

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

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INQUIRE UK Inaugural Webinar
Anywhere on Earth, 22 April 2020

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).

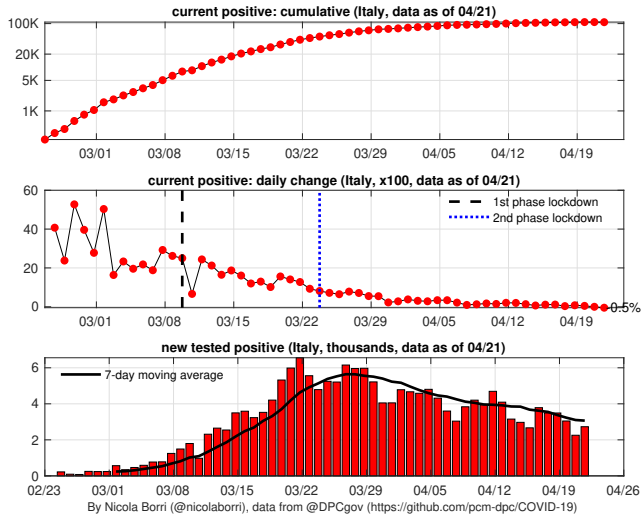
Why Italy?

- 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

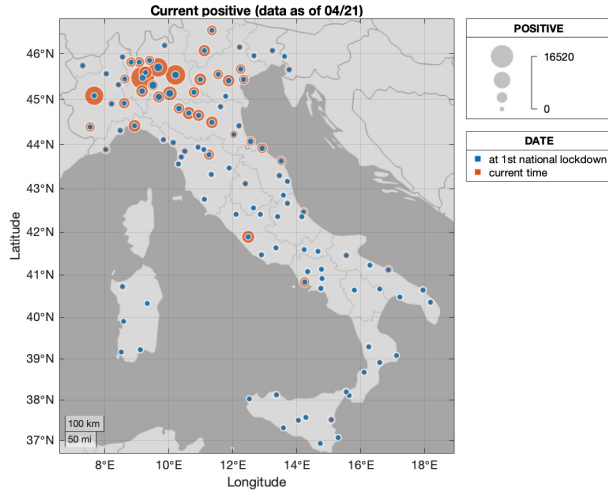


What have we learnt about testing?

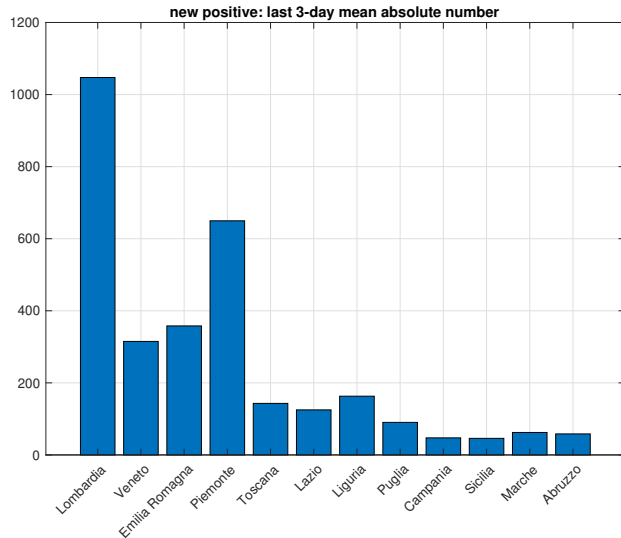
- Number of tested positive depends critically on number of tests.
- Large differences across countries and within countries (e.g., within Italy):
 - comparison “positive” across countries misleading (also because different phases of virus spread),
 - symptomatic vs asymptomatic, severe vs. mild cases,
 - 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



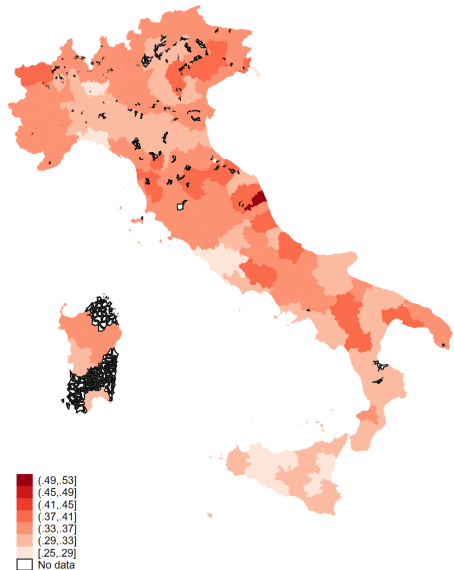
Persistence of regional differences



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.

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

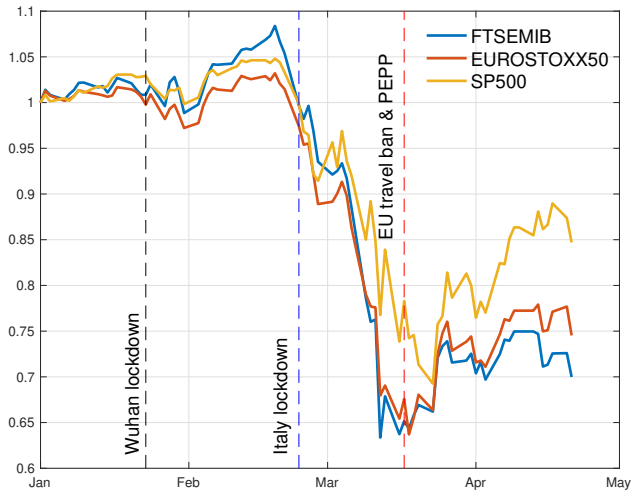
Source: Istat and Algebris Policy & Research Forum.

Estimated impact on Italian economy

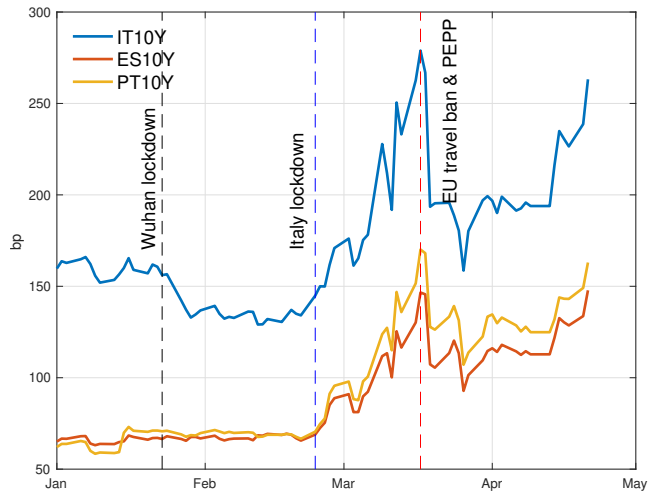
- GDP 2020 (YoY%): -7.3 (4.2 in 2021)
 - consumption: -6.8; investment: -7.8; government consumption: 0.8; industrial production: -8.2
 - high uncertainty around these estimates: low estimates for GDP: -15
- Government budget (%): -6.5 (2020), -4.2 (2021)
- Government debt (%): \approx 150 GDP (from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

Source: Bloomberg

Italy equity market

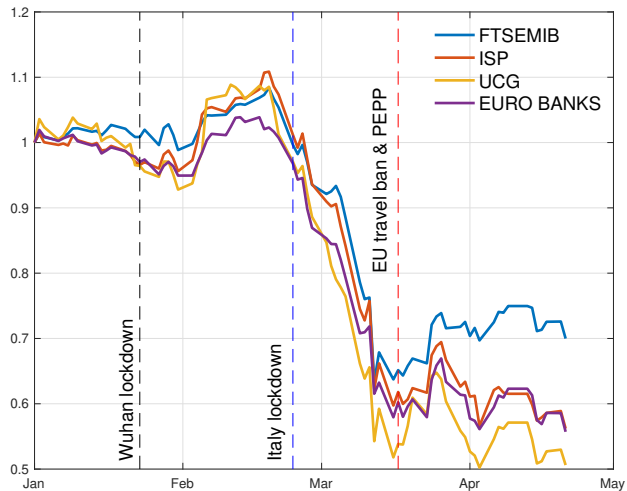


Italy sovereign risk



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.

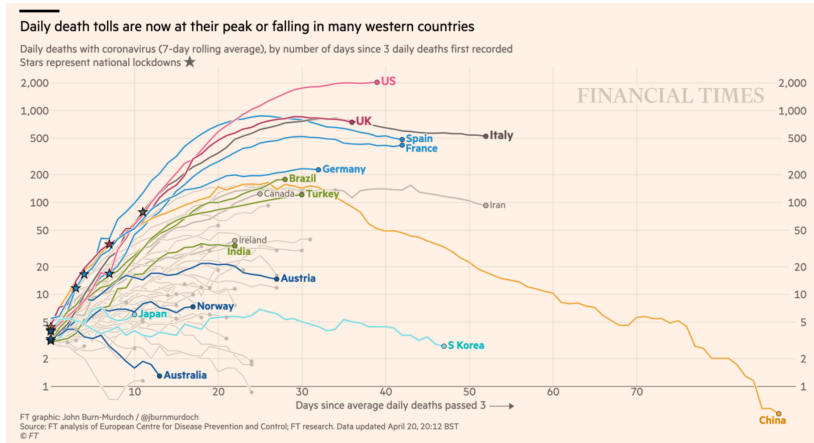
Conclusions

- 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!

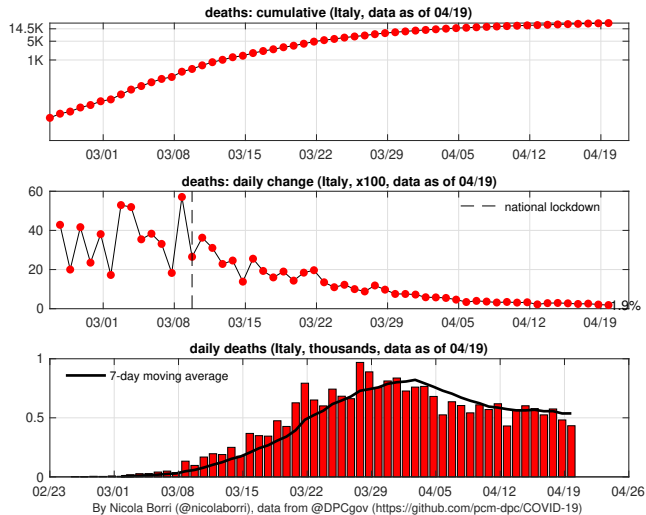
Additional Slides

Covid-19 Evolution Around the World

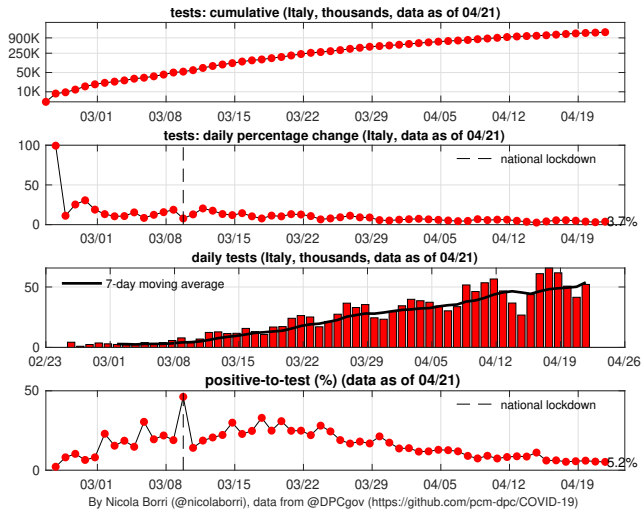


Source: [The Financial Times](#) [▶ back](#)

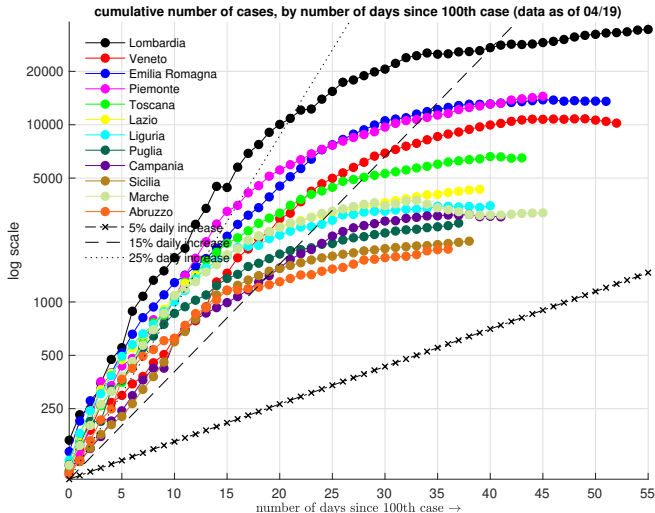
An Alternative Measure: Deaths



Evolution of testing

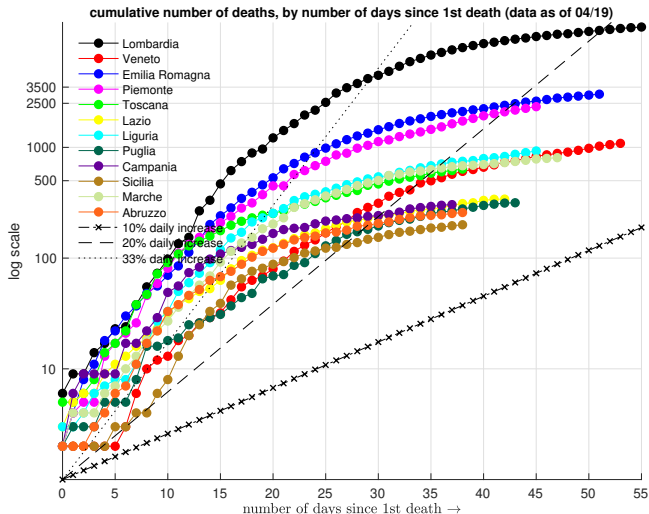


Regional Differences: Current Positive



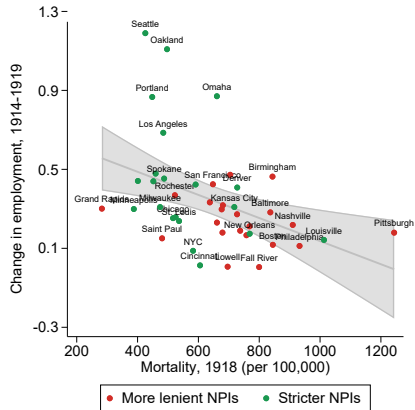
By Nicola Borri (@nicolaborri), data from @DPCgov (<https://github.com/pcm-dpc/COVID-19>)

Regional Differences: Deaths



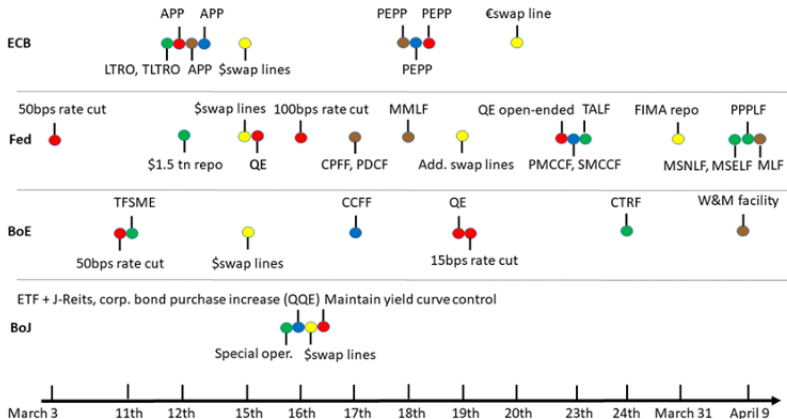
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What does history say about effectiveness of lockdowns?



Source: Correia et al. (2020) [▶ back](#)

Timeline Central Bank Actions



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