

The Covid-19 Challenge to European Financial Markets: Lessons from Italy

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Outline

Evolution of outbreak in Italy

Lockdown, economic Impact, and potential recovery

Eurozone dynamics and financial market consequences

Evolution of the Covid-19 outbreak in Italy

The evolution of the coronavirus pandemic

- The coronavirus pandemic has sickened more than 2.5 million people around the world.
- At least 175,000 people have died.
- Nearly 3 billion people are under covid-19 lockdowns.

A short timeline of the coronavirus pandemic

- 12/31 (2019) in Wuhan, China, dozens of cases from unknown virus,
- 1/20 first confirmed cases outside mainland China: Japan and South Korea,
- \approx 2/21-23 surge of infections in South Korea and Italy,
- \approx 2/28 number of infections in Europe spikes,
- 2/29 first coronavirus death in the U.S.,
- 3/19 for the first time China reports zero local infections (after more than 3 months).

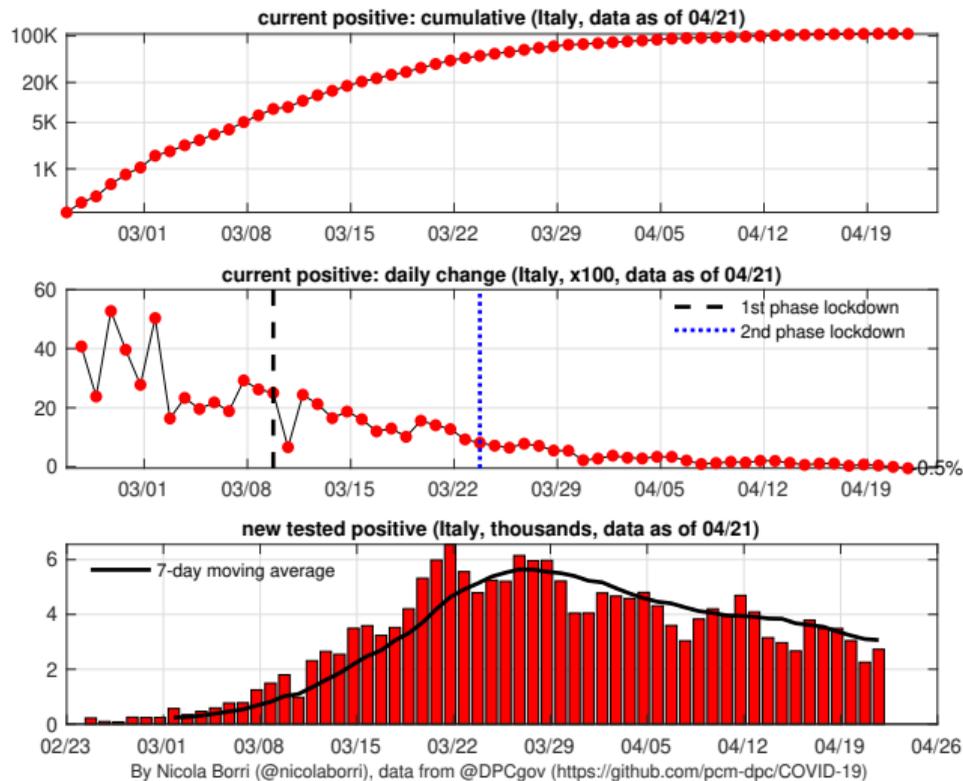
Why Italy?

- First country hit by the virus in Europe.
- Several cases in other European countries can be traced back to Italy.
- Italy is about 2-3 weeks ahead of most other advanced economies.
- Very strict lockdown.
- One of weakest economy in Europe (pre-covid).

Italy: Where do we stand?

- After almost two months, situation is finally stabilizing, but death toll is dramatic:
 - Number of current cases is starting to decline
 - Number of daily deaths is (very slowly) approaching zero
 - Number of patients in hospitals is declining (both ICUs and less severe cases)
 - However, there are important regional differences that are likely to matter for:
 - plan to relax lockdown measures,
 - estimates of economic damage.

Current cases

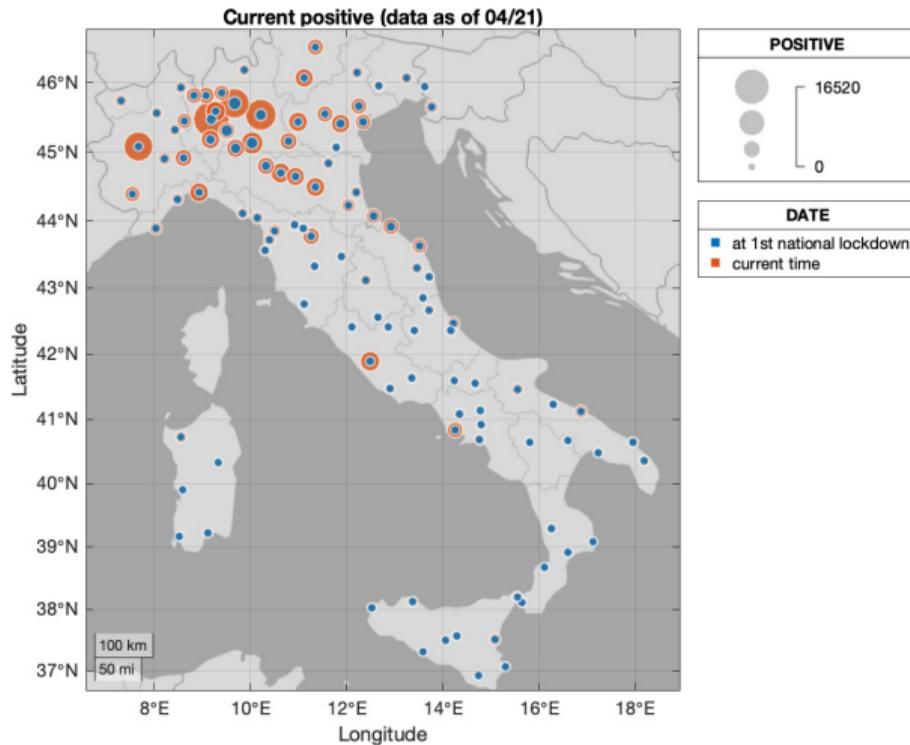


What have we learnt about testing?

- Number of tested positive depends critically on number of tests.
- Large differences across countries and within countries (e.g., within Italy):
 - comparison “positive” across countries misleading (also because different phases of virus spread),
 - symptomatic vs asymptomatic, severe vs. mild cases,
 - unreliable mortality and R_0 (basic reproduction number) estimates.
- Key to test representative sample (see, for example, [Galeotti and Surico \(2020\)](#), or [Stock \(2020\)](#)).

▶ evolution testing

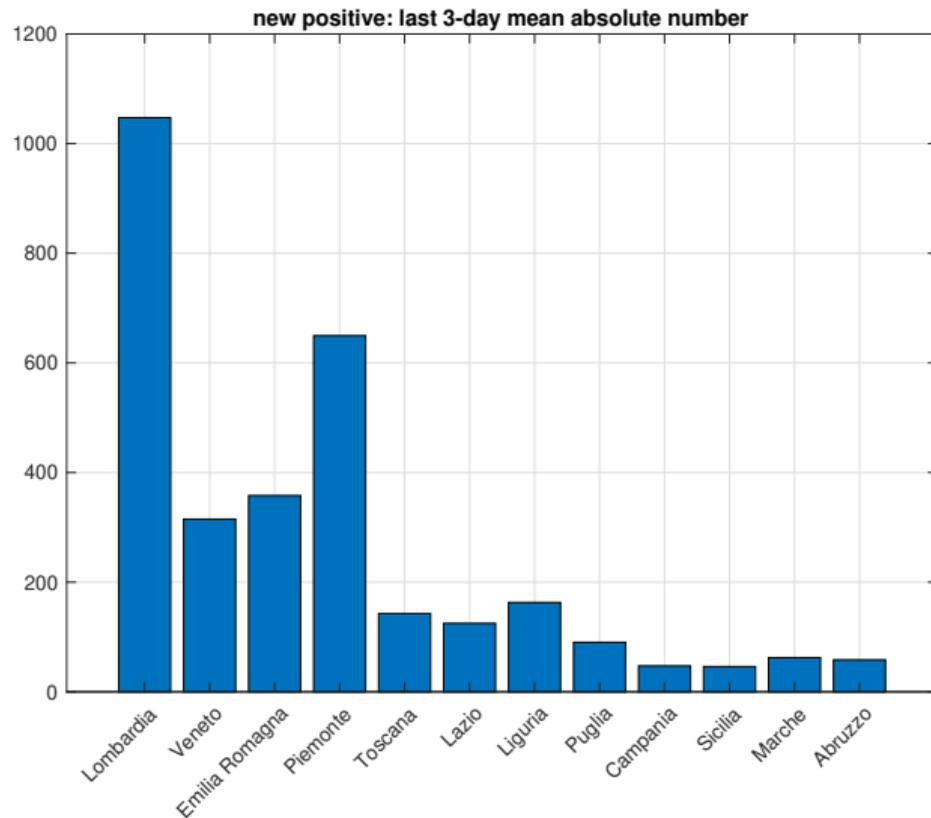
Regional differences



▶ deaths

▶ current cases

Persistence of regional differences

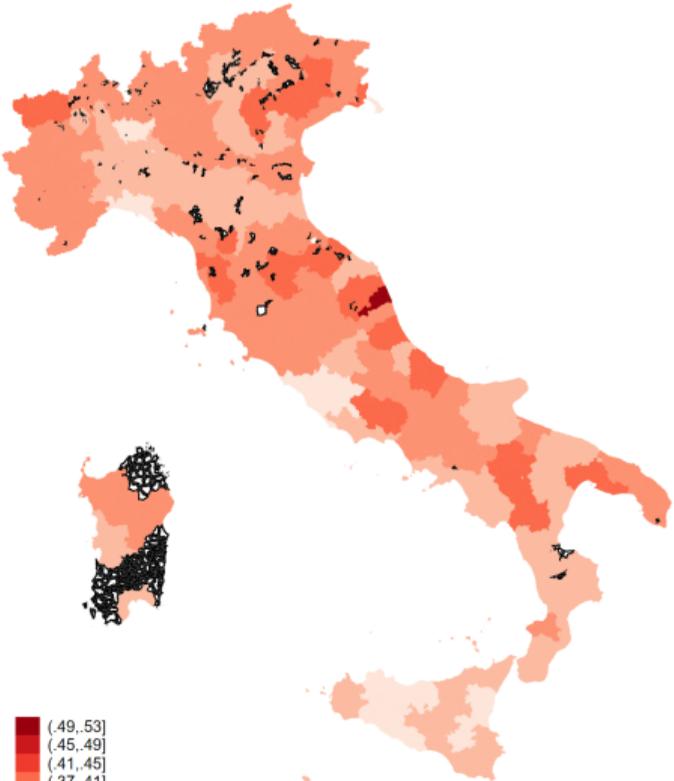


Was the lockdown effective?

- A preliminary study finds a positive effect of first (mild) lockdown of March 9 in reducing virus spread.
- In current research (with F. Drago and F. Sobbrío) we consider the marginal effect of the *strong* lockdown of most factories of March 23:
 - we exploit province differences in number of inactive workers due to lockdown measures, and control for province and region-time fixed effects.
 - however, results do not show any clear effect.
- Our takeaway:
 - governments need better data to do cost/benefit analysis (i.e., track mobility data, and more in general granular data),
 - need for studies on heterogeneous risk exposure in different workplaces or occupations.

▶ What does history say about effectiveness of lockdowns?

Change Fraction of Inactive Workers



Effect on positive cases

| | Covid-19 positive cases (province level) | | |
|---------------------------------------|--|-----------------------|------------------------------------|
| | all provinces | provinces in North | provinces above median at lockdown |
| Δ inactive post-lockdown | -139.977 (87.030) | -356.936 (218.068) | -305.268 (229.712) |
| Obs. | 3640 | 1540 | 1540 |
| FE province level | YES | YES | YES |
| FE region-day | YES | YES | YES |
| unconditional mean dependent variable | 796.8 | 1496 | 1556 |

Notes: robust standard errors clustered at provincial level. Regression includes five lags of dependent variable.

Lock-down and economic impact and the potential recovery

Timeline of lockdown in Italy

- 2/23: lockdown of small town in Lombardia (Codogno),
- 3/9: first lockdown of whole country (factories remain open),
- 3/22: factories in all non-essential sectors are closed (second lockdown),
- 5/4: possible lift of lockdown

Impact on Italian economy

- First phase of lockdown (up to 3/22) affects sectors accounting for 40% of Gross Value Added:
 - hospitality is the sector mostly hit,
 - also retail and wholesale trade (food segment ↑, non-food segment ↓)
- Second phase of lockdown (since 3/25):
 - it implies loss of approximately 40% of potential economic activity,
 - still active:
 - 51% firms ,
 - 55% workers
- Note:
 - North account for 40% of GDP,
 - tourism accounts for 14% of GDP (but 50% is domestic)

Second phase of lockdown

| Sector | % active |
|------------------------|----------|
| Agriculture | 95 |
| Manufacturing | 41 |
| Construction | 42 |
| Retail | 55 |
| Transport | 61 |
| Hotels and Restaurants | 7 |
| Real Estate | 0 |
| Finance | 100 |

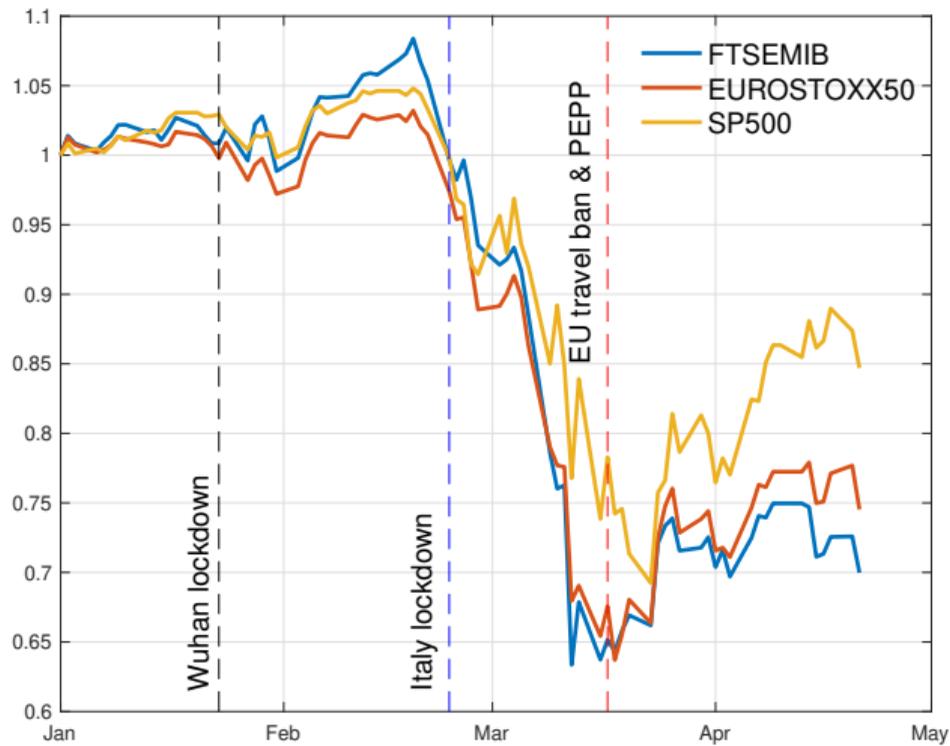
Source: Istat and Algebris Policy & Research Forum.

Estimated impact on Italian economy

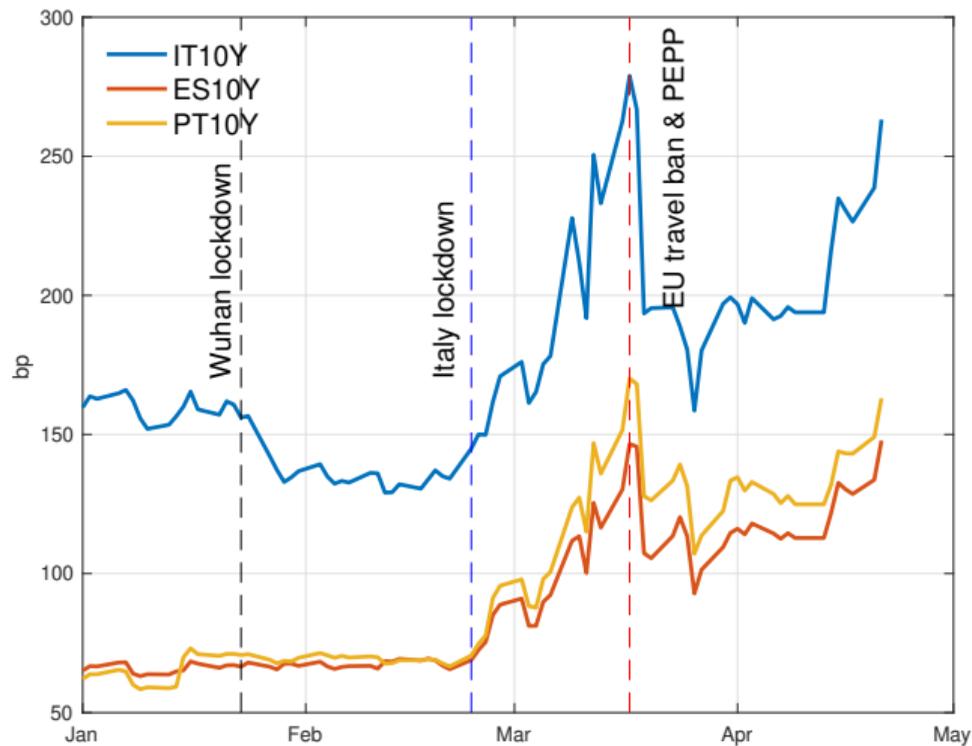
- GDP 2020 (YoY%): -7.3 (4.2 in 2021)
 - consumption: -6.8; investment: -7.8; government consumption: 0.8; industrial production: -8.2
 - high uncertainty around these estimates: low estimates for GDP: -15
- Government budget (%): -6.5 (2020), -4.2 (2021)
- Government debt (%): \approx 150 GDP (from 130)

Source: Bloomberg

Italy equity market

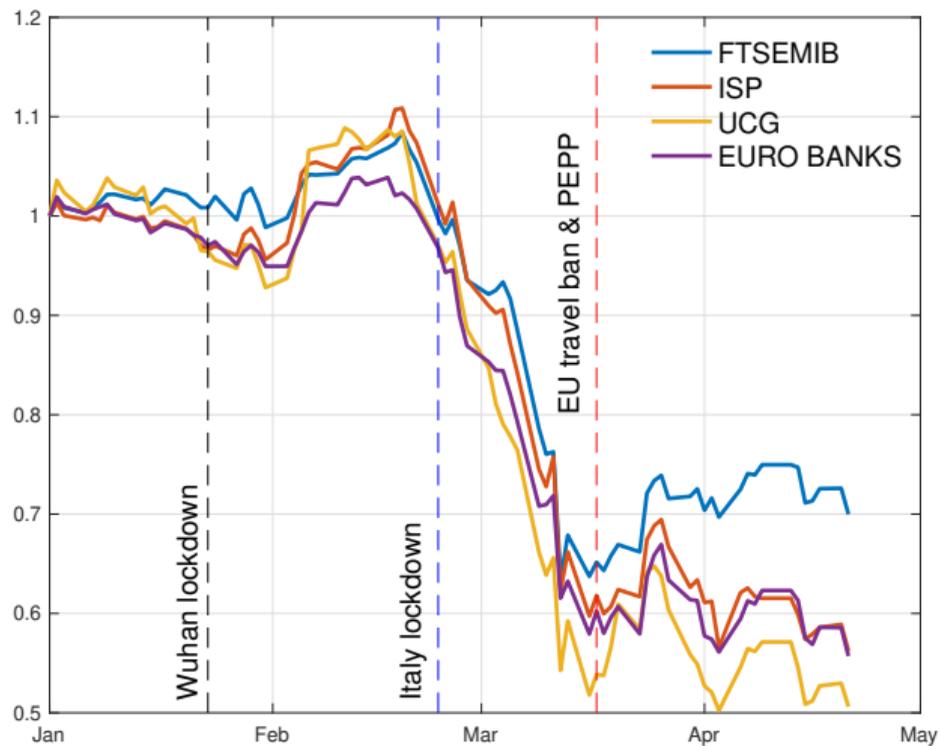


Italy sovereign risk



Note: yield spreads with respect to DE10Y

Italian banks (I/II)



Italian banks (II/II)

- Italian banks before covid-19 crisis in better position than before Great Recession:
 - strong reduction in bad loans (from EUR 350 bn in 2015 to EUR 200 bn in 2019),
 - some consolidation and restructuring
 - support from ECB QE programs
- However:
 - doom loop: holdings of Italian government debt \uparrow (+14% in Feb 2019 with respect previous year)
 - over exposure to domestic economy and low diversification
 - low margins in low-interest rate environment
- What to expect: speed up of concentration process and difficulties for smaller lenders

Italian non-banks

- Too early to say which are the other firms more exposed to covid-19 risk, but some of the biggest losers so far:
 - automotive (e.g., FCA, CNH, Brembo),
 - transport (Autogrill),
 - food catering (Marr),
 - oil (e.g., Eni).
- Interesting to develop tools to estimate firm-level exposure to epidemic risk (see, for U.S. firms, [Hassan et al. \(2020\)](#) and public available data at firmlevelrisk.com for indices based on textual analysis of earnings conference calls).

Fiscal response

- On 3/16 government approved stimulus package of EUR 25 billion (\approx 1% GDP):
 - emergency financing of health system: 3.2 bn
 - employment and income support: 10.3 bn
 - tax deferrals and utility bills: 6.4 bn
 - support of credit supply (guarantees): 5.5 bn

Next phase?

- On May 4 we expect a significant relaxation of lockdown measures (official decision expected this Friday).
- Not clear if there will be different measures for different parts of the country (i.e., North vs. rest of the country).
- Schools are likely to stay close at least till September (i.e., start of next A.Y.):
 - effect on productivity and labor supply in families with young children and labor supply,
 - long-run effects on human capital? (especially of children from poorer families and younger one).

Eurozone dynamics and their financial market consequences

The “Great Lockdown” Shock

- Since shock affects most countries and investors, hard to share risk
- Ideally, inter-temporal risk-sharing: more public debt to support economy
- However, not all countries have this option:
 - *stronger* countries are putting on the table large fiscal packages (e.g., U.S. and Germany),
 - concern is that *weaker* countries cannot finance required fiscal stimulus,
 - an inadequate stimulus might not be able to avoid that the initial supply shock generates also a large demand shock
- What are the options?

Central banks

- Central banks have been among the first to intervene:
 - keep risk-free rates low (lowering reference rate)
 - help banks provide liquidity (easing collateral requirements and conditions)
 - maintain transmission mechanism (ECB with PEPP, Fed asset purchases)
 - maintain dollar supply (swap lines)

Financing the fiscal injections

- The size of Italian public debt is a constraint on new borrowing:
 - last Tuesday Italy raised EUR 16 bn with orders for EUR 110 bn, but yield \uparrow 25bp,
 - next Friday S&P is set to review credit rating (current BBB with negative outlook).
- Current debate in Eurozone is considering:
 - loans by the European Stability Mechanism (ESM),
 - issuance of joint debt (so called coronabonds),
 - transfers financed using EU budget,
 - debt financing by the ECB.

What is the Italian position?

- Government (M5S+PD) is split:
 - PD wants to tap the ESM:
 - EUR 35 bn in loans ready available at below market rate for covid-related expenditures with no strings attached
 - M5S is firmly against ESM (“They strangled Greece”)
 - demands transfers, and ECB debt financing (yesterday, deputy finance minister of M5S proposed to issue “perpetuities with zero interest rate”)
- Opposition (Lega and far-right) also against ESM:
 - demand ECB financing, or eurexit

Voting Intentions

| | 4/20 | 4/13 | 2/24 |
|---------------------|------|------|------|
| Lega | 29.5 | 29.7 | 31.3 |
| Partito Democratico | 20.0 | 19.9 | 20.1 |
| M5S | 14.4 | 14.2 | 13.4 |
| Fratelli d'Italia | 13.3 | 12.8 | 11.3 |
| Forza Italia | 5.8 | 5.3 | 5.4 |
| Support of PM Conte | 57 | 60 | |

Source: SWG.

My take

- Any form of debt mutualizations (i.e., coronabonds) extremely unlikely, as ECB for direct debt financing
- ESM loans best available solution, but:
 - ESM lending capacity is limited to EUR 400 bn (but in principle could be expanded),
 - political resistance in Italian government is strong,
 - it could give room to opportunistic reactions of opposition and eurosceptic parties
- Access to ESM also automatically makes country eligible for ECB OMT program (Draghi's "whatever it takes").
- Not clear what is the cost of transfers using EU budget (the "Spanish proposal") as they should not imply any joint guarantee.

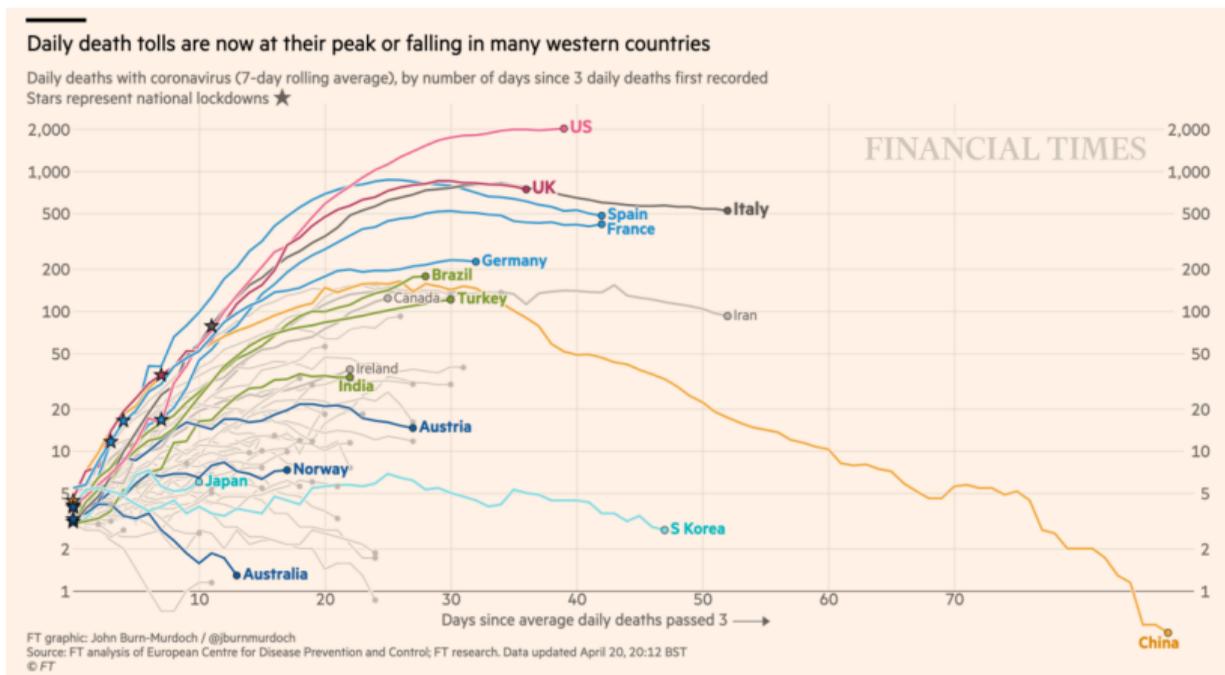
Conclusions

- Covid-19 health crisis in Italy is stabilizing.
- Social distant measures and lockdown should end soon.
- Economic damage is large.
- Large public debt limits the space of fiscal intervention, and this could prolong the period of low growth (i.e., L-shape recession).

Thank you! Stay safe!

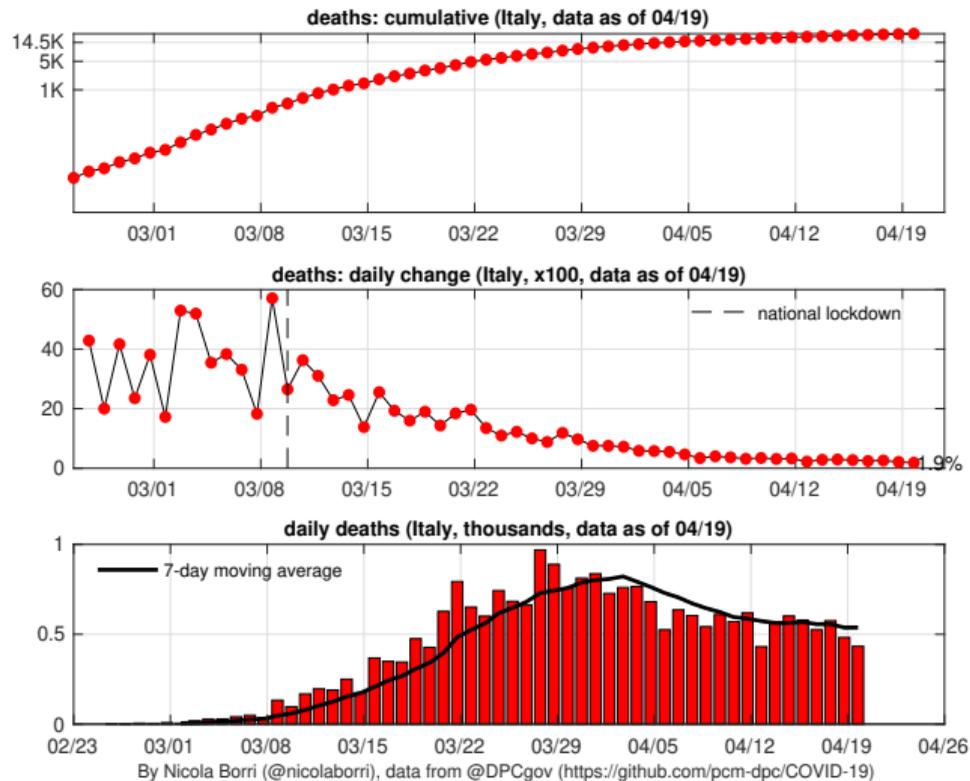
Additional Slides

Covid-19 Evolution Around the World

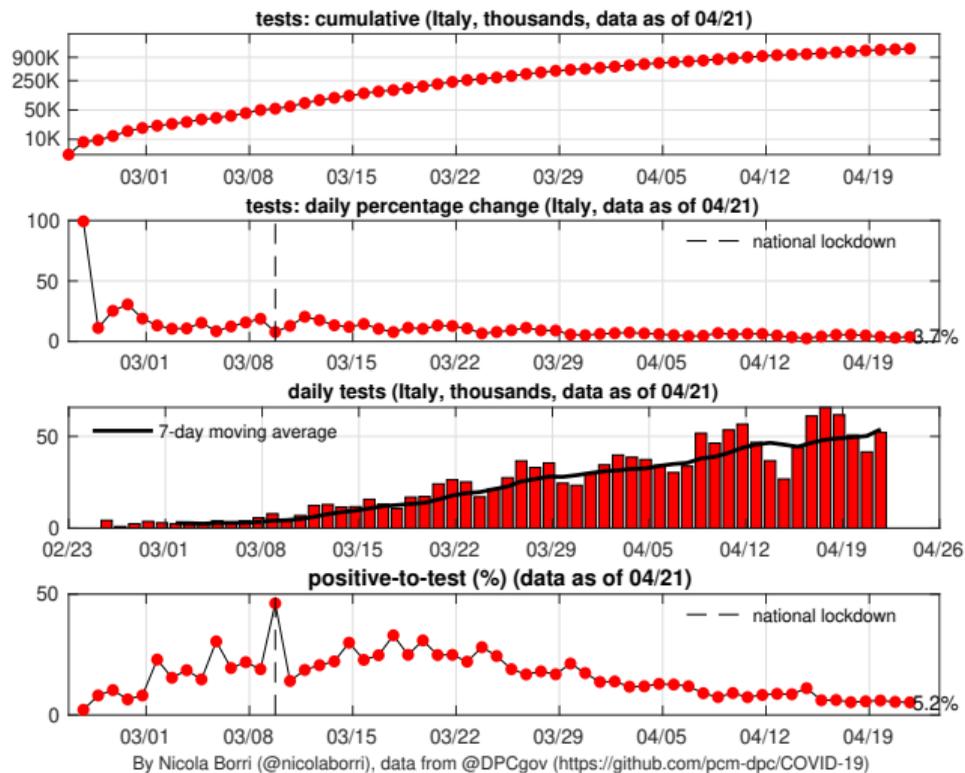


Source: [The Financial Times](#) [▶ back](#)

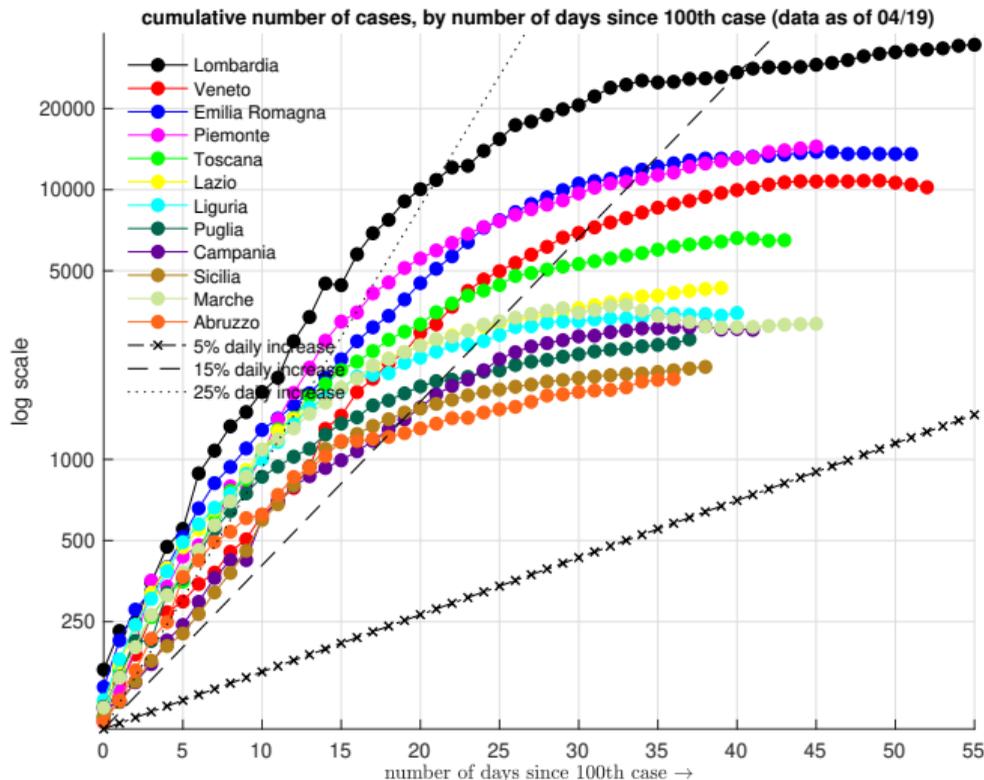
An Alternative Measure: Deaths



Evolution of testing

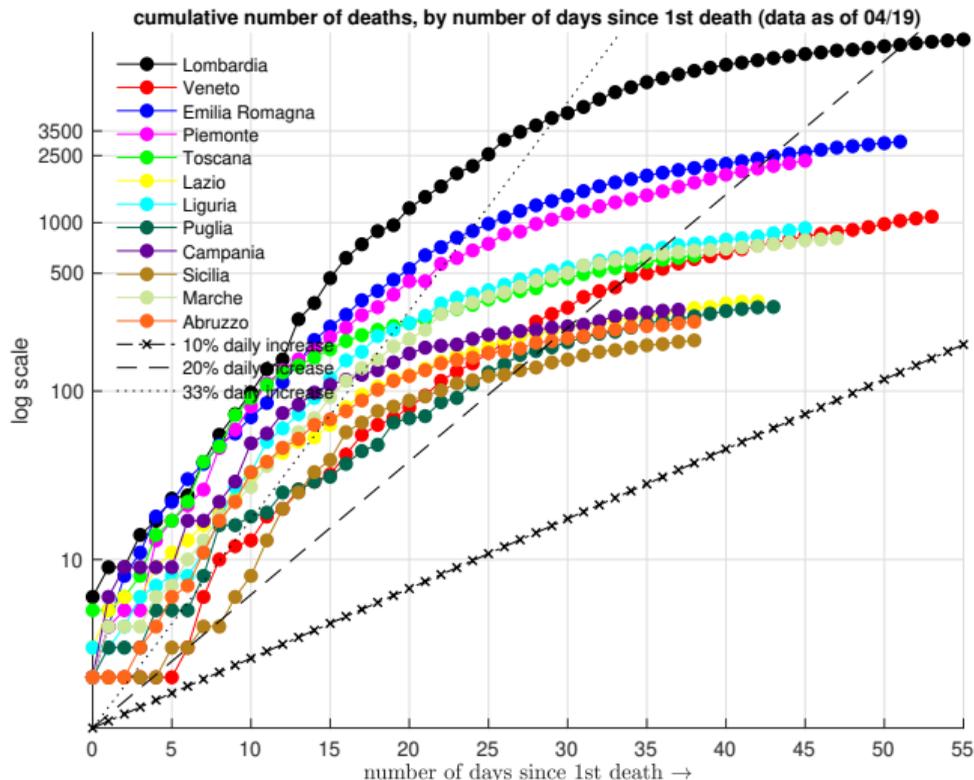


Regional Differences: Current Positive



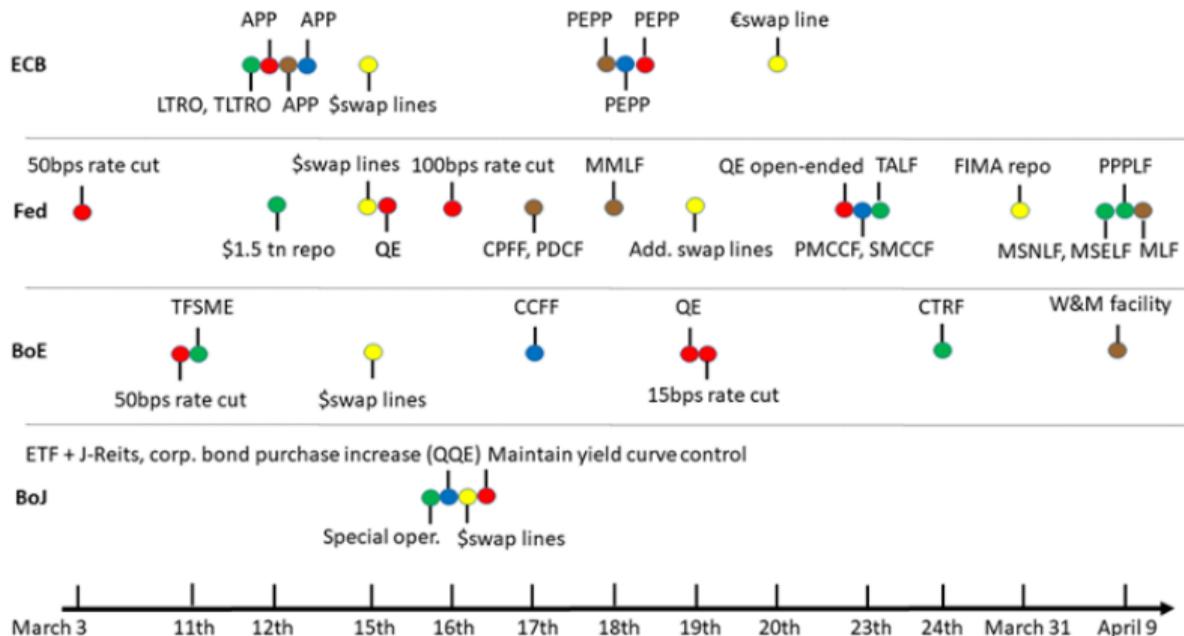
By Nicola Borri (@nicolaborri), data from @DPCgov (<https://github.com/pcm-dpc/COVID-19>)

Regional Differences: Deaths



By Nicola Borri (@nicolaborri), data from @DPCgov (<https://github.com/pcm-dpc/COVID-19>)

Timeline Central Bank Actions



Reference: [Banque de France Note 157](#); risk-free rate (red), liquidity (green), capital markets (blue), spreads (brown), swaps (yellow).