lower R rate for a given hit to the economy or a better economic outcome for a given R rate). A government could opt for either approach, and either would constitute a (Pareto) improvement



from the previous status quo — i.e. a positive without a corresponding negative. The analogy of the long-run Phillips curve falls away here — while the long-run prediction of the Phillips curve model is that policymakers can target whatever rate of inflation they like in the long run without affecting real economic outcome's, the model of Professor Wren-Lewis suggests that you could wind up changing the economic hit (or there is at least the potential to do so).

The economic-epidemiological trade-off



Behavioural changes and improvements in contact tracing mean that the short-run relationship has probably shifted to the left since the first wave of the virus hit, and we would not expect either the economic or health impacts from a second wave to be as bad as they were from the first.

The first wave of the virus elicited an impressive fiscal response which helped to soothe some of the economic consequences of lockdowns. Data published last week showed a euro area budget deficit worth 11.6% of GDP in the second quarter of this year, the widest since Eurostat began collecting the data in 2002.

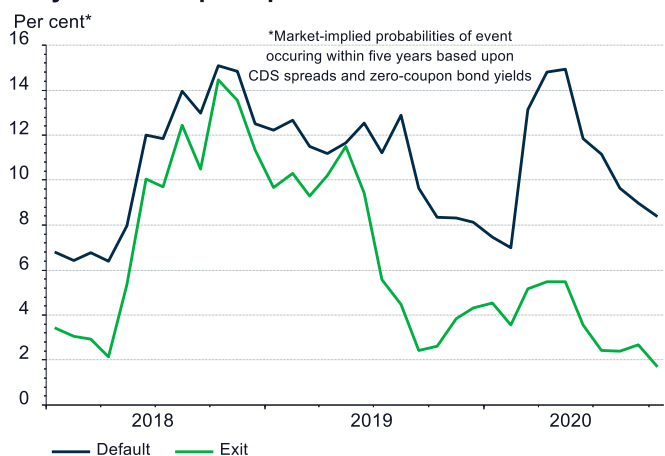
Euro area general government budget balance



China Even so, investors appear relaxed about the risks to sovereign fragility in Europe, despite the second wave having taken off in earnest. Indeed, Fathom's proprietary indicators show that the market-implied probabilities of sovereign defaults remain low, despite the fiscal stresses that a second wave could bring.

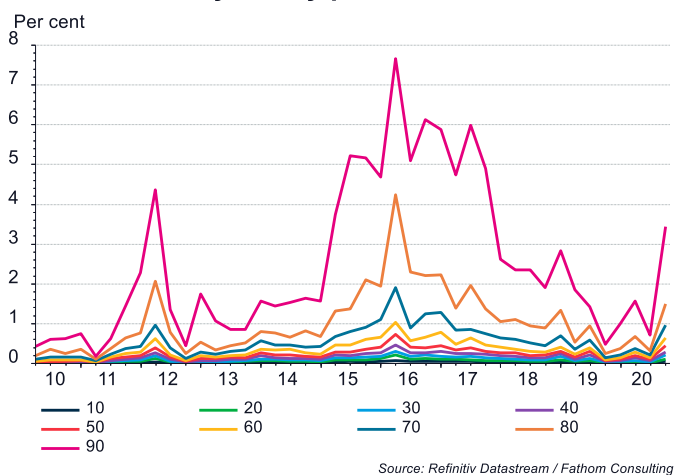


Italy market-implied probabilities of default and exit



Of course, investors have been wrong before and, while most countries did manage to ride out the first wave of the virus, there remains a risk that a second wave of the virus and a second round of lockdowns could trigger a spate of financial crises, especially in emerging markets. For the time being, those risks appear more likely to manifest in the form of currency crises as opposed to either banking or sovereign crises. Indeed, by the end of the last quarter, there had already been a sharp rise in the likelihood of currency crises for countries at the riskier end of the spectrum,¹ as measured by Fathom's Financial Vulnerability Indicator (FVI).

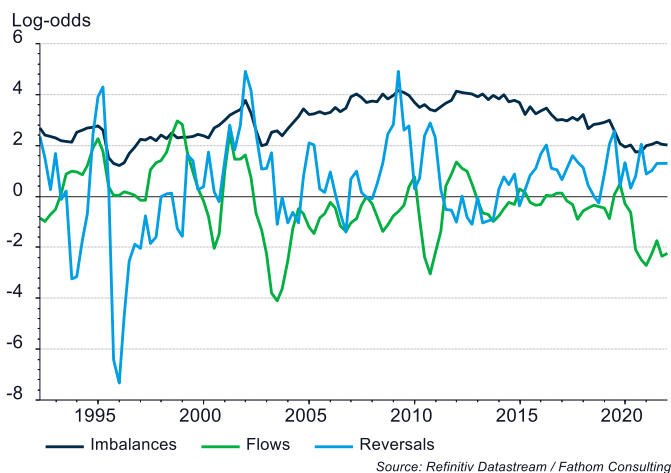
Global currency FVI by percentile



Recent months have put a spotlight on the risks of currency crises in some of the countries hit hard by the pandemic, none less so than South Africa and Turkey. That said, the risk of a crisis in either South Africa or Turkey is currently low by historical standards. This is because the majority of historical crises have been preceded by a build-up of imbalances that make a given country vulnerable to outflows of capital. Neither country's current account balance looks excessive by historical standards nor do their currencies look unusually strong. However, the outlook for South Africa is worth watching given its ballooning government budget deficit. Thus far investors have reacted positively to the central bank's quantitative easing programme — whether this is the new normal for emerging markets is likely to be one of the key issues we address in our upcoming *Global Economic and Market Outlook*.



Turkey currency FVI narrative drivers



[1] Indeed, the probability of a crisis for a country at the 90th percentile (i.e. representing the country above which only 10% of FVI scores are higher) has risen sharply and now sits at its highest value since 2017.

Interesting reading

- Scientists in South Africa report that herd immunity threshold may have been reached: <https://news.sky.com/story/coronavirus-south-africas-covid-lockdown-may-have-created-herd-immunity-12116494>
- UK scientists find that COVID-19 antibodies may fade with time: <https://www.gov.uk/government/publications/react-2-real-time-assessment-of-community-transmission-antibody-waning/react-2-real-time-assessment-of-community-transmission-antibody-waning>
- Simon Wren-Lewis argues that the health-econ COVID-19 trade-off may be thought of in a similar way to the relationship between unemployment and inflation: <https://mainlymacro.blogspot.com/2020/10/why-do-some-find-economicshealth-trade.html>
- NBER paper offers another conceptual framework for understanding COVID-19: https://www.nber.org/system/files/working_papers/w28004/w28004.pdf



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