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Coronavirus and all that – the cost of a bail-out

Could the global economies bear to simply make the private sector whole? To compensate the private sector for the brutal drop in economic activity that looks increasingly likely? Under a set of highly stylised assumptions we conclude - Yes, some countries could.

Some of the worlds largest economies could and may indeed take important steps in a direction that many consider to be destabilising. But these are not normal times.

About that, «at any cost» - let's try a thought experiment

Let us assume that activity in the private sector falls by 50% in the second quarter of 2020. What would happen if the government simply decides to keep the private sector whole? What would happen if the government simply borrows the needed amounts in the bond market – presumably issuing 30 year debt at near zero percent.

The first assumption is not as silly as you may think. Respectable companies are adjusting their expectations to GDP in Q2 and it could very well be that we end in the vicinity of a 50% loss.

The idea comes from St Louis Federal Reserve President James Bullard, who obviously is trying to needle US lawmakers into action. See an interview with him here. Obviously, there are problems with his bold "proposition". What about the public sector who continues to chug along? How should the astronomical amounts be distributed? – how do we get the right money to the right people? And so on.

Yet as an exercise in getting the orders of magnitude right, there is nothing wrong with Bullard's provocation. Governments and their central banks face the choice whether to simply subsidise the private sector in order to avoid a massive loss of jobs and a loss of demand. Everybody knows that the amounts could end up being very significant.

Most governments obviously are obviously queasy at the idea of writing a huge cheque and then borrow the money to finance it.

Instead they propose some kind of mix of government subsidies and credit facilities offered by the public sector or the central bank. Nothing wrong with that. There can be huge gains by avoiding the destruction of productive capacity that would follow from a deep recession.

A 2020 recession is on our hands. Yesterday IMF conceded here by lowering their Dec 2019 assertion for then "Tentative stabilisation – sluggish recovery?", to the following:

"a recession at least as bad as during the global financial crisis or worse, but we expect recovery in 2021".

Assumptions

Now in order to examine Bullard's proposition and therefore to give an impression of the magnitude of the economic loss, we have collected data for the world's 10 largest economies (and since we hail from the Nordics, we've included the Nordic countries as well). In order to get as recent data as possible we have taken data from a number of sources and we have made no checking of the accuracy of the data except that they roughly had to correspond to our preconceived notions about a given country.

This method is known as a "quick and dirty" and we stand by it all the way. Except for China, whose data we do not really believe in, since no independent data source exists. But we have included the official PR data anyway for comparison.

We record all data in USD. We assume that the public sector simply will continue without changes. That public employees will be paid as normal and delayed tax incomes will be booked as a receivable. We use the General Government Expenditure category from OECD as a measure of government weight in the GDP. We assume that GDP in Q2 of 2020 is 25% of the annual GDP in 2019.

Accordingly, we set 12.5% of the private sector GDP of a given country as a proxy for the size of the chock to the country's GDP in Q2.

Further, we use the most recent numbers for the general government debt in order to see how an aggressive subsidy to the private sector would impact the Debt/GDP ratio in the various countries.

Conclusions

The conclusions are stark. Certain countries could without further problems (except maybe losing a AAA standing at the rating agencies) simply go ahead. China, Germany, South Korea, Australia and the Nordics could make the ginormous subsidy without even coming close to the 90% limit of GDP that many consider as destabilising. (reference, Reinhart & Rogoff "This time is different", March 2008)

Germany would jump to above the 60% Debt /GDP ratio the country had imposed on the other EU member states. Tsk, tsk.

USA, France, UK and Spain are in an uncomfortable situation where it would probably be dangerous even in the medium term to make these huge handouts and they must likely resort to a mix of fiscal expenditure aimed at employees of the private sector and credits or loan guarantees to companies.

Italy and Japan would be playing with fire. So far, they have been partially shielded by the fact that their debt is largely held by domestic savers. But in a critical situation their indebtedness certainly could lead to a run on their government debt for a European debt crisis 3.0.

Further, we may learn something not particularly surprising. The chock to the GDP is more severe, the smaller the public sector. Just as conservatives dislike a big public sector in normal times, they should perhaps appreciate it in the current situation.

Would this lead to interest rates/bond yields? Given that it would represent a significant dissaving in the public sector, it would change the global balance between investments and savings. So far, we have had a savings glut and hence low (real) bond yields. That would come to an abrupt end if bail-out programmes were to become the order of the day. So yes, bond yields would increase.

So far for the good and the bad.

Now for the ugly: what will it look like if we have not managed to get the coronavirus under some kind of control by 1 July 2020? Will we then look at a similar situation in Q3?

Since we have on several occasions dabbled in scaremongering, we remind readers of IMF's report of November 2019 where the organisation pointed out that if a recession would be half as bad as that of 2008-9, trouble would be brewing in corporate credits. We are past that point now.

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	GDP 2019 (USD) '000	Public sector % of GDP	Private sector (USD) '000	Chock to GDP (USD) '000	Public sector debt (USD) '000	Debt/GDP	Cost of stimulus as % of GDP	Debt/GDP post stimulus
USA	21,427,199	37.90%	13,306,291	1,663,286	22,700,000	106%	7.8%	114%
China	14,140,000	34.10%	9,318,260	1,164,783	7,518,360	53%	8.2%	61%
Japan	4,971,767	39.40%	3,012,891	376,611	10,181,200	205%	7.6%	212%
Germany	3,863,344	44.00%	2,163,473	270,434	2,319,500	60%	7.0%	67%
UK	2,743,586	42.30%	1,583,049	197,881	2,378,600	87%	7.2%	94%
France	2,707,074	56.80%	1,169,456	146,182	2,684,700	99%	5.4%	105%
Italy	1,988,636	50.30%	988,352	123,544	2,677,600	135%	6.2%	141%
Australia	1,450,000	36.20%	925,100	115,638	629,000	43%	8.0%	51%
South Korea	1,408,870	30.40%	980,574	122,572	581,600	41%	8.7%	50%
Spain	1,397,870	43.90%	784,205	98,026	1,207,750	86%	7.0%	93%
Sweden	531,498	49.50%	268,406	33,551	181,700	34%	6.3%	40%
Norway	402,023	49.30%	203,826	25,478	163,100	41%	6.3%	47%
Denmark	352,058	54.50%	160,186	20,023	117,900	33%	5.7%	39%
Finland	269,714	56.50%	117,326	14,666	162,000	60%	5.4%	66%