Outlook for 2021: Recovery soon, but not yet

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Although it is a myth that the word "unprecedented" was the top Google search in 2020 (the top search was "coronavirus", followed by "election results"), the year that was certainly felt like an unprecedented period of time in our lives. The pandemic, the resulting – but necessary – social distancing measures, with their negative effects on both the global economy and basic human interaction, will take several years to be overcome completely.

2021 is therefore being compared to the start of a post-war era, with an expected economic rebound, as well as gradual normalisation of social interaction, work organisation and travel. The advantage that we have, compared to a post-war environment, is that the pandemic did not destroy our infrastructure (as a war would do), therefore the economic reset which needs to happen will be faster than after a war – although the overall shape of the global economy might not look exactly like it did in 2019. For example, "hardcore" globalisation will be replaced by a gradual return to onshoring and regional supply chains – which might slow down the overall economic growth speed in the years ahead, however preparing and protecting economies from the potential re-occurrence of globalised events like another pandemic.

While many economists are anticipating a strong rebound in economic growth already in 2021, recent events pose marked downside risks in the short term, with a third wave of Covid-19 infections developing fast in many countries after the December holidays season, further delaying the onset of a sustained recovery. New strains of the virus, which have developed in the UK and South Africa, are also bringing new challenges in the containment of the pandemic, as they appear to be circulating at a faster rate than previously known strains.

The roll-out of the recently discovered and approved vaccines – albeit a welcome key development – also remains slow, as many countries have potentially under-estimated the logistical challenges, and in some cases political and social opposition, to inoculating large swathes of the population – with notable exceptions like Israel, where over 12% of its total population have been administered the first dose of the vaccine at the time of writing. It is expected that only by September 2021 the diffusion of the vaccines will reach the critical mass necessary to achieve herd immunisation in the Western world, while most emerging markets will reach such targets only in 2023-2024.

Against this background, the economic rebound which was experienced in 3Q20 will most likely be short-lived. Data from more advanced economies show a pronounced slowdown in both October and November, which is likely to continue into December and January – as a number of European countries entered more stringent lockdown measures (notably the UK and Germany), with such measures not expected to be relaxed significantly at least until Easter 2021. If lockdowns are protracted until early summer, there is real possibility that many European countries (especially in the Mediterranean region) will miss a second tourism revenue season, with a significant hit to economies which depend on such sector (Greece, Spain, Italy, Malta, Cyprus, Turkey).

To counter this bleak scenario, central banks need to keep injecting money and governments need to keep spending to support their economies and households during this protracted phase of the recession – without such extended monetary and fiscal support, the spending efforts made in 2020 during the first phase of the pandemic would prove futile. In this context, the EUR750 billion financial package put together by the EU (named Next Generation EU, or NGEU) represents an extra-ordinary response to an unprecedented situation. The package is designed to put the EU's economy back on its feet through investments and reforms and to improve its future resilience, while also building a greener and more digital EU economy. The European Commission estimates that NGEU can contribute by increasing the EU's GDP by around 2% on average and

by creating up to 2 million additional jobs by 2024. If politicians in Brussels will succeed in launching this financial package in the coming months (a few more political hurdles need to be overcome to start such funding flowing into the real economy), then the prospects for a robust recovery to take hold in the second half of 2021 in Europe will become more realistic.

However, continued spending comes at a cost for future generations. At some point, governments will have to start designing fiscal consolidation strategies, possibly as early as in the second half of 2021. Global leverage peaked at 265% of GDP at the end of 2020 – mainly because of fiscal stimulus measures – and will ease only slightly in 2021, only due to the expected rebound in GDP growth. With vaccine availability and a 5% rebound in the global economy, the focus in the second half of 2021 will likely turn to the gradual unwinding of extraordinary fiscal support. Governments will be faced with a fine balancing act between two choices: withdrawing support too fast or reining in debt expansion, which cannot continue indefinitely.

The excessive debt overhang will be mainly an emerging markets problem for 2021. As economic growth will remain weak outside of China and Emerging Asia, most emerging markets will find it increasing difficult to finance their budget deficits, also because of limited appetite from international lenders – including China - to expand their exposure towards certain sovereign issuers. At particular risk of distress are major economies such as Turkey, South Africa and Brazil, because of their weak fundamentals and heavy reliance on international capital flows. A number of smaller, poorer countries such as Zambia and Costa Rica already face such stresses and had to turn their attention to extraordinary financial support from multilateral lenders like the IMF. This, coupled with climate change, will increase internal conflicts and migration flows from poorer countries.

In this scenario of unwinding fiscal support and gradual tightening of regulatory forbearance, banking systems across the globe will have to face the harsh reality of deteriorating asset quality and increasing defaults. While banks were pivotal in 2020 in supporting struggling economies by keeping credit flowing and granting moratoria to borrowers for loan repayments, 2021 will most likely be a year of reckoning for these fundamental economic actors, revealing the true impact of the Covid-19 shock on banks' borrowers. On the positive side, banks are entering this period of stress supported by strong capitalisation and liquidity, prudent provisioning against losses in 2020 and expected careful management on the part of regulators as to when and how their support to banks will be withdrawn. This, combined with a push for sector consolidation, cost containment and increasing digitalisation, will enable the majority of banks to face the upcoming asset quality test with confidence.

Another feature which was exacerbated by the pandemic crisis, and which might hinder recovery in 2021, is the rise in economic and social inequality. The largest portion of jobs lost permanently during the pandemic has been related to low-income workers, while on the other hand, high income earners have not only kept their jobs (which are more adaptable to remote working arrangements) but have also increased their savings rate and overall financial wealth, as consumption decreased and travel-related spending was simply not possible because of lockdowns and reduced overall mobility. The combination of these trends has increased inequality at a fast rate in a number of economies, especially in the West. There is also a risk that economic insecurity could lead to further populist backlashes and rises in unrest and crime. In the long-term, digitalisation, the development of artificial intelligence, the green transition and other emerging trends bring potential for more inclusion, but also for exacerbating or generating new forms of inequality and economic imbalances between rich and poor.

The Covid-19 pandemic has impacted heavily cultural and creative sectors across the globe, as live performances and art exhibitions were amongst the first events to close during lockdowns and the last to re-open, under very strict sanitary conditions and with much reduced audiences. Cultural activities employ around 4% of workers in the EU and, while such activities are not included in the calculation of GDP, they play an

important role in our social relations, general well-being and health. As such, culture represents a very important factor of the recovery post-Covid. Unesco's Director General, Audrey Azoulay, recently stated that culture must be central to the recovery efforts, since it is an overarching need, underpinning all aspects of our societies: "*culture is a purpose, not a cost*".

In conclusion, while the road to global economic recovery is gradually taking shape, a number of uncertainties still exist and are likely to take some time before being fully resolved. This points to 2021 as being potentially a year of "false starts" in the much awaited re-ignition of the global economic engine. Nonetheless, as the year progresses, the recovery will eventually start showing momentum and take hold. A bit more patience is therefore required.